ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

12 July 2017

Committee Secretariat
Senate Standing Committees on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Chairperson

Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017

Thank you for the opportunity to lodge a submission on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 ('the Bill') to amend the *Corporations Act 2001* to provide for safe harbour for insolvent trading and a stay on enforcing ipso facto clauses.

ARITA first began the push for these reforms some 15 years ago[1] and we support the Government's stated intention to 'drive cultural change amongst company directors' through these reforms.

As previously highlighted to The Treasury, a balance must be struck between the importance of creditors' rights and the imperative that directors are able to explore options for the turnaround of a financially distressed company or its business. It is our view that these are vitally important reforms to be able to preserve jobs and avoid value destruction in distressed businesses and must be put in place before any future financial downturn occurs.

ARITA is, therefore, generally supportive of the broad settings and direction reflected in the Bill, but, drawing on our domain expertise in this area, we highlight some aspects of the proposed legislation which we believe still need to be addressed so that the legislation

[1] See ARITA's submission of 30 April 2003 to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws and the joint submission of 2 March 2010 made by Law Council of Australia, Insolvency Practitioners Association of Australia (as ARITA was then known) and Turnaround Management Association of Australia to the Treasury in response to the discussion paper "Insolvent trading: A safe harbor for reorganization attempts outside of external administration".

strikes an appropriate balance while still driving the cultural change sought from these important reforms.

These concerns have been raised in our previous submissions on the exposure draft legislation preceding the Bill, which are referred to in this submission and annexed for your ease of reference.

Key points

- To mitigate abuse of the provisions by those that facilitate illegal phoenix activity, 'Safe harbour' restructuring advice should only be provided by a registered liquidator, or a specially qualified sub-class thereof. In the absence of such a requirement, the legislation should specify that the adviser entity must hold professional indemnity insurance that covers that entity for the provision of relevant advice.
- ARITA supports increased action against miscreant company directors and the introduction of a Director Identification Number ('DIN') which will assist such action.
- A technical omission in the provisions for the stay on ipso facto clauses requires an amendment to the Bill so that a liquidator - following a compromise/arrangement or administration - can provide written consent to lift the stay
- To improve the effectiveness of the stay on ipso facto clauses, ARITA supports the implementation of a moratorium in schemes of arrangement
- It is important that the regulation-making power in the provisions for the stay on ipso facto clauses works effectively as an anti-avoidance mechanism.

Yours sincerely

[redacted]

John Winter
Chief Executive Officer

About ARITA

The Australian Restructuring Insolvency and Turnaround Association (ARITA) represents practitioners and other associated professionals who specialise in the fields of insolvency, restructuring and turnaround.

We have more than 2,000 members including accountants, lawyers, bankers, credit managers, academics and other professionals with an interest in insolvency and restructuring.

Some 84 percent of registered liquidators and 89 percent of registered trustees are ARITA members.

ARITA's mission is to support insolvency and recovery professionals in their quest to restore the economic value of underperforming businesses and to assist financially challenged individuals.

We deliver this through the provision of innovative training and education, upholding world class ethical and professional standards, partnering with government and promoting the ideals of the profession to the public at large.

The Association promotes best practice and provides a forum for debate on key issues facing the profession. We also engage in though leadership and advocacy underpinned by our members' knowledge and experience.

Table of contents

1 Safe Harbour for insolvent trading

1.1 'Appropriately qualified entity'

Recommendation 1.1: To mitigate abuse of the provisions by those that facilitate illegal phoenix activity, 'safe harbour' restructuring advice should only be provided by a registered liquidator, or a specially qualified sub-class thereof. In the absence of such a requirement, the legislation should specify that the adviser entity must hold professional indemnity insurance that covers that entity for the provision of relevant advice.

In our earlier submissions, ARITA contended that only a registered liquidator, or a specially qualified sub-class thereof, is appropriate to provide the advice necessary for 'safe harbour' restructuring. We do, again, draw the attention of the Committee to the importance of this issue.

We also highlight that the requirement for a registered restructuring adviser as part of the safe harbour reforms was recommended by the Productivity Commission in its Report on Business Set-up, Closure and Transfer[2].

The perils of inadequate qualifications of advisers are evident in the financial planner space, where the Government has been forced to take dramatic action across the sector to enforce qualification and continuous professional education standards. This consequence of the lack of qualifications in that space has been significant financial loss to countless individuals and small businesses who were exploited.

We also note the current issues presented by the proliferation of unregulated and untrustworthy 'pre-insolvency advisers', again to the detriment of innocent stakeholders. Pre-insolvency advisers are widely known for facilitating illegal phoenix activity which undermines our insolvency processes and reduces potential recoveries for creditors.

We anticipate that unqualified pre-insolvency advisers will take advantage of the new safe harbour laws if adequate standards are not put in place requiring the engagement of a qualified and regulated professional. Indeed, this simple requirement may afford directors a higher level of protection both through advice from a qualified professional and greater certainty that they are eligible to access the safe harbour protection. Taking account of the interests of all stakeholders in a distressed entity, we do not accept that this is, or needs to be, an onerous requirement. We reject any notion that the advice of a registered liquidator may be difficult to access or too costly. There are over 700 registered liquidators in Australia including many in regional and suburban locations. Due to the highly competitive nature of the profession, many insolvency practices provide low cost options, including those provided by small insolvency practices.

[2] Recommendation 14.2.

However, if the legislation is not going to specifically include a requirement for licencing, it must, as a minimum, include specific criteria for who may offer advice.

ARITA supports the inclusion of the factors set out in s 588GA(2) which will be considered in establishing 'whether a course of action is reasonably likely to lead to a better outcome', including 'whether the person is obtaining appropriate advice from an appropriately qualified entity'.

However, we submit that the provision should specify a minimum base line for the notion of 'appropriately qualified', namely that the adviser entity holds professional indemnity insurance that covers that entity for the provision of relevant advice. This would invariably ensure that the entity is either:

- a member of a recognised professional body and/or is required by law to hold insurance (e.g. lawyer, registered liquidator or member of an accounting professional body); or
- has independently applied for and obtained insurance against the risk of liability for acts or omissions in providing advisory services.

In short, 'uninsured advisers' should not be considered 'appropriately qualified' for the purposes of s 588GA(2). ARITA concurs with the tenor of the statements in the Explanatory Memorandum to the Bill at [1.69] and [1.74] that, while the nature of any advice may vary according to the size of a business and its circumstances, it should be a bona fide 'professional' whose advice is sought. However, these matters must be prescribed in the legislation itself.

This is consistent with a significant focus of the *Insolvency Law Reform Act 2016* – that registered liquidators must carry the appropriate type and level of professional indemnity insurance to protect stakeholders. The same public policy approach must be adopted here, in that it would be unthinkable that a director of a company that relies on the advice of a safe harbour adviser could not also rely on them being appropriately insured.

1.2 Director Identity Number (DIN)

Recommendation 1.2: ARITA supports increased action against miscreant company directors and the introduction of a Director Identification Number ('DIN') which will assist such action.

As noted above, we hold concerns that a lack of registration or guidance regarding what constitutes an 'appropriately qualified entity' may lead to abuse of the safe harbour provisions by unregulated and untrustworthy pre-insolvency advisers who facilitate illegal phoenix activity. Together with our above recommendations, we encourage the Committee to consider the implementation of a Director Identity Number (DIN). This again was a

recommendation from the Productivity Commission's report into on Business Set-up, Closure and Transfer[3].

A DIN would provide a balance between encouraging entrepreneurialism and driving cultural change amongst company directors' and protecting against director misconduct, including the manipulation of the safe harbour protections.

ARITA has long advocated increased action by ASIC regarding director misconduct and we commend to you the 'Phoenix Activity: Recommendations on Detection, Disruption and Enforcement' report issued by Melbourne Law School and Monash Business School in February 2017. The report is part of ongoing research into fraudulent phoenix activity.

2 The stay on ipso facto clauses

2.1 Technical omission: Liquidator's consent to enforcement of right

Recommendation 2.1: The provisions of the Bill which extend the ipso facto stay to the end of any liquidation which follows a scheme of arrangement or voluntary administration do not allow the relevant liquidator to consent to the enforcement of rights. This oversight should be rectified by an amendment to the Bill.

Pursuant to proposed ss 415D(2)(b)(iv) and 451E(2)(c) of the *Corporations Act* (items 7 and 14 of the Bill), where:

- a company is undertaking a compromise or arrangement for the purpose of avoiding being wound up in insolvency or enters administration; and
- a winding up follows the compromise/arrangement or administration,

the stay will extend for a period until the company's affairs 'have been fully wound up'.

For the reasons stated at [2.2] of our earlier submission of 24 April 2017, ARITA supports the extension of an ipso facto stay to liquidations and contends that the policy underlying such an extension equally justifies an extension of the stay to any liquidation (however commenced).

However, there appears to be a technical omission in the provisions which extend the stay to a subsequent liquidation.

When the company is the subject of an approved compromise/arrangement or in administration, the stay does not apply if the person administering the compromise/arrangement or administrator consents in writing to the enforcement of the right:

[3] Recommendation 15.6

proposed ss 415D(8) and 451E(7). However, if a liquidation follows, these provisions do not similarly allow a liquidator to consent in writing to the enforcement of the right.

It appears that this is a technical oversight which should be corrected by an amendment to the Bill – presumably to ss 415D(8) and 451E(7) – to ensure that a liquidator in these circumstances has the same (appropriate) ability to provide written consent to 'lift the stay'.

2.2 Schemes of Arrangement – Standalone moratorium

Recommendation 2.2: To improve the effectiveness of the stay on ipso facto clauses ARITA supports the implementation of a moratorium in schemes of arrangement.

ARITA continues to support the introduction of a stay on ipso facto clauses in a Scheme of Arrangement. However, we again assert that the effectiveness of such a stay will be limited unless a standalone moratorium against creditor claims is also available.

As noted in ARITA's Policy Position paper of February 2015, we believe that schemes of arrangement can be made more usable via a combination of reforms - a general moratorium, the limitation of ipso facto clauses and the use of a schemes panel to limit the involvement of the court. Simply providing for a stay on ipso facto clauses will not go far enough and, as a minimum, a general moratorium against creditor claims (similar to that in a voluntary administration) is required.

2.3 Anti-avoidance

Recommendation 2.3: It is important that the regulation-making power in the provisions for the stay on ipso facto clauses works effectively as an anti-avoidance mechanism.

We have noted recent commentary questioning the effectiveness of the regulation-making power as an anti-avoidance mechanism.[4] Specifically, as we understand the point, self-executing termination clauses in contracts which take effect just prior to a s 411 application or the appointment of an administrator or managing controller may escape the ipso facto clause prohibition. This is because, according to the wording of the stay provisions, any 'enforcement reasons' prescribed by regulations will have to co-exist with a voluntary administration/managing controller appointment or s 411 application to be caught by the stay.

Consideration should be given to whether the regulation-making power is adequate to ensure that enforcement reasons which might self-execute just prior to a voluntary administration/managing controller appointment or s 411 application can be effectively prescribed for the purposes of the intended ipso facto stay.

[4] G Hamilton, '*Contracting out of the new ipso facto provisions*' (4 July 2017), published at https://www.linkedin.com/pulse/contracting-out-new-ipso-facto-provisions-dr-garry-hamilton

Appendix A
ARITA submission to The Treasury 24 April 2017

ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

24 April 2017

Mr James Mason
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Mason

National Innovation and Science Agenda – Improving Corporate Insolvency Law (Exposure Draft Legislation)

Thank you for the opportunity to lodge a submission on the draft legislation to amend the *Corporations Act 2001* to provide for safe harbour for insolvent trading and a stay on enforcing ipso facto clauses.

Given that ARITA first began the push for these reforms some 15 years ago,[1] ARITA supports the Government's stated intention to 'drive cultural change amongst company directors' through these reforms.

Clearly, a balance must be struck between the importance of creditors' rights and the imperative that directors are able to explore options for the turnaround of a financially distressed company or its business. It is our view that these are vitally important reforms to be able to preserve jobs and avoid value destruction in distressed businesses and must be put in place before any future financial downturn occurs.

ARITA is, therefore, generally supportive of the broad settings and direction reflected in the draft legislation.

That said, drawing on our domain expertise in this area, ARITA's submission highlights some detailed and technical aspects of the draft legislation which could be improved,

[1] See ARITA's submission of 30 April 2003 to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Australia's Insolvency Laws and the joint submission of 2 March 2010 made by Law Council of Australia, Insolvency Practitioners Association of Australia (as ARITA was then known) and Turnaround Management Association of Australia to the Treasury in response to the discussion paper "Insolvent trading: A safe harbor for reorganization attempts outside of external administration".

clarified or calibrated so that the legislation strikes an appropriate balance while still driving the cultural change sought from these important reforms.

Yours sincerely

[redacted]

John Winter
Chief Executive Officer

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1 Safe Harbour for insolvent trading

1.1 'Appropriately qualified entity'

In our earlier submission, ARITA contended that only a registered liquidator, or a specially qualified sub-class thereof, is appropriate to provide the advice necessary for 'safe harbour' restructuring. We do, again, draw the attention of the Government to the importance of this issue.

The perils of inadequate qualifications of advisers are evident in the financial planner space, where the Government has been forced to take dramatic action across the sector to enforce qualification and continuous professional education standards. This consequence of the lack of qualifications in that space has been significant loss to countless individuals and small businesses who were taken advantage of.

We also note the current issues presented by the proliferation of unregulated 'pre-insolvency advisers', again to the detriment of innocent stakeholders.

The same situation is likely to arise if adequate professional standards are not put in place requiring a qualified and regulated professional to be formally engaged for a safe harbour protection to be effective. Indeed, the simple engagement may afford directors a higher level of protection both through qualified advice and to give certainty that they are provided a safe harbour protection. Taking account of the interests of all stakeholders in a distressed entity, we do not accept that this is, or needs to be, an onerous requirement.

However, ARITA notes the Government's decision to refrain from imposing prescriptive expectations of the course of action directors may take or what advice directors may obtain.

On that basis, ARITA supports the inclusion of the factors set out in s 588GA(2) which will be considered in establishing 'whether a course of action is reasonably likely to lead to a better outcome', including 'whether the person is obtaining appropriate advice from an appropriately qualified entity'. However, the provision as drafted raises the obvious question as to who and what is an 'appropriately qualified' entity.

ARITA submits that the provision should specify a minimum base line for the notion of 'appropriately qualified', namely that the adviser entity holds professional indemnity insurance that covers that entity for the provision of relevant advice. This would invariably ensure that the entity is either:

- a member of a recognised professional body and/or is required by law to hold insurance (e.g. lawyer, registered liquidator or member of an accounting professional body); or
- has independently applied for and obtained insurance against the risk of liability for acts or omissions in providing advisory services.

In short, 'uninsured advisers' should not be considered 'appropriately qualified' for the purposes of s 588GA(2). ARITA concurs with the tenor of the statement in the draft

Explanatory Memorandum at [1.35] that, while the nature of any advice may vary according to the size of a business and its circumstances, it should be a bona fide 'professional' whose advice is sought.

This is consistent with a significant focus of the *Insolvency Law Reform Act 2016* – that registered liquidators must carry the appropriate type and level of professional indemnity insurance to protect stakeholders. The same public policy approach must be adopted here, in that it would be unthinkable that a director of a company that relies on the advice of a safe harbour adviser could not also rely on them being appropriately insured.

1.2 Holding companies and s 588V

ARITA notes the independent liability of holding companies under s 588V for failing to prevent insolvent trading. ARITA considers it anomalous if a safe harbour is afforded to a person exposed to an alleged contravention of s 588G but not afforded to a holding company exposed to a contravention of s 588V. If the intention is to prevent premature instigation of a Part 5.3A voluntary administration, the position of holding companies also needs to be addressed in order to ensure the goal of creating a safe harbour is achieved.

1.3 Section 588GB and failure of directors to meet statutory obligations

ARITA supports the approach reflected in s 588GB of the draft legislation. However, it seems that the statutory obligations referred to in s 588GB(1) should include the analogous obligations to which directors are subject in any voluntary administration which might precede a liquidation.

Thus, if a director 'fails to permit the inspection of, or deliver, any books of the company' or 'fails to give any information about the company' in accordance with ss 438B and 438C of Part 5.3A of the Corporations Act, then the director should be similarly prevented from relying on those books or that information as admissible evidence in a 'relevant proceeding' (as defined in s 588GB(6)). This would seem to accord with the stated intention at [1.49] of the draft Explanatory Memorandum that s 588GB 'sets out rules to prevent a director relying on books or information … where these materials have been withheld from a liquidator or administrator.'

It might be considered whether some sort of 'safety valve' should be built into s 588GB(1) and (2) – e.g., that the inadmissibility of books or information is subject to court leave – in order to guard against potential injustice where, for instance, certain books or information are not provided to a liquidator due to a genuine or 'innocent' oversight.

Provision of Report as to Affairs ('RATA') should be a condition of any safe harbour

Given the importance of directors' obligations to provide information and assistance to administrators and liquidators, ARITA submits that safe harbour protection be denied to directors in circumstances where directors:

- do not provide, within time, a RATA required by either ss 438B, 475 or 497 of the *Corporations Act 2001* (the Act); and
- fail to comply with their obligation under s 530A(3) of the Act to do whatever the liquidator reasonably requires of the director to help in the winding up.

In respect of a failure to provide a RATA, rather than providing that the relevant information is not admissible for the safe harbour protection, ARITA submits that any safe harbour should be simply denied, in a similar vein to the condition of compliance with tax returns, notice and statements imposed by s 588GA(4).

In short, a director who does not comply with the most basic and fundamental obligations in an administration or winding up should not be afforded – and does not warrant - a safe harbour.

1.4 Drafting issues: clarity required

ARITA considers that the following aspects of the draft legislation require further clarity:

- Section 588GA(1)(a): The subjective requirement that the safe harbour protection only apply 'at a particular time after the person starts to suspect the company may become or be insolvent' may have the unintended consequence of unduly narrowing the protection which it is intended the provision will provide. Given that there can only be an actionable contravention of s 588G where the director has reasonable grounds for suspecting that the company is insolvent, we think that this subjective requirement of suspicion of insolvency should be removed from s 588GA(1)(a). This provision might also be simplified to merely refer to a 'better outcome' (without need for the words 'for the company and the company's creditors'), given that 'better outcome' is a defined term in s 588GA(5);

- Section 588GA(1)(b): ARITA supports the intention of a required 'connection' or nexus between the course of action and the relevant debt incurred to enjoy the protection afforded by the safe harbour defence.

  That said, it might be that this aspect of s 588GA(1)(b), as drafted, is ambiguous and open to potential arguments that the safe harbour defence applies more narrowly than is intended. For example, if the first step in the 'course of action' is to obtain professional advice then presumably the safe harbour should extend to protect the incurring of debts in the ordinary course of business (at least until that advice is obtained). Naturally, any new 'outlier' debts – e.g., signing up to a new long-term lease – would not have the necessary nexus to the course of action and would fall outside the safe harbour. However, a narrow interpretation of the provision might be that it is only the fee for the professional advice which is sufficiently connected to the course of action, significantly narrowing the director's safe harbour.

  While we agree that this aspect of the provision is necessary to strike the necessary balance, we submit that further clarity is needed.

- Guarding against 'hindsight bias' in a court's application of s 588GA(1): In addition to the points raised above, the safe harbour provision must be clear that both:

    - the reasonable likelihood of the course of action leading to a better outcome (s 588GA(1)(a)) and
    - the cessation of that reasonable likelihood (s 588GA(1)(b))

  are assessed according to the circumstances at the time the relevant course of action was taken. That is, these two matters should not be determined by a court according to what follows the time at which the safe harbour is claimed to apply (including the fact that a liquidation has in fact eventuated). Given that the safe harbour provision will only ever be tested in the event of a subsequent liquidation, it is important to ensure that directors are not afforded or denied safe harbour according to a test of 'reasonable likelihood' which is susceptible to hindsight bias.

- Section 588GA(4): The reference to 'a standard that would reasonably be expected of a company that is not at risk of being wound up in insolvency' appears relevant to the provision for employee entitlements (subsection (4)(a)) but does not appear relevant to the notion of giving returns, notices and statements under tax laws (subsection (4)(b)). As currently drafted, this 'standard' applies to both matters which appears erroneous. ARITA submits that, so far as tax lodgements are concerned, a company has either complied with these obligations or it hasn't.

  ARITA also considers that clarity is required in relation to the notion of 'providing for' employee entitlements 'to a standard reasonably expected of a company that is not at risk of being wound up in insolvency'. The s 596AA(2) definition of 'entitlements' includes retrenchment payments in respect of termination of employees. Section 588GA(4), as drafted, raises questions as to how and to what extent contingent or accrued obligations must be 'provided for' in order to enjoy the safe harbour. For example, would this require companies in financial distress (and looking to restructure) to hold sufficient cash to meet or 'cover' accrued entitlements?

  Indeed, the requirement of 'providing for' employee entitlements may be inconsistent with a 'better outcome' for the company and its creditors *as a whole*. We suggest that the requirement for the provision for employee entitlements be amended and clarified to require that entitlements due and payable in the ordinary course be remitted and paid – i.e. a condition of safe harbour is that superannuation, PAYG instalments, wages and leave entitlements be remitted and/or paid as when they are due and payable;

- Section 588GB(1)(a) makes reference section 477 at both subparagraphs (i) and (iii). We are unsure of the distinction between the dual references and suggest that a single reference at section (1)(a)(iii) is sufficient.

2 The stay on ipso facto clauses

2.1 ARITA supports general approach

As stated in its earlier submission of 27 May 2016, ARITA supports the notion of a stay on the enforcement of ipso facto clauses upon a company's entry into formal insolvency proceedings such as a scheme of arrangement or voluntary administration.

However, ARITA submits that the rationale of preserving business and enterprise value – and with it the preservation of jobs – equally extends and applies to any insolvency process where an external administrator has the power to manage, trade and/or sell a business. That is, there is ample justification for the operation of a similar stay where a company enters liquidation or a managing controller is appointed to all of a company's assets and undertaking.

2.2 Extension of ipso facto stay to liquidations

Where a company is wound up, the liquidator has specific power to trade the company's business 'so far as is necessary for the beneficial disposal or winding up of that business': s 477(1)(a) of the Act. Section 477(2) of the Act also provides for the express power of a liquidator to sell the company's property which includes its business.

Indeed, a liquidator may appoint an administrator under s 436B of the Act. While rare, a liquidator has the option of such a course of action where the interests of the company and/or its creditors might be served by a Part 5.3A voluntary administration.

ARITA also notes the exposure draft provision contemplates the extension of an ipso facto stay in voluntary administration to any subsequent winding up (i.e., the stay will remain in force until the company has been wound up following a voluntary administration). ARITA supports this extension of any stay and contends that the policy underlying such an extension equally justify an extension of the ipso facto stay to any liquidation, however commenced.

It would be undesirable if directors considering the appointment of an external administrator are minded to opt for voluntary administrations rather than immediate creditors' voluntary windings up because of a perceived advantage in taking the Part 5.3A 'scenic route' to a winding up (i.e., because an ipso facto stay will extend to a CVL following a VA but will not extend to a 'direct' CVL).

Again, for the intent of these reforms to deliver on the intention to preserve jobs and avoid value destruction, ARITA considers that the ipso facto stay should apply to any company which enters liquidation, whether voluntarily or by court order.

2.3 Ipso facto stay for managing controllers

ARITA renews its submission of May 2016 supporting the implementation of a stay on the operation of ipso facto clauses against companies where a managing controller is appointed to the whole (or substantially the whole) of a company's assets and undertaking (business).

Again, ARITA considers this to be consistent with the stated goal of a turnaround and restructuring culture and the preservation of business value and jobs.

Any exclusion of managing controllerships from such protection would further encourage the concurrent appointment of a voluntary administrator to ensure a business could be afforded the benefit of the stay.

2.4 List of 'Excluded Contract' types

Replacement of trustees

The intersection of the law pertaining to corporate trading trusts and Chapter 5 of the Act continues to have a detrimental effect on the cost and efficiency of winding up corporate trustees.

While there are a variety of issues afflicting corporate trading trusts which warrant legislative attention, one key issue is the effect of 'ejection clauses' in trust instruments which automatically remove a corporate trustee in the event of a winding up or other external administration appointment. The operation of such clauses casts doubt upon the power of sale of a liquidator appointed to a company which has been removed as trustee.[2]

Trust deeds may contain provision for automatic removal of (or right to replace) a trustee upon an insolvency event such as the commencement of a winding up. The new trustee's right to the trust assets will conflict with the right of the 'old' corporate trustee (in external administration) to assert a charge over the trust assets to secure its right of indemnity in relation to debts incurred in the proper administration of the trust (that right of indemnity and charge is of value to creditors in a winding up). There is conflicting authority among states as to whether the interest of the outgoing trustee takes priority over the right to possession of the new trustee.[3]

The 1988 Harmer Report recommended limits on clauses in trust instruments which automatically remove, or provide power to remove, a company as trustee upon an external administration. The Report noted that 'the operation of such a provision may lead to conflict between the liquidator and the new trustee and impair the efficient winding up of the affairs of the company, resulting in additional expense and delay.' The Harmer Report recommended that if a corporate trustee was subject to a winding up application, 'any

[2] See D'Angelo N, 'Trustee "ejection clauses": consequences for liquidators, receivers and creditors', (2016) 17(6) *Insolvency Law Bulletin* 96.
[3] See Hannan N, 'Liquidators dealing with trust assets', (2015) *Insolvency Law Bulletin* 7, citing *Re Suco Gold Pty Ltd (in liq)* (1983) 33 SASR 99 and *Lemery Holdings Pty Ltd v Reliance Financial Services Pty Ltd* (2008) 74 NSWLR 550.

provision in the trust instrument allowing for the removal of the company as trustee or the exercise of any power that allows for the removal of the company as trustee shall have no effect.' The Harmer Report's recommendation was that such limitation be subject to existing court powers to remove trustees.

The Harmer Report also recommended that its draft legislation regarding the winding up of corporate trustees 'should, so far as relevant, also be made applicable to the situation of a company under administration.'

ARITA endorses and renews the observation of the Harmer Report that 'the administration of a corporate trustee will be more efficient if the … [external administrator] is able to take complete control of trust assets and if there are limits on the power to remove the company as trustee.' The cost-effectiveness and efficiency of external administrations will be served if the new stay on enforcing ipso facto clauses prevents the removal of a company as trustee in the event of the appointment of an external administrator.

Therefore, ARITA submits that 'replacement of trustees' be removed from the proposed list of excluded contract types.

Consultation on types of contracts and rights excluded from stay

ARITA acknowledges the need to update or adjust the types of excluded rights 'in a timely way' (as explained at [2.24] of the draft Explanatory Memorandum). However, ARITA suggests that Government commits to a process of consultation with industry (including ARITA) on the question of further additions to the list of 'excluded rights' prescribed by regulation.

ARITA submits that consultation is vital to ensure that the intended effect and operation of the stay on ipso facto clauses is not unduly diluted by an uninformed (or premature) use of regulation-making power.

2.5 Court extension orders and s 444F orders

ARITA supports the provision of the capacity for a court order extending the period of the stay pursuant to proposed s 451E(3) of the Act. However, ARITA does not see why any such order should be limited to circumstances where an order has been made under s 444F.

If, for example, a supplier's ability to enforce an ipso facto clause was the only thing standing in the way of a workable deed of company arrangement (DOCA), it would be appropriate that an administrator or deed administrator could apply to Court for an order extending the stay for the duration of the proposed DOCA. Indeed, such a situation is analogous to the very situation s 444F addresses in the context of owners, lessors or secured creditors who could otherwise circumvent the achievement of the purposes of a DOCA.

There may also be circumstances where it would be beneficial to apply to Court to seek an extension order where a DOCA has not been approved by creditors or executed, but an administration may still have ended under s 435C due to some procedural failing (e.g., expiry of the convening period without the convening of a s 439A meeting: s 435C(3)(d)). In

such a situation, no s 444F order would (or could) be in force as there would be no DOCA either approved or executed.

We support the submission of the Law Council of Australia calling for further clarity regarding the factors relevant to 'the interests of justice' for the purposes of s 451E(3). We agree that the terms of s 444F provide a useful reference point in this regard.

2.6 Drafting issues: clarity required

ARITA also considers that the following aspect of the draft legislation requires further clarity:

- Section 451E(2)(c): The intention appears to be that, where a voluntary administration transits to a creditors' voluntary liquidation, the stay extends until the conclusion of the winding up (that is, until the point in time when all of the company's property and affairs have been fully wound up). This could be made clearer, perhaps by drawing upon the terms of s 509 of the Act which refers to a time when 'the affairs of the company are fully wound up'.

  If the intention instead is that the stay ends when a winding up 'starts', and the company is being wound up, then it would appear that subsection (c) is redundant and subsection (a) will suffice. (Note however, our comments above in respect of extending the stay on ipso facto clauses for all liquidations, no matter how commenced.)

2.7 Application of amendments (transitional issues)

We support the submission of the Law Council of Australia that the stay provisions affect all contracts, agreements and arrangements existing after a transitional period (excluding those expressly excluded by regulation).

2.8 Schemes of Arrangement – Standalone moratorium

As noted above, ARITA supports the introduction of a stay on ipso facto clauses in a Scheme of Arrangement. Notwithstanding we assert that the effectiveness of such a stay will be limited unless a standalone moratorium against creditor claims is also available.

As noted in ARITA's Policy Position paper of February 2015, we believe that schemes of arrangement can be made more usable via a moratorium, the limitation of ipso facto clauses and the use of a schemes panel to limit the involvement of the court. However, the implementation only of a moratorium and limitation of ipso facto clauses still provides significant improvement to the process and we note that any company using a Scheme is likely to be large enough to bear the cost of court involvement.

Appendix B
ARITA submission to The Treasury 27 May 2016

ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

27 May 2016

The Manager
Corporations and Schemes Unit
Financial Systems Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: insolvency@treasury.gov.au

Dear James

Improving bankruptcy and insolvency laws – Proposals Paper April 2016

The Australian Restructuring, Insolvency & Turnaround Association (ARITA) is grateful for the opportunity to provide feedback on the Government's Proposals Paper on Improving bankruptcy and insolvency laws as part of the National Science and Innovation Agenda reforms announced by the Prime Minister last year.

Two of the three proposed reforms – a safe harbour for directors and a limitation on the operation of ipso facto clauses – are key ARITA policy positions that were adopted in the final report of the Productivity Commission's Inquiry into Business Setup, Transfer and Closure through our advocacy.

While we believe that some important challenges must be resolved in the drafting, the intent of the provisions in the Proposals Paper appears to align with ARITA's published policy positions.

ARITA remains concerned that many of our interconnected policy recommendations – as adopted by the Productivity Commission – such as pre-positioned sales and streamlined SME liquidations, still need to be addressed to create a true business rescue culture in Australia.

Yours sincerely

[redacted]

Chief Executive Officer

About ARITA

The Australian Restructuring Insolvency and Turnaround Association (ARITA) represents practitioners and other associated professionals who specialise in the fields of restructuring, insolvency and turnaround.

We have more than 2,200 members including accountants, lawyers, bankers, credit managers, academics and other professionals with an interest in insolvency and restructuring.

Some 84 percent of registered liquidators and 89 percent of registered trustees are ARITA members.

ARITA's mission is to support insolvency and recovery professionals in their quest to restore the economic value of underperforming businesses and to assist financially challenged individuals.

We deliver this through the provision of innovative training and education, upholding world class ethical and professional standards, partnering with government and promoting the ideals of the profession to the public at large.

The Association promotes best practice and provides a forum for debate on key issues facing the profession. We also engage in though leadership and advocacy underpinned by our members' knowledge and experience.

ARITA

Table of contents

1 Reducing the default bankruptcy period

1.1 Misconduct

Recommendation 1.1: ARITA acknowledges the proposal to reduce the default bankruptcy period but notes that mechanisms are required to protect the integrity of the regime.

While we acknowledge the basis of the Government's decision to reduce the default bankruptcy period to one year, ARITA's members who practice in bankruptcy have mixed views as to whether it will achieve the desired objectives.

We do however note the views and recommendations in the report of the Productivity Commission's Inquiry into Business Setup, Transfer and Closure[1] partly based on international experience and research, that a reduction in the bankruptcy period does have beneficial outcomes for the economy and entrepreneurial culture. This supports the Government's intention in these reforms being implemented.

As the Productivity Commission's Report acknowledges, if the default period is reduced, it is important that mechanisms are retained or added that provide protection for abuse. For example, we recommend that the right of trustees to object to the discharge of a bankrupt be strengthened and continue to allow a trustee to extend the period of bankruptcy for up to eight years.[2]

The grounds for filing an objection to discharge, as detailed in section 149D of the *Bankruptcy Act 1966* (the Bankruptcy Act), are extensive and we do not believe that these need to be changed. However we believe that the following grounds could be added:

- if the discharge would prejudice the administration of the estate, and
- if the trustee has determined that the bankrupt will have on-going obligations after bankruptcy and more time is required to assess the bankrupt's capacity and willingness to comply with those obligations.

As noted in the Proposals Paper, the reduced bankruptcy period may lead to practical challenges for trustees in gathering sufficient evidence to support filing of an objection within the reduced one-year period. On this basis, we believe that the standard of evidence to support an objection should reflect this fact.

In addition to the standard of evidence required, we believe that a provision should be made for a trustee to file an objection on an interim basis, for a limited period, where more time is required to substantiate a permanent objection. A lesser standard of evidence in support of an interim objection would be required. This interim objection would then need to be followed

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1 Productivity Commission 2015, Business Set-up, Transfer and Closure, Final Report 75, Canberra. At pp 334-342. As to Ireland (p 337-338), it has since the Report implemented its reduction in the bankruptcy period to one year, with a three year income contribution regime.

2 Consistent with recommendation 12.1 of the Report.

by a further permanent objection to discharge within that interim period or else the objection lapses.

1.2 Ongoing obligations for bankrupts

Recommendation 1.2: ARITA believes that the majority of current obligations placed on bankrupts should continue to apply for a minimum of three years, including the obligation to pay income contributions. Any failure to comply with the obligations could be an act of bankruptcy, or alternatively allow the discharge of the bankrupt to be reversed.

1.2.1 Requirement to assist Trustee

In order to balance the benefits of a reduced bankruptcy period, we support proposal 1.2.1 to change the Bankruptcy Act to ensure the obligations on a bankrupt to assist in the administration of their estate remain even after they have been discharged in order to allow for the proper administration of the bankruptcy by the trustee. To some extent the law requires this at present: s 152. For example, a former bankrupt can be summonsed for their public examination under s 81 of the Bankruptcy Act.[3]

In addition to the general requirement pursuant to section 152 of the Bankruptcy Act to 'give such assistance as the trustee reasonably requires', we believe that the majority of the specific obligations currently placed on a bankrupt should be ongoing for the a minimum of three years, subject to any extension of the bankruptcy period due to an objection. These include:

- complying with all requests made by the trustee
- supplying all books, bank statements and other documents that the trustee requests
- advising the trustee of a change in address
- advising the trustee if their income increases from that already disclosed
- returning a completed statement of income form each year if asked to do so by the trustee
- advising the trustee immediately if the bankrupt forgot to disclose any assets or creditors in their Statement of Affairs
- fully and truthfully disclose to the trustee all property and its value, and
- not disposing of any property vested in the trustee.

Ensuring compliance with the ongoing obligations is necessary to maintain the integrity of the bankruptcy regime. Even if there are other alternatives to encourage compliance, the ultimate consequence of non-compliance should be a return to bankruptcy. We believe that

3 *Official Receiver v Todd* (1986) 14 FCR 177; [1986] FCA 463.

there are two alternatives in this regard, that non-compliance is either an act of bankruptcy or a grounds for reversing the discharge from bankruptcy.

Non-compliance could be added to the various acts of bankruptcy in s 40 of the Bankruptcy Act, and this could ultimately result in another bankruptcy. The commission of an act of bankruptcy permits bankruptcy proceedings to be commenced but also usually determines the date of commencement of any new bankruptcy, although we believe that any such mechanism should somehow connect the 'new' bankruptcy with the previous bankruptcy and effectively be a continuation of the previous administration.

Otherwise there may be a situation whereby there are no or limited creditors in the second estate (if the bankrupt had incurred no debts subsequent to discharge) and any benefits arising from the second estate not flowing to the existing pool of creditors (for example, through ongoing income contributions).

Alternatively, this non-compliance could be grounds to have the discharge of the bankrupt reversed and the period of bankruptcy extended as if an objection to discharge had been lodged. This option may be administratively more effective in ensuring the continuation of the original estate and that any future benefits are made available to the existing pool of creditors.

In either situation, consideration will need to be given to how any transactions in the intervening period are dealt with.

We note the Law Council's submission suggests extending automatic disqualification from managing a corporation (section 206B of the *Corporations Act 2001*) to people who have outstanding notices to provide information to a trustee in bankruptcy where those notices have been outstanding for more than one month.

ASIC could add those persons to the disqualified persons register on receipt of evidence from the trustee of the outstanding notice. The trustee could have an obligation to advise ASIC that the notice has been satisfied and ASIC will remove the person from the disqualified persons register. The person may refer the notice from the trustee to the Inspector-General in Bankruptcy for review.

We agree with this proposal, but would extend it to non-compliance with any obligation that a bankrupt is required to comply with in the post-discharge period.

1.2.2 Income contributions

ARITA strongly believes that the separation of the obligation to pay income contributions from the default bankruptcy period, and the continuance of that obligation for three years, subject to any extension for misconduct, is a necessary adjunct to the reduced default term.

Income contributions provide a substantial source of funds for trustees and creditors.[4]

We also highlight that income contributions are only assessed based on after-tax income exceeding an indexed threshold and only half of any income over the threshold is payable to the estate.

However, there needs to be a mechanism to enforce the contributions after discharge, for the remaining two-year period. Non-payment can be a matter which results in the consequences detailed above at 1.2.1. The amount not paid can be a debt recoverable in a court of competent jurisdiction, and there may be some process of recording that default on the National Personal Insolvency Index (NPII).

1.3 Restrictions

Recommendation 1.3: ARITA supports proposal 1.3.1a to reduce credit restrictions under the Act to one year, subject to any extension for misconduct.

1.3.1 Access to credit

Access of a former bankrupt to credit is important to encourage entrepreneurial endeavours and reduce the associated stigma of bankruptcy. ARITA supports proposal 1.3.1a to reduce credit restrictions under the Bankruptcy Act to one year, subject to any extension for misconduct.

We believe that it is appropriate to reduce the period for personal insolvency information in credit reports[5] and suggest that the retention period should simply be two years from the date of discharge which addresses the needs for any longer period of disclosure due to any extension of the period of bankruptcy.

We accept that while the retention of the permanent record of bankruptcy in the NPII may not meet the objective of a fresh start, encourage and facilitate further entrepreneurial endeavours and reduce the associated stigma, it is important that the fact of the bankruptcy remain on permanent record. Bankruptcy has a significant legal impact on the bankrupt and other parties, and a record of its occurrence should not be removed.

1.3.2 Overseas travel

ARITA supports the reduction of the overseas travel restriction to one year, subject to any extension for misconduct but we consider that the bankrupt should still have to notify the

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[4] AFSA selected statistics:

- Table 13: Monies administered by the Official Trustee under Parts IV and XI of the Bankruptcy Act
- Table 14: Monies administered by registered trustees in administrations under Parts IV and XI of the Bankruptcy Act

[5] See s 20X Privacy Act 1988.

trustee of the travel if it is within the further two-year period. This supports our other recommendation at 1.2.1.

1.3.3 Licences and industry associations

ARITA supports the Government working with relevant professional, industry and licensing associations with a view aligning restrictions with the reduced period of bankruptcy, where appropriate. In that respect, from our brief research into the wording of these restrictions, some refer to the period of bankruptcy and others refer to three years.

For example, as to the latter, s 56AC of the *Queensland Building and Construction Commission Act* 1991 refers to a person excluded from holding a building licence as an individual who 'takes advantage of the laws of bankruptcy or becomes bankrupt (relevant bankruptcy event), and 3 years have not elapsed since the relevant bankruptcy event happened.'

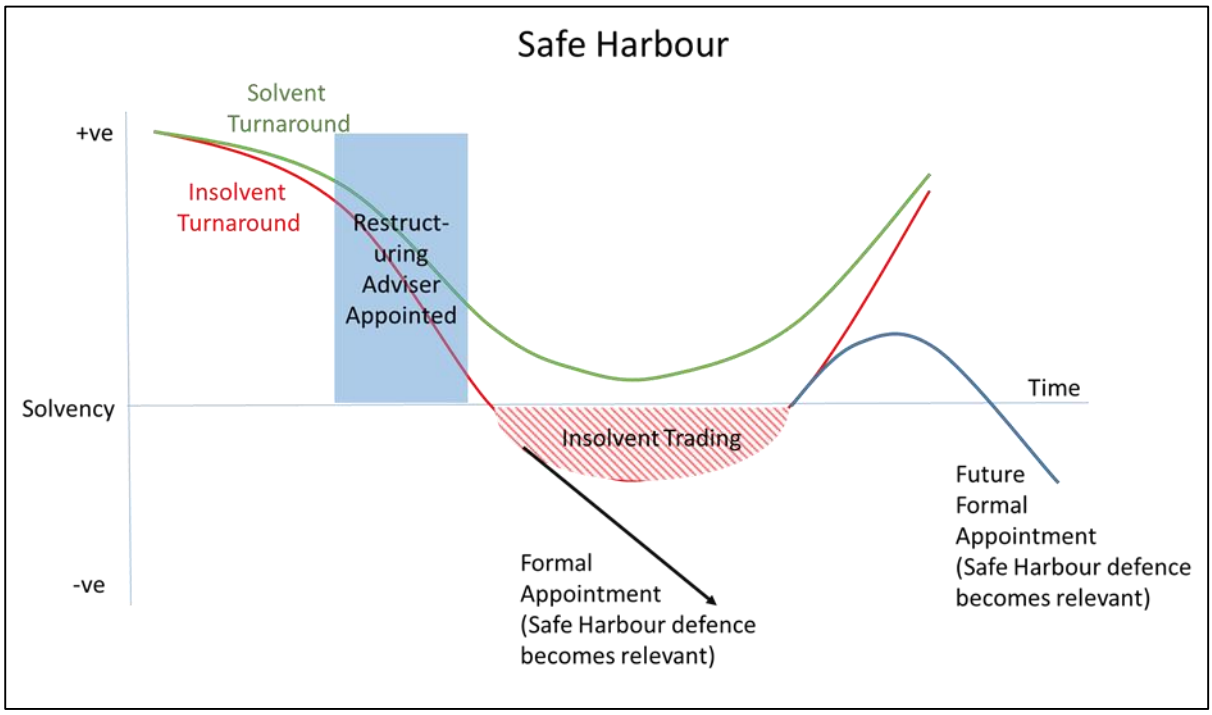
As to the former, s 206B(3) of the *Corporations Act 2001* (Corporations Act) refers simply to a person being under restriction as an 'undischarged bankrupt'.

2 Safe Harbour

2.1 Background

ARITA has been a long-time advocate for a safe harbour defence to encourage directors to seek appropriate professional advice in order to increase the options available to companies in financial distress, while still providing protection for the interests of creditors.

This diagram depicts how ARITA believes a safe harbour defence should operate in terms of the financial distress timeline.



Both safe harbour models detailed in the Proposals Paper make reference to returning the company to solvency. We do not believe that a safe harbour defence needs to be solely based on the aim of returning the company to solvency and we discuss this issue further below.

2.2 Safe Harbour Model A

Recommendation 2.2: ARITA supports the proposed safe harbour Model A with some modifications.

Model A from the Proposals Paper

It would be a defence to s588G if, at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so.

The defence would apply where the company appoints a restructuring adviser who:

a) is provided with appropriate books and records within a reasonable period of their appointment to enable them to form a view as to the viability of the business, and

b) is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time.

The restructuring adviser would be required to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify.

ARITA's policy positions

ARITA's Policy Positions paper issued in February 2015, details a safe harbour based on a business judgement rule with the following elements, that directors:

- make a business judgement in good faith for a proper purpose
- after informing themselves about the subject matter of their judgement to the extent they reasonably believe to be appropriate
- rationally believe that the judgement is in the best interests of the company (and its shareholders)
- have taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed

- were informed with restructuring advice from an appropriately experienced and qualified professional engaged or employed by the company, with access to all pertinent financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time
- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring, and
- the director took all reasonable steps to ensure that the company diligently pursued the restructuring.

We see many of the elements of ARITA's safe harbour defence in Model A, with the exception of the requirement to consider the interests of the company's body of creditors as a whole, as well as members. We maintain that this is an important element. In this regard, we refer you to the decision in The Bell Group case.[6]

As noted in our Policy Positions paper, directors should not be permitted to view the restructuring moratorium provisions as a relaxation or reduction of their responsibilities. If anything, their responsibilities should be seen as being heightened during this period by the business judgement rule requiring positive and beneficial governance thresholds to be met before the rule can be relied upon.

In situations where the obligations for the safe harbour protections are not met, the insolvent trading criteria should, in our view, be made easier for a liquidator to prove in order to be able to obtain compensation for the affected creditors. In this regard, we refer you our further discussion at section 4 of this submission.

Requirement to return to solvency

We hold concerns that the requirement to return the company to solvency is not the appropriate test. Rather, a restructuring that takes place during the safe harbour period may actually involve the sale of all or part of the business for proper value to an unrelated third party, with the original company remaining insolvent after the sale occurs.

However, as a result of the sale being undertaken outside of, and in advance of, a formal insolvency appointment, a better price is able to be achieved for the business and the creditors of the original company are much better off. This is in line with ARITA's policy on pre-positioned sales which was also a recommendation in the Productivity Commission's 2015 report into Business Set-up, Transfer and Closure (Productivity Commission Report 75)[7].

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6 *Westpac Banking Corporation v the Bell Group Ltd (in liq)* (No 3) [2012] WASCA 157.

7 Productivity Commission 2015, Business Set-up, Transfer and Closure, Final Report 75, Canberra.

We suggest that the appropriate test should instead be that the director took reasonable steps to minimise a significant risk of loss to the creditors of the company.

2.2.1 The restructuring adviser

ARITA agrees that the restructuring adviser would need to be an appropriately experienced and qualified individual, who is an accredited member of an organisation approved by the Minister, with its own:

- disciplinary framework
- educational framework, and
- ethical standards.

Each of the above are essential elements of what defines a professional association, which is defined by Professions Australia to be

> 'a disciplined group of individuals who adhere to ethical standards and who hold themselves out as, and are accepted by the public as possessing special knowledge and skills in a widely recognised body of learning derived from research, education and training at a high level, and who are prepared to apply this knowledge and exercise these skills in the interest of others. It is inherent in the definition of a profession that a code of ethics governs the activities of each profession. Such codes require behaviour and practice beyond the personal moral obligations of an individual. They define and demand high standards of behaviour in respect to the services provided to the public and in dealing with professional colleagues. Further, these codes are enforced by the profession and are acknowledged and accepted by the community.'[8]

We do believe that the education framework should include topics which are specifically relevant to the restructuring work typically undertaken with a distressed business, as well as a comprehensive knowledge of insolvency law and an ability to ascertain financial viability.

To maintain the integrity of the safe harbour framework, we believe that a restructuring adviser should be a registered professional who is subject to regulatory oversight.

We strongly believe that that only professionals who have obtained the qualification of ARITA Professional Membership or are a registered liquidator should be able to oversee this process given their innate high level understanding of insolvency law that is required to facilitate the restructuring of the company or its business and ensure directors appropriately discharge their duties. Persons without this level of qualification may place creditors and other stakeholders in an otherwise worse position.

We provide this matrix which sets out the relevant professional bodies and what we consider to be their ability to meet the criteria set out in the Proposals Paper. We have also considered Continuing Professional Development requirements as we believe that the

8 http://www.professions.com.au/about-us/what-is-a-professional

requirement to maintain ongoing education is a fundamental requirement for such an adviser.

Restructuring adviser matrix

Affiliation	Professional body status	General ethics requirements	Insolvency specific professional standards	Professional conduct oversight and complaints	Post Grad insolvency/ turnaround specific education required for membership	Insolvency/ turnaround CPD requirements	Insolvency/ turnaround CPD education offered?
ARITA[9]	Yes	Yes	Yes	Yes	Yes [10]	Yes (40 hours per annum)	Yes – structured and topical CPD offered nationally
Registered Liquidator	Government	No	No	Yes (regulator)	Under Insolvency Law Reform Act	Yes	No
CAANZ	Yes	Yes	APES 330 only	Yes	No	Limited [11]	No
CPA	Yes	Yes	APES 330 only	Yes	No	Limited [12]	1 course [13]
Law Societies	Yes	Yes	No	Yes	No	No	Some
Turnaround Management Association (TMA)	No	Limited	No	No	No [14]	No	Yes

We note that the *Insolvency Law Reform Act 2016* (ILRA), provides for different classes of registration for registered liquidators: s 20-35. Consistent with the current sub-class for receivers, we suggest that an additional sub-class could be established for restructuring advisers. Such a sub-class would enable professionals who meet the registration criteria to be considered by an appropriately convened committee.

The ILRA also provides for the qualification, experience, knowledge and abilities required for registration to be prescribed in the Insolvency Practice Rules (IPRs) and we suggest that this is the appropriate forum to set out the registration requirements, including the approved membership organisations.

9 ARITA Professional Members include accountants from both CAANZ and CPA as well as lawyers who hold Law Society membership.

10 ARITA education requirements for admittance as a Professional Member are two subjects from a possible three post-graduate level insolvency and restructuring subjects. Each subject is studied via distance education and takes 12 weeks to complete (study of 6-8 hours per week required).

11 CAANZ requires a minimum 20 hours of CPD per year and a total of 120 hours for a three-year period. Holders of statutory registration must complete 40% of their CPD in the specialist field.

12 CPA require a minimum 20 hours of CPD per year and a total of 120 hours for a three-year time period. Registered liquidators must complete 50% of their CPD in the specific field.

13 Five self-study modules of an intermediate level.

14 TMA education requirements are three, three-day modules on restructuring topics. Completion of the education requirements is not required to become a TMA member.

We understand that the ILRA will also expand persons eligible to become a registered liquidator to include solicitors. The IPRs will provide clarification on qualifications that will be required for registration.

Independence of the restructuring adviser

We have considered the independence of the restructuring adviser. We see that a company is most likely to turn to its existing advisers' firm, particularly where it is a multidisciplinary practice, for assistance in times of distress. If the firm has registered restructuring advisers, we do not see why they could not take the appointment.

The restructuring adviser is engaged by the company to act for the company. This is different to the fiduciary role taken by a registered liquidator in a liquidation or voluntary administration where they are acting for all of the creditors and have strict independence requirements.

The independence requirements in the ARITA Code of Professional Practice, for example, do not apply to receiverships, as this is a contractual appointment between the secured creditor and the receiver. We would not envisage that they would extend to a restructuring adviser.

We do however agree that the restructuring adviser must not be an officer of the company or related entity, or a relative of an officer of the company or related entity. We see that such roles and relationships would create an inherent conflict with the duty to the company.

Unregulated insolvency advisers (pre-insolvency advisers)

In recent years there has been a proliferation of unregulated insolvency advisers (also called pre-insolvency advisers). These businesses undertake prominent advertising (radio, online, billboard, etc.) and claim to offer advice to directors on how to protect themselves in an insolvency. These advisers are not registered liquidators and are often not members of any professional body or even qualified as accountants or lawyers.

Many of these advisers give advice to directors of distressed businesses to avoid their legal obligations coming into insolvency, providing guidance that includes methods of asset stripping, destruction of books and records or advice on how to reduce the extent of investigations any future liquidator may be able to undertake. These unregulated advisers undermine the integrity of the insolvency regime.

ARITA is concerned that the creation of the role of 'restructuring adviser' will attract the interest of this group. If suitable regulation, registration, qualification and oversight is not placed around the role, the safe harbour provisions are likely to rapidly become subject to abuse. We note that the Law Council's submission also supports this view.

Further, to build a better culture of business restructuring in Australia, ARITA is strongly of the view that more needs to be done to outlaw unregulated insolvency advisers and to actively prosecute directors who follow their advice.

Viability

ARITA believes that viability, or potential viability, is a different measure than solvency and a test for viability by the restructuring adviser should not be dependent on solvency.

ARITA's response to the Draft Productivity Commission Report into Business Set-up, Transfer and Closure of May 2015 noted that ARITA believes that, like insolvency, there are a number of factors which must be considered when considering viability.[15] These would include, but not be limited to:

- that there is a business to rescue or restructure as a going concern
- that the business is sustainable for its purpose
- that it has current and/or future profitability, and
- has access to future capital requirements.

A once-off event may make a viable business insolvent, or different business units within one company may be viable despite an overall insolvent position, or a business may be viable if operated by an owner with the necessary capital to maintain/inject into the business.

The factors that should be taken into account when considering viability are extensive and may be unique to the specific circumstances. An appropriately qualified and experienced restructuring adviser should be able to use their discretion to determined viability, however it would be reasonable to expect that some guidance was provided.

Obligations and protections

ARITA agrees with the following obligations and protections suggested in the Proposals Paper, that the adviser be:

- appointed by the company, not the directors, and thus owe any duties to the company
- required to exercise their powers and duties in good faith in the best interests of the company
- not be civilly liable to third parties for an erroneous opinion provided that it was honestly and reasonably held
- unable to be appointed in any subsequent insolvency of the company (or any company which bought the original company's business) without the leave of the Court, and
- specifically carved out of the expanded definition of director contained in the Corporations Act.

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15 Being submission DR 53 referred to at 14.1 of the Productivity Commission Report 75.

We do not believe that it would be appropriate for a restructuring adviser to have a specific obligation to inform ASIC of any misconduct they identify. We believe that any such obligation would be a deterrent to the engagement of restructuring advisers and not encourage the directors to seek early advice.

In addition to the above, we note that International Ethics Standards Board for Accountants (IESBA) is currently working with the Australian Accounting Professional and Ethical Standards Board (APESB) to implement a requirement for accountants to refer breaches of the law, subject to certain safeguards, to relevant authorities. A restructuring adviser, if covered by the Accounting Professional and Ethical Standards, would be subject to this obligation without having to impose a specific obligation.

ARITA supports the proposal in McGrathNicol's submission that payments made to restructuring advisers (or security taken to for such payments) should not be capable of claw back under the unfair preference regime in section 588FA of the Corporations Act. We believe that is important that such protection should not extend to protection for uncommercial transactions.

2.2.2 Other features of safe harbour

We highlight that any law reform needs to offer protection from any unintended consequences in relation to a breach of directors' duties, such as those imposed by sections 180 - 184 of the Corporations Act, by virtue of the directors' valid reliance on the safe harbour defence and attempts at restructuring. We refer to the submissions of the Law Council of Australia to the Productivity Commission's Inquiry into Business Set-up, Transfer and Closure which addresses the issues that may arise from the court judgments in The Bell Group.[16]

We agree with the Law Council that any safe harbour provision needs to be carefully drafted.

We agree that any requirement to inform ASIC or the ASX (beyond the existing continuous disclosure requirements) could undermine the ability of the director to explore the restructuring or turnaround of the company outside of a formal appointment. Any public disclosure of financial distress may lead to the same (or more) issues than are currently experienced when appointing a voluntary administrator.

In particular, creditors would not have the same guarantee for payment of debts incurred by the company that they have in a voluntary administration (where the administrator is personally liable for payment – s 443A, Corporations Act*)* and they may be reluctant to continue to deal with the company. They may also more forcefully attempt to recover any debts owed.

16 *Westpac Banking Corporation v the Bell Group Ltd (in liq)* (No 3) [2012] WASCA 157; see footnote 4. Submissions 14 and 36

2.2.3 Where safe harbour is not available

ARITA agrees with the proposed circumstances where safe harbour would not be available and supports any limits which encourage directors and the company to comply with their duties and obligations. We also support any limits which discourage the inappropriate dealing with assets, particularly unlawful phoenixing of businesses without true value being made available to creditors.

However, we are not confident that ASIC has sufficient resources, time or focus to undertake this role unless a straight forward criterion for ineligibility is set that does not require discretion in any determination by ASIC. We instead prefer that this is an issue determined by the Court.

We also have concerns about safe harbour not being available where significant employee entitlements that accrue during the safe harbour period are not paid. We note that there is no requirement for an employer to pay accrued employee entitlements, unless for example the employee requests to take leave. Those entitlements accrue until such time as the employee wishes to use them, or their employment is terminated – they are not moneys that the company can pay as they accrue.

If the restructuring were to be unsuccessful, and liquidation were to occur, all employees would generally be terminated and accrued entitlements would become due, but they are not due until that time.

We refer you further to our discussion at 4.2 regarding the incurring of debts for the purposes of insolvent trading actions.

2.3 Safe Harbour Model B

Recommendation 2.3: ARITA supports the safe harbour defence proposed in Model A and does not support the carve out proposed in Model B

Model B from the Proposals Paper

Section 588[G][17] does not apply:

(a) if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time, and

(b) the person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole, and

(c) incurring the debt does not materially increase the risk of serious loss to creditors.

[17] We note that the reference in Model B in the Proposals Paper was simply to s588 rather than s588G. We believe that this was an oversight and have corrected the reference in our submission.

As noted above, ARITA supports the safe harbour defence proposed in Model A and does not support the carve out proposed in Model B.

ARITA has also consulted widely with other relevant professional bodies in preparing our submission and we note that a number of those tend to favour Model B or hybrids thereof, recognising that it is, potentially, more supportive of directors. We believe that, for example, Law Council and Australian Institute of Company Directors are of this view.

While we are respectful of their position, as ARITA represents those most likely to be undertaking the work of restructuring advisers and, indeed, as those who will be required to manage a business should it actually move into a formal appointment, we believe Model A provides a solution that better balances creditors' reasonable rights and opportunities for proper investigation of errant directors with greater scope for responsible business risk taking, innovation and entrepreneurialism and, most importantly, to save otherwise viable businesses.

From our considered viewpoint, a hybrid Model B is workable and would be acceptable to ARITA, however, Model A delivers a better public policy balance.

We comment on what amendments we would suggest for Model B below.

We observe that the burden of proof already lies with the liquidator to prove insolvent trading. Once proved, the burden of proof to resist a claim should rest with the director. It does not seem reasonable to require a liquidator to establish that the company traded while insolvent and then also establish that the director had breached a limb of the carve out.

Amendments to Model B

We do not agree that directors should have the protection from insolvent trading unless they engage a suitably qualified restructuring adviser. We strongly believe that without a statutory requirement to engage such a regulated professional the provision would be open to abuse. If the government chooses to proceed with Model B, we recommend that the same requirements for a restructuring adviser that are proposed in Model A, including our comments at 2.2.1 above, are incorporated into Model B.

Noting that the terms are also applicable to Model A, we support the inclusion of the indicia of 'reasonable steps' and 'reasonable time'. However, we are of the view that to ensure certainty these should properly appear in the legislation or regulations, even if otherwise explained in the Explanatory Memorandum which accompanies any legislation.

We are of the view that the following commentary previously discussed in relation to Model A should equally apply to Model B:

- protection against unintended consequences discussed at 2.2.2 in relation to a breach of directors' duties, such as those imposed by sections 180 - 184 of the Corporations Act, by virtue of the directors' valid reliance on the safe harbour defence and attempts at restructuring
- no mandatory requirement to disclose the appointment of a restructuring adviser discussed at 2.2.2, and

- any restrictions on the availability of safe harbour discussed above at 2.2.3.

3 Ipso Facto

3.1 Background

ARITA agrees that any term of a contract or agreement which terminates or amends that or any other contract or agreement (or any term of any contract or agreement), by reason only that an 'insolvency event' has occurred should be void, subject to necessary exclusions.

3.2 The ipso facto model

Recommendation 3.2: ARITA supports the implementation of a limitation of the operation of ipso facto clauses.

We believe that a provision as such as Proposal 3.2 would extend to other instances, such as the acceleration of payments or the imposition of new arrangements for payment, or a requirement to provide additional security for payment.

In relation to 3.2b, we query as to what circumstance the retrospective operation is proposed to apply. We would support retrospective operation if it were to apply to ipso facto clauses in existing contracts or agreements in relation to new insolvency administrations which begin after the commencement of the change in the law. However, we would not support retrospective operation to insolvency administrations which began prior to the commencement of any legislation.

ARITA has concerns regarding the insolvency events included in the ipso facto proposal and suggests that:

- The list should be expanded to include liquidations (including provisional liquidation) as many liquidations have businesses which require this protection, consistent with the obligation of the liquidator to carry on the business of the company with a view to its sale: s 477(1)(a) of the Corporations Act.
- The application to receivers and controllers should be limited to managing controllers over the whole or substantially the whole of the company's assets, where a business is being managed, and not to appointments simply involving the sale of an asset.
- A company entering a Deed of Company Arrangement should be removed from the list as any issues regarding ongoing contracts should be resolved during the voluntary administration period and any moratorium should not be extended to a period when an independent external administrator is not in control of the company.

  We further note that the Deed Administrator generally has no liability for debts incurred during the Deed and thus the counterparties to the contracts do not have any protection regarding payment. However, we instead say that the prior insolvency

event should not be able to be relied on as a grounds for termination or alteration of a contract subsequent to the conclusion of a formal appointment. The counterparty would instead have to rely on another ground if they wish to take action in respect of the contract.

In addition to the ipso facto proposal, we also support the introduction of a specific provision enabling a Scheme of Arrangement, subject to court approval, to have a stand-alone moratorium against creditor claims.

We note however, that this should be integrated with consideration of issues such as whether a registered insolvency practitioner is appointed and liability for amounts that become payable during the moratorium period. Without the introduction of a moratorium against creditor claims it would still be necessary to appoint an external administrator prior to a Scheme of Arrangement to provide such protection.[18]

3.2.1 Anti-avoidance

In addition to the anti-avoidance measures detailed in the Proposal Paper, ARITA suggests including a statutory provision enabling an external administrator to apply to the court for an order restricting the termination of a contract where they believe a supplier is undermining or avoiding the intent of the proposed ipso facto restriction and the termination of the contract is not in the best interests of the creditors of the company as a whole.

Any such measure should include protection where contracts contain 'termination for convenience' clauses which may be relied upon purely to avoid the operation of the ipso facto provisions. ARITA understands that such clauses are common in mining contracts and are effectively open termination clauses which do not require an event or circumstance to occur to allow termination.

With the introduction of safe harbour and the appointment of a restructuring adviser, we see that this is likely to be incorporated into contracts as an event of default. Therefore, we agree with Henry Davis York's submission that a counterparty to a contract should be prohibited from retrospectively relying on the appointment of a restructuring adviser as a termination event, once a formal insolvency regime has commenced or in the case of a scheme of arrangement, an application has been filed with the court.

3.2.2 Exclusions

ARITA recognises, and agrees with, the need to specifically exclude certain 'prescribed financial contracts' from the operation of the ipso facto proposal.

We are not subject matter experts in relation to such contracts and are unable to provide specific comment on what contracts or classes of contracts should be specifically included. However, we comment that we believe that any ipso facto restriction should not prevent a

[18] This recommendation is in accordance with ARITA's Policy Position Paper of February 2015 and recommendation 14.6 of the Productivity Commission Report 75.

secured creditor from taking advantage of their right to appoint a controller if currently allowed to do so under the law (for example in the decision period in a voluntary administration under section 441A).

We suggest that any exclusions appear in the regulations, or similar, so that there is flexibility to amend this list as required.

3.2.3 Appeal

In addition to the power to apply to the court regarding anti-avoidance provisions, ARITA agree that affected counterparties should have a similar power to apply to the court to appeal against the operation of the ipso facto restriction. We agree with the Law Council that the appeal should be limited to the operation of the ipso facto clause and not the terms of the contract generally.

4 Other issues

In addition to the specific matters raised in the Proposals Paper, ARITA also notes the following matters which we believe are important factors to be considered in implementation of the proposed reforms.

4.1 Productivity Commission recommendations

The Productivity Commission's report on the Inquiry into Business Setup, Transfer and Closure made a number of interconnected recommendations from ARITA's policies that still need to be addressed to create a true business rescue culture in Australia.

This table summarises the proposals recommended in the Productivities Commission's Report and the current status of the recommendations.

Productivity Commission 2015 proposals	Status
Safe harbour	Announced
Ipso facto	Announced
Streamlined SME liquidations	Awaited
Public interest administration fund	Awaited
Pre-positioned sales	Awaited
Voluntary Administration – one month for a company to show its viability	Awaited
Scheme of arrangement moratorium	Awaited
Receiver's duty to unsecured creditors	Awaited
Review of the Fair Entitlements Guarantee (FEG)	Awaited
Director identity number	Awaited
One-year bankruptcy	Announced
Bankruptcy contributions to continue after bankruptcy	Proposed

ARITA awaits the Government's response to the Report and again highlights the interdependence of many of these proposed reforms.

4.2 Underlying obligations in s 588G

We believe that consideration should be given to streamlining or easing the burden of proof upon a liquidator for a s 588G insolvent trading action where the safe harbour defence is not available. That is, where the requirements of safe harbour protection are not met, it should be less onerous than it is currently for a liquidator to take action for insolvent trading. This might be achieved by the following:

- Streamlining or easing the burden of satisfying the existing elements of a claim under s 588G, for example, as to proof of insolvency and reasonable grounds to suspect insolvency.

- Deeming certain obligations and debts which accrue during (or are attributable to) the safe harbour period (but which may not be 'incurred' during the safe harbour period) to be 'debts incurred' for the purposes of s 588G.

  One example might be employee entitlements which arise under contracts entered into prior to the safe harbour period. Certain employee entitlements may accrue and be partly attributable to a period of service which spans the safe harbour period, but not be 'incurred' or payable during that period.

  We note that s 588G(1A) already deems certain actions of a company to be 'debts incurred' for the purposes of s 588G. This provision might be expanded to address moral hazard concerns relating to the Fair Entitlements Guarantee or to 'catch' other obligations which a company incurs or undertakes during the safe harbour period but which may not fall within the concept of a 'debt' incurred (such as retailer gift cards).

- A general expansion of the reach of s 588G to a class or category of obligations beyond that of 'debts' incurred (though we believe that directors should not be held responsible for failing to prevent all provable claims which might arise during the safe harbour period).

4.3 Australian Financial Services Licence

The advice provided by a restructuring adviser may fall within the current requirements for holding an Australian Financial Services Licence (AFSL). Registered liquidators are currently not required to hold an AFSL for undertaking formal insolvency administrations. We believe that a specific exemption should also apply to restructuring advisers on the basis that if they were a sub-class of registered liquidator, they would already be subject to regulation and oversight by ASIC.

We have also raised this issue with ASIC.

Appendix C
Policy Positions of the Australian Restructuring Insolvency and Turnaround Association as at February 2015

Policy Positions

of the

Australian Restructuring Insolvency and Turnaround Association

as at February 2015

ARITA

Policy 15-01: ARITA law reform objectives (corporate)

We believe that the Australian corporate restructuring, insolvency and turnaround regime should:

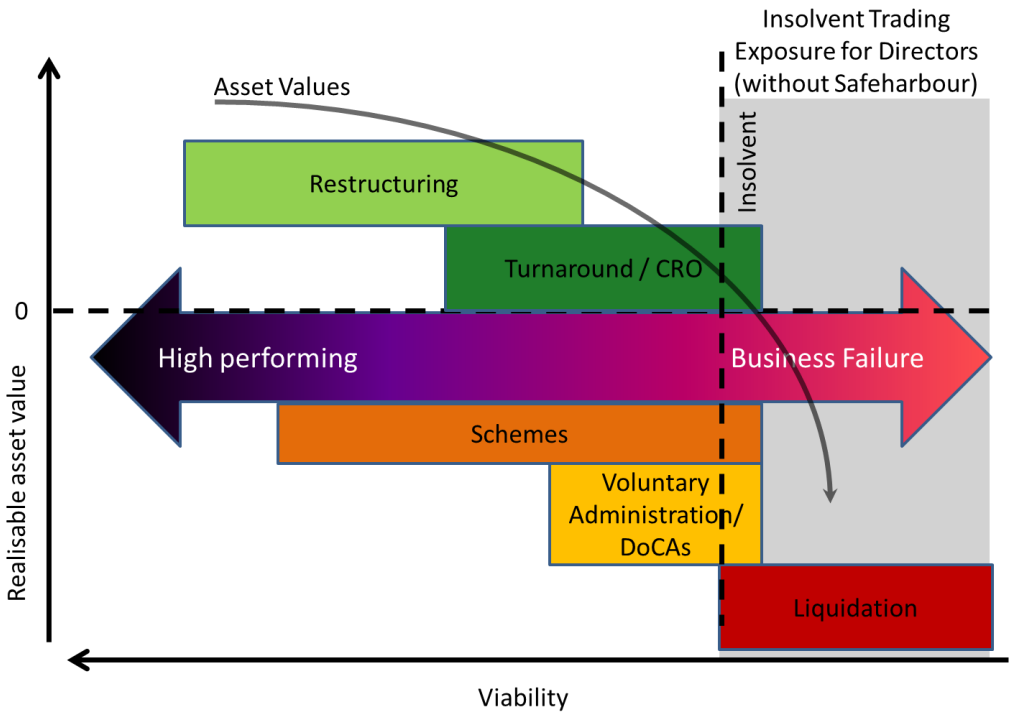
- support the preservation of viable organisations that have otherwise found themselves in, or heading towards, financial distress, provided they:
  - have good financial systems and controls
  - are tax compliant
  - are compliant with other regulatory obligations (e.g. corporate, WHS, environmental, product safety, etc.), and
  - demonstrate good corporate governance
- recognise the value to the economy of sustaining continuous employment for employees involved in viable organisations facing financial distress
- recognise as a micro-economic principle that capital should be recycled from non-performing businesses to performing businesses and that some element of business failure is a necessary and appropriate mechanism in ensuring an efficient and productive economy
- encourage directors, management, and independent and qualified financial and insolvency advisers to assist organisations operating viable businesses to recover from financial distress and provide a restructuring moratorium (safe harbour) from potential later claims, subject to certain requirements
- otherwise support the preservation of a viable business as a going-concern, including to allow the business to continue to have the benefit of existing contracts and leases
- require the interests of existing and new creditors to be taken into account, but at the same time recognise their responsibilities to attend to their own interests and to do so at a cost in proportion to the value and potential of the business
- allow the resolution of a company's financial distress to be dealt with as quickly as possible, consistently with the interests of creditors and of the company
- provide for the prompt assessment and orderly disposal of a failed business, recognising that there is a cost to delivering this service

- acknowledge that different sized companies may require different approaches to dealing with financial distress
- have regard to international precedents and best practice in the UK, US, New Zealand, Canada and elsewhere, and
- provide proper remuneration for its practitioners, and not require them to do work or incur expenses in assetless administrations without recompense.

Explanatory notes:

The distinction between high performing and distressed companies and the impact on asset values over the viability spectrum is depicted below.

Value vs. viability



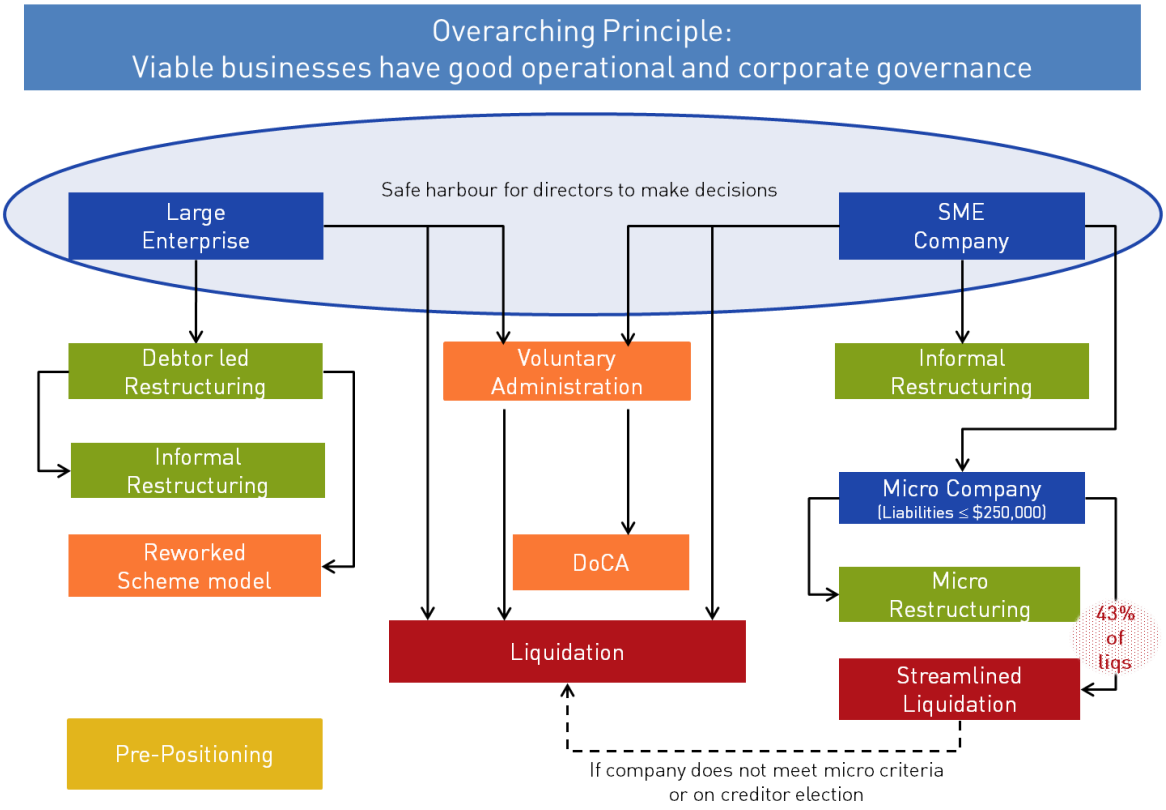
A foundation of our thinking is that a "one size fits all" approach to dealing with companies in financial distress is flawed. For example, such an approach does not take into account the scale of societal impacts of insolvencies in large enterprise collapses compared to small. Nor does it take into account the differences in governance between large and small entities.

To that end, we conceive that there are three framework approaches required:

- large enterprises
- small-to-medium enterprises (SMEs)
- micro companies (provable liabilities less than $250,000).

The following flowchart provides a summary of the proposed reform concepts developed by ARITA based on the three approaches detailed above and the belief that size distinctions are required to better achieve the aims of Australian insolvency law.

Reformed insolvency regime



Policy 15-02: Aims of insolvency law

We believe that the fundamental principles of and aims of insolvency law are to:[1]

- provide an equitable, fair and orderly procedure for handling the affairs of insolvent debtors to ensure that claims of priority creditors are appropriately recognised and other creditors receive an equitable distribution of the debtor's remaining assets: the pari passu (equal sharing) principle
- provide procedures and processes for dealing with an insolvency with the greatest efficiency and as little expense as possible
- ensure that administrations are conducted in an independent, competent and efficient manner
- provide mechanisms that allow for rehabilitation of the affairs of insolvents before their position becomes hopeless
- provide procedures which enable both debtors and creditors to have a voice in the resolution of the reality of the insolvency
- ascertain the reasons for the insolvency and to provide powers and mechanisms which allow for the examination of the conduct of insolvents, their associates and the officers of corporate insolvents, and
- enable identification of any offences have been committed by insolvents or their associates with a view to those offences being prosecuted.

[1] The list is adapted from the Harmer Report ([33]) and the Cork Report ([198]). See also the 2004 Parliamentary Joint Committee Report, Appendix 4.

Policy 15-03: Current Australian corporate restructuring, insolvency and turnaround regime and the need for change

It is ARITA's position that our current corporate insolvency regime has served, and continues to serve, Australia well. In particular, it has sustained economic value through a number of downturns and market shocks and major corporate failures.

Importantly, during the 2008 global financial crisis the Australian economy fared better than other comparable economies. It is reasonable to claim that our robust insolvency regime played a part in that – especially from credit provision and market confidence perspectives.

At the same time, we do believe that fundamental changes are needed, in particular in relation to government involvement in the regime, and the need for greater emphasis on enabling restructuring outcomes.

Explanatory notes:

Australians tend to hold an idealised view of how other markets operate: we see the successes but gloss over some of the failings.

ARITA believes we should carefully and systematically analyse recovery and insolvency regimes elsewhere to see what approaches we may employ here to improve our regime. However, the notion that we can simply transplant other systems here fails to acknowledge our own unique circumstances and ethos.

ARITA's view is that change and reform is needed for the regime to improve its social and economic outcomes. We necessarily accept some of the current legal and practice structures in place in Australia and do not wish to suggest the impossible or impractical; for example, we are content to maintain the separate laws for personal and corporate insolvency.

The current Australian regime could be described as having a strong bias towards preserving creditors' rights. Other jurisdictions are more biased towards preserving the troubled company as a going concern. There are significant arguments around where the balance is appropriately set between these two approaches, and the balance point advocated may alter depending on where an economy's performance is trending.

ARITA

Policy 15-04: Creation of a restructuring moratorium

ARITA supports a business judgement rule with the following elements, that directors[2]:

- make a business judgement in good faith for proper purpose
- after informing themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate
- rationally believe that the judgement was in the best interests of the company (and its shareholders)
- the director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed
- the director was informed with restructuring advice from an appropriately experienced and qualified professional engaged or employed by the company, with access to all pertinent financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time
- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring, and
- the director took all reasonable steps to ensure that the company diligently pursued the restructuring.

A restructuring moratorium (safe harbour) that provides a defence to insolvent trading liability is required as:

1. the existing law, without any restructuring moratorium, can impede or prevent proper attempts at informal workouts
2. the adverse effect of the existing laws on honest, capable directors, particularly non-executive directors
3. the focus of directors of a financially troubled company should primarily be (as it is in many other comparable jurisdictions) on the interests of creditors
4. the existing insolvent trading laws limit the options available to deal with financial distress, and

[2] Taken directly from the ARITA (then IPA), Law Council of Australia and the Turnaround Management Association Australia joint submission dated 2 March 2010 in response to the discussion paper *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*

5. a restructuring moratorium would promote the critically important policy objective of obliging directors to obtain early restructuring advice.

We note that directors should not be permitted to view the restructuring moratorium provisions as a relaxation of their responsibilities. If anything, their responsibilities should be seen as being heightened during this period by the business judgement rule requiring positive and beneficial governance thresholds to be met before the rule can be used.

In situations where the obligations for the protections are not met, the insolvent trading rules should actually be easier for a liquidator to prove in order to be able to obtain compensation for the affected creditors.

Policy 15-05: Stronger regulation of directors and creation of a director identification number

The strengthening of insolvent trading rules should be supported by stronger regulation of directors. Consideration should be given to the implementation of a unique “director identity number” (DIN) in order to more readily identify and monitor a director’s involvement in companies.

Explanatory notes:

Presently there is no requirement to provide proof of identity when updating the corporate register maintained by the Australian Securities & Investments Commission (ASIC) of a director appointment. Safeguards, such as proof of identity requirements, could be put in place at the time of obtaining a DIN to mitigate the chance of inconsistent, misleading or false information being included on the corporate register.

The skills and abilities of directors cover a wide spectrum. There is a need to ensure that all directors adequately understand the duties and responsibilities of their position, and the good corporate and financial judgment requirements that underpin our proposal for the creation of a restructuring moratorium. We recommend that the successful completion of a suitably structured “new director” course be required as a pre-requisite to the issuing of a DIN. This could be endorsed by ASIC and offered as an online course.

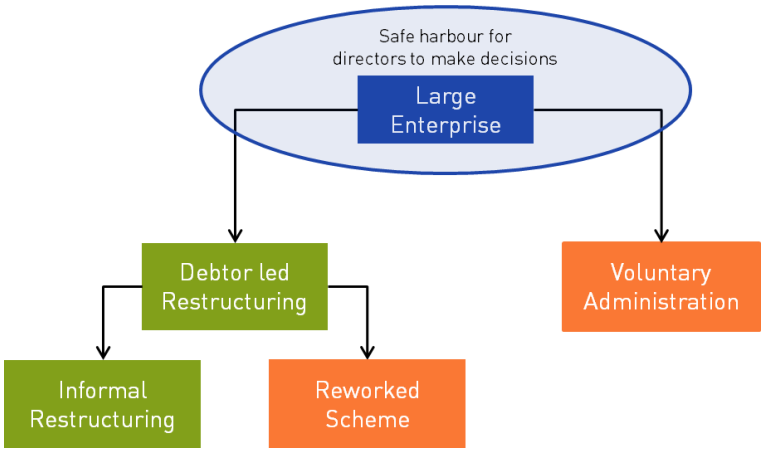
Policy 15-06: Advocate for informal restructuring

Restructuring moratorium proposals are intended to provide an environment whereby, in appropriate circumstances, companies and their directors can undertake informal restructuring initiatives without the threat of incurring liability from insolvent trading. It is reiterated that eligibility for this protection is dependent on meeting specific criteria.

Furthermore, the protections will mean that appropriately qualified and experienced professionals can be engaged in roles such as a chief restructuring officer (CRO) without facing the potential risk of incurring an insolvent trading liability as a shadow director[3]. This would allow greater scope in a CRO role than is currently possible due to the risks imposed under current legislation.

To The protection provided by the safe harbour of a restructuring moratorium would also deliver time to explore informal restructuring options where the solvency of a company may be in doubt.

Explanatory notes:



[3] Noting that other statutory duties may still apply to these types of roles

Policy 15-07: Reworked Schemes/Voluntary Administration to aid in the rehabilitation of large enterprises in financial distress

ARITA recommends that the following enhancements be made to the current Scheme of Arrangement provisions (and in some instances, to the Voluntary Administration/Deed of Company Arrangement provisions in Part 5.3A of the *Corporations Act 2001*) to further foster restructuring in Australia via statutory insolvency administration:

- implement ARITA's restructuring moratorium (safe harbour) proposal to remove the current necessity for a precursor administration in Schemes of Arrangements
- enact a specific provision enabling a Scheme of Arrangement, subject to court approval, to have a standalone moratorium, including a restriction on the exercising of ipso facto clauses
- extend the voluntary administration moratorium to ipso facto clauses (refer policy 15-08 below)
- legislate to enable recovery of director related antecedent transactions in Schemes of Arrangement and Deeds of Company Arrangement to reduce their misuse by directors to protect their own interests
  - directors to have the ability to contract out of this liability with the Administrator in both Schemes and Deeds
- implement statutory provision for the obtaining of financing via a Scheme of Arrangement (or Voluntary Administration/Deed of Company Arrangement)
- remove related party voting in a Scheme of Arrangement and Voluntary Administration/Deed of Company Arrangement and reduction of voting requirements to a majority threshold in line with those in a Voluntary Administration/Deed of Company Arrangement, and
- limit voting using purchased debts to the value of consideration paid, consistent with the current requirements in the *Bankruptcy Act 1966*.

In addition to the above, ARITA believes that consideration should be given to the implementation of a "Schemes Panel" to replace the Court's oversight of Schemes of Arrangement. It is envisaged that this panel would operate in a similar manner to the Takeovers Panel and be a government regulated peer review panel.

Policy 15-08: Extension of moratorium to ipso facto clauses

It is ARITA's view that successful restructuring through voluntary administrations is hampered because the moratorium in a voluntary administration does not extend to clauses that allow the termination of contracts simply because of the insolvency event (ipso facto clauses).

Extending the moratorium to cover such clauses will ensure that important contracts of the business are maintained so that goodwill is preserved while the company is under administration. This serves to maximise the potential of the company and its business continuing as a going concern or otherwise maintaining its value to third parties. Currently the experience of our members is that where the business is reliant on maintenance of contracts, voluntary administration sees the swift demise of the business due to automatic termination of these contracts – the rights of contractual counterparties are escalated above the rights and interests of creditors as a whole.

Voluntary administration already provides a limited and temporary moratorium against ipso facto clauses in some types of contracts. The law restricts the rights of landlords, secured creditors, and others during the voluntary administration process, but not contracts generally. We see the need for a restriction on the right to enforce all ipso facto clauses at least for the period of the administration, which is generally some few weeks. Leave of the court could be available to challenge the moratorium.

Explanatory notes:

An ipso facto contractual clause allows one party to terminate a contract by reason only of the fact (ipso facto) of the insolvency of the other party. These clauses are found in the majority of critical supplier contracts, franchise and license agreements as well as leases for land and equipment.

Under s 301 of the *Bankruptcy Act 1966*, ipso facto clauses are rendered void if the relevant obligor becomes bankrupt. However, there is no such prohibition in relation to corporate insolvency, and more particularly voluntary administration, under the *Corporations Act 2001*.

As a result, if a financially distressed but viable business that is reliant on essential contracts continuing enters into voluntary administration, it is likely that:

- contracts will immediately be terminated
- there will no longer be any business to restructure, and
- there will no longer be any going concern value for creditors.

In some cases, directors may in fact be reluctant to place their companies into voluntary administration because of concern that this may result in creditors exercising their right to terminate under an ipso facto clause and in effect terminate the company's business. This delay may weaken the company's chance of financial recovery.

Policy 15-09: Streamlined liquidation for micro companies

Given the inherent lack of funding available for a formal insolvency process in financially distressed SMEs. ARITA believes that a reduced process liquidation option should be made available in certain circumstances for those companies at the small end of the SME spectrum, "the "micro companies".

For companies where the micro criteria is not met, or creditors elect for a creditors voluntary liquidation in order to ensure investigation processes are undertaken, ready access for practitioners to an enhanced Assetless Administration Fund-style arrangement is necessary.

The current requirements of Australia's liquidation processes impose a number of statutory reporting and process obligations on liquidators, which have the effect of increasing the costs of the liquidation and reducing, or eliminating, the return to creditors

We propose that to maximise the return to creditors, where companies with minimal liabilities fail, and they meet the micro company criteria (i.e. liabilities to unrelated entities less than $250,000), a new streamlined liquidation process automatically apply.

A new streamlined liquidation process would differ from the current liquidation requirement as follows:

- no requirement to call meetings, report to creditors, undertake investigations into the company and officers' conduct and complete statutory reporting (e.g. s 533 report)
- expedited dividend process:
  - streamlined proofs of debt dealing process for debts under $10,000
  - no tax clearance required from the Australian Taxation Office where the dividend is less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
  - streamlined advertising and notice requirements for dividends less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
- fixed fee set by government for this type of liquidation, no remuneration accounting or approval.

In order to protect the rights of creditors and the integrity of the regime, the streamlined liquidation process would incorporate provisions whereby:

- the liquidator would report to creditors on appointment and gives them the option of converting the streamlined liquidation into a full creditors' voluntary liquidation (i.e. where normal investigating and reporting obligations apply and remuneration of liquidator is given priority in the normal way)
- if a majority of creditors (excluding related party creditors) vote for this to occur then it converts and the liquidator does not have the power to convert to a full liquidation without this consent
- if the liquidator subsequently becomes aware of a matter which may warrant investigation, they can again seek creditor directions (including resolution by circulation, if appropriate) as to whether the liquidation should convert to a full liquidation, and
- if provable liabilities at any time in the process exceed $250,000 to unrelated entities the streamlined liquidation process would no longer be available and the existing creditors' voluntary liquidation requirements would apply.

ARITA

Policy 15-10: Micro Restructuring

Section 185C of the *Bankruptcy Act 1966* provides a mechanism for individual debtors who meet specific eligibility criteria to enter a binding agreement with their creditors to accept a sum of money that the debtor can afford, more commonly referred to as a Part IX Debt Agreement.

Maximising the prospects of continuing the operations of financially distressed but viable small companies, we propose that a similar mechanism be implemented to deal with micro companies. It is envisaged that this process would be more streamlined and cost effective to implement than the compromise alternatives that are available under the existing Voluntary Administration/Deed of Company Arrangement provisions of the *Corporations Act 2001*.

To be eligible to undertake a micro restructuring agreement the company must:

- meet the definition requirements of a micro company
- be insolvent, and
- not have, or have directors who have, previously done a micro restructuring agreement. Such protection would be available under our restructuring moratorium proposals in Policy 15-04.

We would recommend that any micro restructuring mechanism would require:

- The company to prepare a Report as to Affairs (RATA) to be provided with the proposal.
- A Registered Liquidator to oversee the development and implementation of the proposal, possibly referred to as a Restructuring Monitor:
  - who examines and approves the proposal
  - issues the proposal to creditors, and
  - may set fixed or other fee basis for creditor consideration and approval at same time as proposal.
- Creditors vote to accept or to put the company into liquidation:
  - no need for physical meeting, with the resolution able to be considered by circulation
  - if creditors vote for liquidation then the company proceeds to liquidation immediately
  - related parties cannot vote, and

- if debt is purchased then purchaser only entitled to vote for amount for which debt purchased.

- An accepted proposal would be put into effect by the Liquidator/Restructuring Monitor and would be subject to the following provisions:
  - no requirement to call or hold further meetings
  - if provable debts to unrelated entities exceed $250,000 then appointment would automatically convert to a Voluntary Administration with full investigation and reporting requirements (if directors wish to continue to put a Deed of Company Arrangement proposal to creditors), or creditors voluntary liquidation (if there is no Deed of Company Arrangement proposal)
  - streamlined proofs of debt process for debts under $10,000
  - no tax clearance from Australian Taxation Office required where dividend is less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
  - a default longer than six months automatically results in the company being placed into liquidation.
- Creditors may apply set aside the proposal if there is a lack of full disclosure in the proposal or injustice provisions, similar to the current requirements in a Part IX Debt Agreement.

Policy 15-11: Pre-positioned sales

ARITA supports a "pre-positioning" arrangement in situations of corporate financial distress, to enable viable businesses to continue and maximise return for creditors via a sale of business negotiated prior to an insolvency appointment.

Pre-positioning is work done prior to a statutory insolvency appointment. Directors take advantage of the proposed restructuring moratorium protections, subject to meeting the criteria for eligibility, to undertake an orderly wind down of the company's operations – that is a well-managed process where assets may be realised for market value in a non-distressed sale – prior to making a formal insolvency appointment. Directors may obtain the assistance of advisors, including insolvency practitioners, during this process.

ARITA's proposed pre-positioning framework would require that:

- Any advisor retained by the directors in the pre-positioning phase could not subsequently be appointed in any formal insolvency administration. This is consistent with the current and appropriate independence requirements for insolvency practitioners in Australia.
- Any sales that occur in the pre-positioning phase must be for value and would be subject to review in any subsequent statutory insolvency administration.
- Any sale of assets undertaken during the statutory insolvency administration, where the terms of sale were negotiated in the pre-positioning phase, would be subject to review by the external administrator prior to being effectuated and the external administrator would be subject to the currently existing statutory and professional requirements regarding the sale of assets.

It is ARITA's view that consideration should be given to restricting the sale of company assets/business to related entities during this pre-positioning phase. Rather, where the sale of a business or the assets to a related entity is contemplated, and the company is insolvent, that sale must be undertaken under the control of an independent insolvency practitioner through a statutory insolvency regime; either a Voluntary Administration (subject to ARITA's recommendations for improvements), a micro restructuring (refer Policy 15-10) or liquidation.

For a number of reasons (including independence, whether the sale is for value and the lack of creditor involvement) we do not consider that a UK-style pre-pack process would be suitable for Australia.

Appendix D
ARITA's 'A Platform for Recovery 2014 - Dealing with Corporate Financial Distress in Australia: A Discussion Paper' October 2014

ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

A Platform for Recovery 2014

Dealing with Corporate Financial Distress in Australia: A Discussion Paper

Policy Development and Thought Leadership by the

Australian Restructuring Insolvency and Turnaround Association

October 2014

ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

Executive Summary

ARITA believes that the existing Australian insolvency and restructuring framework not only serves the Australian financial system and economy well, but that it also stands up strongly in comparison to other regimes across comparable global markets. Nonetheless, there are several key areas for improvement and these are identified as the following:

Issue:	Lack of a restructuring culture in Australia
Solution:	Safe Harbour
Issue:	Value destruction as a result of entering external administration
Solution:	Informal Restructuring
Issue:	No 'Chapter 11' style regime to aid in the rehabilitation of large enterprises in financial distress
Solution:	Reworked Schemes/Voluntary Administration
Issue:	Critical supplier contracts automatically terminated on appointment of an external administrator, inhibiting formal restructuring
Solution:	Extension of moratorium to ipso facto clauses
Issue:	Maximising the chance of continuing the operations of financially distressed but viable small companies
Solution:	Micro Restructuring
Issue:	Maximising the return to creditors where companies with minimal liabilities fail
Solution:	Streamlined Liquidation
Issue:	Enabling viable businesses to continue, and maximise return for creditors, via a sale of business negotiated prior to the appointment
Solution:	Pre-positioning

Please note that Annexure A provides for a comparison table of major comparable markets' formal restructuring mechanisms and ARITA's position on these mechanisms.

We Value Your Input

The goal of this discussion paper is to create informed debate, which will inform our final policy paper.

To that end we'd like to hear your thoughts, comments and feedback on the issues raised.

Please contribute to the debate on ARITA's online discussion forums at www.arita-forums.com.au.

1 Introduction

It is part of the good operation of market economics that some businesses and individuals will enter into financial distress. Indeed, this process is vital in ensuring the efficient allocation of capital. However, there are also significant human and social elements to financial distress of which a responsible society takes ownership.

The Australian regime for dealing with corporate and personal insolvency seeks to find a balance between these elements and to cover for various market failures that are naturally found in a market economy. We, as a society, make decisions about the framework that best suits our view of the balance we seek. That view changes over time and as a result of the economic cycle itself.

Australia's corporate insolvency regime has evolved to have a bias towards protecting the rights, and capital, of creditors i.e. those who provide the funding to allow businesses to undertake their activities with some level of financial gearing. In other markets, the bias may be viewed as being more towards the sustaining of the corporate entity itself, at the cost of the creditors' interests.

Australia's last major review of our corporate insolvency regime came in 1993 following the highly respected Harmer Report[1]. Its recommendations continue to underpin our current regime, including the voluntary administration framework. As with any regime, it is important that it evolves and is improved over time, especially as markets themselves change and evolve. Indeed, it's important to note that the economy itself has evolved substantially since that time.

2 About *A Platform for Recovery*

A Platform for Recovery is a discussion paper. It isn't a final policy document, though that is its ultimate evolution. The goal of this document is to create active and informed discussion of the issues and concepts that are raised. This will inform ARITA's final policy position.

We invite you to contribute to the debate on ARITA's discussion forums or add your comments on our website.

Importantly, this paper does not go to the detail of specific legislative change. Rather, it identifies current issues or deficiencies in the current insolvency regime and proposes concepts, by way of law reform or best practice, to remedy these issues.

[1] Australian Law Reform Commission Report No 45: General Insolvency Inquiry 1988

3 ARITA's past policy and thought leadership work

Over the last several years ARITA has actively and thoroughly responded to many of the government inquiries into different aspects of insolvency law and practice. Outcomes from these by way of actual legislative reform have been limited.

The most significant of these have been in relation to our:

2007 insolvent trading submission where ARITA [then IPA] recommended a financial judgment rule – a safe harbour – in order to ameliorate the potential liability of directors for insolvent trading

2010 joint submission with Turnaround Management Association (TMA) and Law Council to Treasury, again on the safe harbour proposals

2010 response to the Australian Securities and Investments Commission's (ASIC) insolvent trading guide

2010 recommendation to the Productivity Commission on insolvency alignment reform

2011 response to the government's options paper on insolvency reform

2012 our further response to the government proposals paper on insolvency reform

2013 submissions to the Senate inquiry into ASIC

2013 our responses to the Insolvency Law Reform Bill 2013, and our continued input into 2014

2014 our submissions to the Financial Systems Inquiry.

In deference to these government inquiries, ARITA has variously organised discussion groups, conference topics and ARITA journal articles to promote an informed debate. In addition, in that period, in our journal, forums and our local and international conferences we have raised and debated other issues including directors' liabilities, tax penalties on directors, creditors' rights and engagement, reform proposals for receiverships, and the need for a government role in liquidations.

In particular, ARITA has funded significant empirical research studies, under its Terry Taylor Scholarship, one into the personal costs to liquidators of administering nil return administrations ordered by the court; the other into the dividend returns from DOCAs. Also, more statistics are now available from ASIC, and the Australian Financial Security Authority (AFSA), which confirm the generally poor outcomes of insolvency administrations.

4 Context

It is ARITA's view that the current regime has served Australia well. In particular, it has sustained economic value through a number of downturns and market shocks and major corporate failures. Importantly, during the GFC it should be noted that the Australian economy fared better than its competitors and that is reasonable to claim that our insolvency regime played a part in that – especially from credit provision and market confidence perspectives.

It's also notable that at times Australians tend to hold an idealised view of how other markets operate. We see the success but gloss over some of the failings. ARITA believes that we should carefully and scientifically analyse recovery and insolvency regimes elsewhere to see what may operate better than we have and learn from those approaches, however, a notion that we can simply transplant other systems here fails to acknowledge our own unique circumstances and ethos.

Informed by our past consideration of a wide spectrum of insolvency law reform issues, and by the experience and knowledge of ARITA and its members, we are now offering our view on reform of the Australian restructuring and insolvency regime.

ARITA's view is not whether change is needed, but that change and reform is needed, for the regime to improve its social and economic outcomes. We necessarily accept some of the current legal and practice structures in place in Australia and do not wish to suggest the impossible or impractical; for example, we are content to maintain the separate laws for personal and corporate insolvency.

At the same time, we do say that fundamental changes are needed, in particular in the need for greater emphasis on restructuring outcomes.

It has been put to ARITA in the past that 'evidence' is needed in order to consider reform of aspects of our insolvency laws. While we have gathered some evidence, it is also the case that much is not available, nor readily extracted, given the low levels of information about our insolvency regime. That the Financial Service Inquiry Interim Report had to rely on a 2000 Productivity Commission report on insolvency statistics is indicative of that. However, we ourselves are informed by the considerable experience and views of our members. Law reform can proceed on such an intuitive basis, backed by experience and informed input.

The Australian regime could currently be described as one with a strong bias towards preserving creditors' rights. Some other jurisdictions have more of a bias towards the preservation of the ongoing nature of organisations in financial distress. There are significant arguments around where the balance is appropriately set between these two approaches, and that that balance may alter dependent on where an economy's performance may be trending.

5 Aims of insolvency law

We accept the fundamental principles of and aims of insolvency law are to[2]:

- provide an equal, fair and orderly procedure in handling the affairs of insolvent debtors to ensure that creditors receive an equal and equitable distribution of the debtor's assets - the pari passu (equal sharing) principle
- provide procedures and processes for dealing with an insolvency with as little delay and expense as possible
- ensure that administrations are conducted in an independent, competent and efficient manner
- provide mechanisms which allow for treatment of the affairs of insolvents before their position becomes hopeless
- provide procedures which enable both debtors and creditors to be involved in the resolution of the reality of insolvency
- ascertain the reasons for the insolvency and to provide mechanisms which allow for the examination of the conduct of insolvents, their associates and the officers of corporate insolvents, and
- ascertain whether any offences have been committed by insolvents or their associates with a view to those offences being prosecuted.

These last two go to support the maintenance of the integrity of the insolvency process and of 'commercial morality'.

The reality is however that many of those aims are not being met. We measure our own proposals by those principles and aims, and suggest that they are better met by our new structure, or at least, that our proposals are more worthy of consideration than any acceptance of the status quo.

We therefore positively encourage and invite responses not only from our members, but also accountants, lawyers and financiers, the regulators and from government.

6 ARITA's policy aims

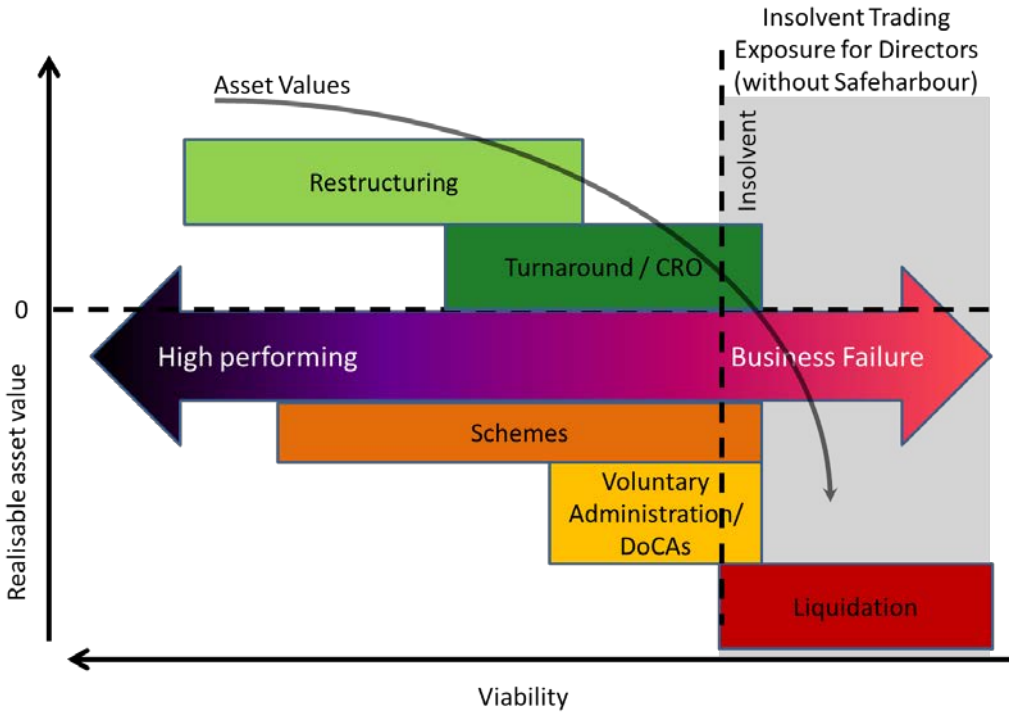
ARITA proposes an alternative regime to address the financial decline and potential termination of businesses.

We have a number of purposes in mind in proposing this, guided by our series of principles as to how the regime should operate. The principles are based on the accepted aims of insolvency law as discussed above. The regime should:

[2] The list is adapted from the Harmer Report ([33]) and the Cork Report ([198]).

- support the maintenance of the viability of good businesses that have otherwise found themselves in or are heading towards financial distress, with the minimum requirements of these businesses being that they have good financial systems and controls, are tax compliant, are compliant with other regulatory obligations – corporate, WHS, environmental, product safety etc - and demonstrate good corporate governance
- recognise the value to the economy of sustaining continuous employment for employees involved in viable organisations facing financial distress
- recognise that, as a micro-economic principle, capital should be recycled from non-performing businesses to performing businesses and that some element of business failure is a necessary and appropriate mechanism in ensuring an efficient and productive economy
- encourage or allow the prevention of the terminal insolvency of a failing but potentially viable business
- encourage and allow directors and management and independent, qualified and experienced financial and insolvency advisers, to assist in the recovery a viable company from financial distress
- to that end, provide a safe harbour from potential later claims, subject to certain requirements
- otherwise support the preservation of a viable business as a going-concern, including to allow the business to continue to have the benefit of existing contracts and leases
- require the interests of existing and new creditors to be taken into account, but at the same time recognise their responsibilities to attend to their own interests
- do so at a cost in proportion to the value and potential of the business
- require and allow any resolution of the company's financial distress to be dealt with as quickly as possible, consistently with the interests of creditors and of the company
- provide for the prompt assessment and orderly disposal of a failed business recognising that there is a cost to delivering this service
- accept that the nature and size of company businesses is extremely variable – from one director micro businesses, through SME businesses, to large enterprises, with a management structure and a board of several independent directors
- have regard to international precedents in the UK, US, New Zealand, Canada and elsewhere, and our on-going assessment of them, and
- provide proper remuneration for its practitioners, and not require its practitioners to do work or incur expenses without recompense.

The distinction between high performing and distressed companies and the impact on asset values over the viability spectrum is depicted below.



Value v Viability Diagram

7 The structure of 'a platform for recovery'

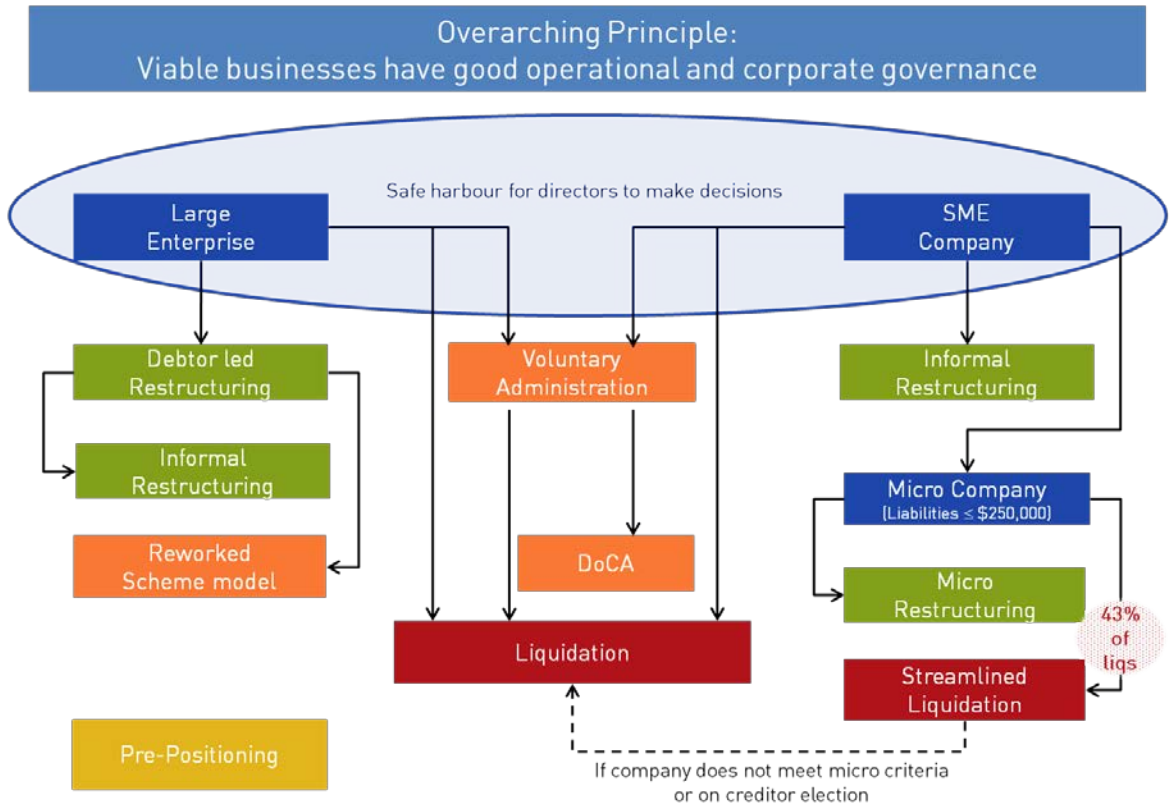
In preparing this paper we identified current issues, or deficiencies, in the current insolvency regime and proposed solutions to those issues. A foundation of our thinking is that the current 'one size fits all' approach to dealing with companies in financial distress is flawed. For example, such an approach does not take into account the scale of societal impacts of insolvencies in large enterprise collapses compared to small and nor does it take into account the differences in governance between large and small entities.

To that end, we conceive that there are three framework approaches required:

- Large Enterprises
- Small/Medium Enterprises (SMEs)
- Micro Companies (Liabilities less than $250,000).

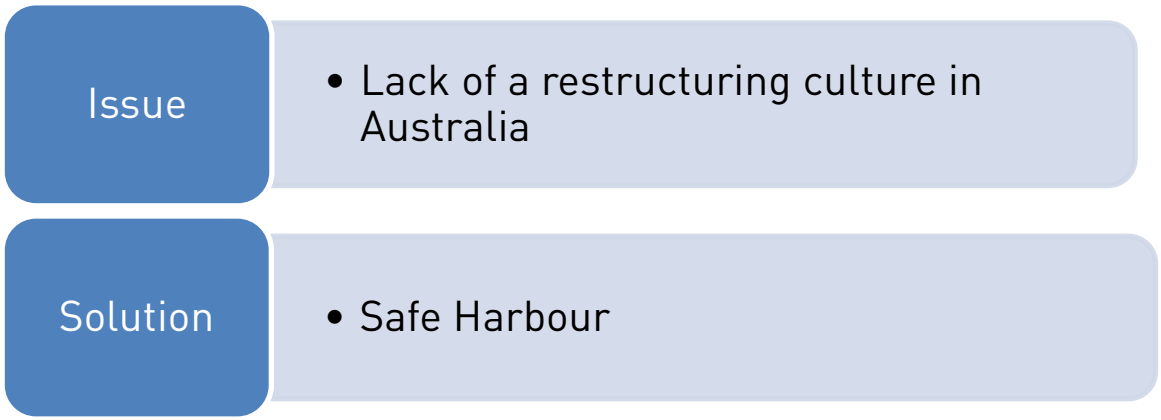
Partnered by Chartered Accountants Australia and New Zealand and CPA Australia, ARITA is currently co-sponsoring empirical research being conducted by leading academics Jason Harris from UTS and Trish Keeper from Victoria University (NZ) on SME insolvency. This work is running concurrently with the consultation on this discussion paper and will be used to hone policy in this space at its completion.

The below overview provides a summary of the proposed reform concepts developed by ARITA based on the detailed three approaches above and the belief that size distinctions are required to better achieve the aims of Australian insolvency law.



ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

8 Restructuring and a safe harbour



Much of what we propose requires there to be some deregulation of any laws that may impede restructuring, in particular the laws that impose on directors, and potentially their advisers, liability for insolvent trading.

There has been significant debate about this in recent years, to which ARITA has contributed, by way of submissions and through encouraging member and community debate. We are keenly aware of the issues and the arguments on both sides. In particular we are aware of the need to balance the rights of existing and on-going creditors of the company, who may suffer through insolvent trading, against the opportunities for the business to be restructured and the consequential benefits that may bring, including to those creditors.

It is said, and it has been raised as recently at the Financial System Inquiry Interim Report[3], that the threat of liability for insolvent trading serves to cause some directors to seek the protection of the voluntary administration regime too readily, rather than allowing those directors to continue to make genuine efforts to reverse and resolve the company's distress. Whether there is 'evidence' of that is problematic, from our members' perspective. But we do nevertheless consider that the liability for insolvent trading does exist in the minds of many directors and their advisers, but this does depend on the size of the company and the nature of its directors.

In that respect, we are also aware of the fact that our insolvency regime pays little regard to the obvious differences between large and small enterprises, and their respective directors and the directors' motivations. That difference is particularly relevant when considering the duties of directors.

Large companies most often have professional directors with little personal involvement in the fate of the company, beyond their duties to it as directors. They may tend to be risk averse in what is often referred to as the insolvency twilight zone in order to preserve their professional reputation and minimise their personal liability. They may be more readily prompted to invoke a formal insolvency appointment in order to avoid any risk of liability for insolvent trading.

[3] The Financial System Inquiry 2014 (Murray) Interim Report, released 15 July 2014

In contrast, small companies most often have directors who are also owners and guarantors of the company's liabilities, and they do not necessarily have the same 'professional' reputation to preserve. Theirs is more a business and commercial focus. Accordingly, in the insolvency twilight zone, they have everything on the line and tend to be comparably large risk takers. The threat of insolvent trading and of breach of directors' duties is far less.

We have addressed this difference in what is a large and threshold issue in this debate. We do not suggest separate insolvent trading regimes. Rather we offer an amelioration of that regime, but only to those directors who can show a satisfactory level of good corporate and financial judgment in the conduct of the company's operations generally and in the lead up to its financial distress.

In the current debates, this is typically expressed in terms of the need for a business judgment rule.

Insolvent trading laws[4] are intended to make directors act to prevent a company from incurring a debt if the company is insolvent at the time the debt is incurred, or becomes insolvent as a result of incurring the debt. Directors who trade whilst the company is insolvent face civil liability for debts incurred, which can be substantial and criminal prosecution, which can result in imprisonment.

It is our view that these laws do not work as intended for the following reasons:

1. In the case of larger companies with directors that are independent of the owners of the company (or listed companies), directors are generally educated and informed of their obligations, duties and risk of personal liabilities. They are also concerned about their reputation of being associated with a 'failed' company. As such, when a company is in financial distress, they are more likely to want to take steps to appoint an administrator to end the potential of insolvent trading liability, rather than 'risk' an informal restructure even if the company could potentially be turned around. Thus the insolvent trading laws act as a deterrent to restructuring attempts, even when a restructuring may be in the best interests of the creditors and the company. In this situation, there is an inherent conflict for directors between protecting themselves from personal liability and acting in a way which is in the best interests of the company and creditors.

2. In the case of SMEs where the directors are also generally the owners of the company, the directors' personal financial affairs are usually inexorably related to the financial affairs of the company and once the company is in a state of financial distress, the directors may well be too. With nothing left to lose, but a lot to gain if the business is able to continue, the distant threat of liability for insolvent trading is not enough to prevent the directors from continuing the business until there is nothing left to continue with[5]. Thus arguably, the insolvent trading laws do not act as an effective deterrent to reckless trading, particularly in the SME sector.

[4] Primarily s 588G of the *Corporations Act 2001*

[5] ASIC statistics support this with 61.1% of companies in external administration having less than $10,000 in assets and 40.1% having less that $1 (Report 371 Insolvency Statistics: External Administrators' Reports for the period July 2012 to June 2013).

3. It is inherently difficult for directors to assess the insolvency of their company in real time. Whilst under law a company is either solvent or insolvent, in reality a company can teeter on the edge of insolvency for some time and determining whether any business of even moderate size is insolvent is difficult unless it is clearly insolvent – even by an experienced insolvency practitioner.

4. Historically insolvent trading actions are difficult to prove and expensive to pursue. The reality that there are limited or no assets in a large number of administrations means that insolvent trading claims are unlikely to eventuate, particularly in SMEs where the claims are likely to be at the smaller end. Furthermore, asset protection strategies employed by directors and the fact that secured creditors and a number of trade creditors will hold personal guarantees from directors, means that often directors are unable to meet any compensation orders if an insolvent trading action is proved against them. We do recognise however that the threat of an insolvent trading action can result in out of court settlements in liquidations and payments under deeds of company arrangement to prevent further action being taken, resulting in benefits for the creditors.

It is clear that there is significant doubt as to whether the insolvent trading laws are achieving any of their objectives, but may instead be preventing directors from undertaking restructuring efforts in situations where that may be in the best interests of the company and creditors. It is ARITA's view a business judgement rule for insolvent trading (commonly referred to as a 'safe harbour) needs to be provided to facilitate directors being able to undertake restructuring efforts in appropriate circumstances.

The US regime does not include a concept of insolvent trading, while the concept above is an element of UK equivalent.

Much work has already been done on what the terms of such a safe harbour should be[6]. ARITA's views have not largely changed since our 2010 Joint Submission with the Law Council of Australia and the Turnaround Management Association. In summary, we support a business judgement rule with the following elements, that the directors7:

- make a business judgement in good faith for proper purpose
- after informing themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate
- rationally believe that the judgement was in the best interests of the corporation
- the director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that

[6] The Minister for Financial Services, Superannuation and Corporate Law released a discussion paper on 19 January 2010 titled *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration*. ARITA (then the IPA) made a submission jointly with the Law Council of Australia and the Turnaround Management Association Australia dated 2 March 2010 and we also made a supplementary submission of our own dated 18 March 2010. Copies of our submissions are available from the ARITA website.
[7] Taken directly from the ARITA (then IPA), Law Council of Australia and the Turnaround Management Association Australia joint submission dated 2 March 2010 in response to the discussion paper *Insolvent Trading: A Safe Harbour for Reorganisation Attempts outside of External Administration*

all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed

- the director was informed with restructuring advice from an appropriately experienced and qualified professional engaged or employed by the company, with access to all pertinent financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time
- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring, and
- the director took all reasonable steps to ensure that the company diligently pursued the restructuring.

Our joint submission put forward five principal reasons why there should be a safe harbour defence to insolvent trading liability:

1. the existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts
2. the adverse effect of the existing laws on honest, capable directors, particularly non-executive directors
3. the focus of directors of a financially troubled company should primarily be (as it is everywhere else in many other comparable jurisdictions) on the interests of creditors
4. the existing insolvent trading law limits the options available to deal with financial distress, and
5. a safe harbour defence would promote the critically important policy objective of obliging directors to obtain early restructuring advice.

We see these principal reasons as continuing to apply.

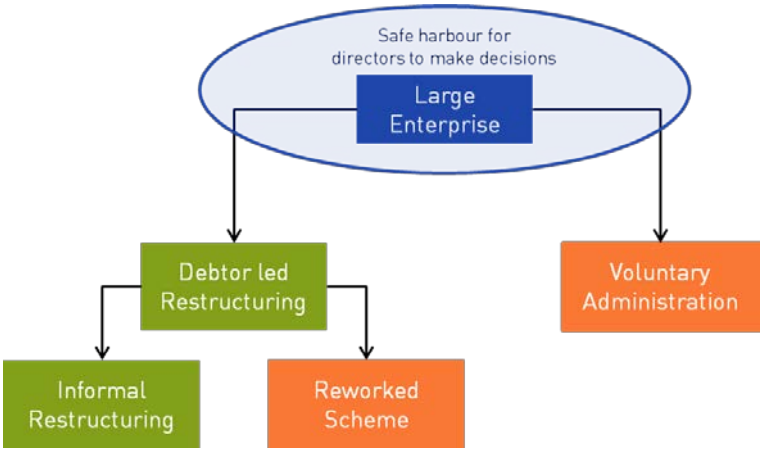
We note that directors should not be permitted to see the safe harbour provisions as a relaxation of their responsibilities. If anything, their responsibilities should be seen as being heightened during this period by the business judgement rule requiring positive and beneficial governance thresholds to be met before the rule can be used.

Consideration should also be given as to whether, in situations where the safe harbour protections are not met, the insolvent trading rules should actually be easier for a liquidator to prove in order to be able to obtain compensation for the affected creditors.

We are also strongly of the opinion that any strengthening of insolvency trading rules should also be supported by better regulation of directors. Consideration should be given to the implementation of a unique 'director identity number' (DIN) in order to more readily identify and monitor a director's involvement in companies. Presently there is no requirement to provide proof of identity when updating the corporate register maintained by ASIC of a director appointment. Safeguards, such as proof of identity requirements, could be put in place at the time of obtaining a DIN to mitigate the chance of inconsistent, misleading or false information being included on the corporate register.

As we have noted above, there is a spectrum of skills of directors and there is a need to ensure that *all* directors adequately understand the duties and responsibilities of their position, and the good corporate and financial judgment requirements that underpin our safe harbour proposal. We recommend that the successful completion of a suitably structured 'new director' course be required as a pre-requisite to the issuing of a DIN. This could be offered by ASIC as an online course.

9 Large enterprise framework



9.1

Issue

- Value destruction as a result of entering external administration

Solution

- Informal Restructuring

As previously discussed in Section 8, the safe harbour proposals are intended to provide an environment whereby, in appropriate circumstances, companies and their directors can undertake informal restructuring initiatives without the threat of insolvent trading liabilities. It is reiterated that eligibility for safe harbour protection is dependent on meeting specific criteria.

Furthermore, the safe harbour protections will mean that appropriately qualified and experienced professionals can be engaged in roles such as a Chief Restructuring Officer (CRO) without the potential for insolvent trading liability as a shadow director. This would allow greater scope in a CRO role than is currently possible due to the risks imposed under current legislation.

The protection provided by safe harbour would also provide more time to explore informal restructuring options where the solvency of a company may be in doubt.

9.2

Issue	• No "Chapter 11" style regime to aid in the rehabilitation of large enterprises in financial distress
Solution	• Reworked Schemes/Voluntary Administration

ARITA recommends that the following enhancements be made to the current Scheme of Arrangement provisions (and in some instances, to the Voluntary Administration/Deed of Company Arrangement provisions in Part 5.3A) to better foster restructuring in Australia via statutory insolvency administration:

- implementation of ARITA's safe harbour proposal to remove the current necessity for a precursor administration in Schemes of Arrangements
- specific provision for application to the court for a scheme to have a standalone moratorium, including a restriction on the exercising of ipso facto clauses
- extension of the voluntary administration moratorium to ipso facto clauses (refer section 9.3 below)
- ability to recover director related antecedent transactions in Schemes of Arrangement (and Deeds of Company Arrangement) to reduce their misuse by directors to protect their own interests.
  - Directors to have the ability to contract out of this liability with the Administrator in both Schemes and Deeds
- statutory provision for the obtaining of financing via a Scheme of Arrangement (or Voluntary Administration/Deed of Company Arrangement)
- removal of related party voting in a Scheme of Arrangement (and Voluntary Administration/Deed of Company Arrangement) and reduction of voting requirements to majority threshold in line with those in a Voluntary Administration/Deed of Company Arrangement, and
- voting using purchased debts to be limited to the value of consideration paid, consistent with the current requirements in the *Bankruptcy Act 1966*.

In addition to the above, ARITA believes that consideration should be given to the implementation of a 'Schemes Panel' to replace the Court's oversight of Schemes of Arrangement. It is envisaged that this panel would operate in a similar manner to the Takeovers Panel and be a government regulated peer review panel.

ARITA recommends that further work be done to recognise and promote Schemes of Arrangement as a viable and functional reorganisation mechanism for large enterprises in the

Australian market. To achieve this, a general shift in the Australian environment from a focus on the return to creditors to the rehabilitation of businesses is required.

In considering the above concepts, ARITA reviewed and considered the following aspects of similar restructuring mechanisms in like economic markets (USA, UK and Canada):

- Main objectives
- Director liability
- Who is appointed/oversees the process
- Stay of proceedings, and
- Voidable transactions.

A detailed analysis of these considerations is provided in Annexure A.

In addition to the above, it is noted that consideration of the adoption of aspects of a US style 'Chapter 11' regime in Australia has been discussed in various forums over a number of years, including

- Senate Economics References Committee 'Inquiry into the Performance of the Australian Securities and Investments Commission' July 2014.
- Parliamentary Joint Committee on Corporations and Financial Services Corporate Insolvency Laws: a Stocktake August 2004.
- Corporations and Markets Advisory Committee 'Rehabilitating large and complex enterprises in financial difficulties Report' October 2004.

None of these reviews has recommended the implementation of a 'carbon copy' Chapter 11 regime in Australia. In 2004, the CAMAC Report into large enterprises found 'no compelling need, or intrinsic shortcoming in the VA procedure, which requires or justifies adopting Chapter 11 as an additional or substitute corporate recovery procedure for large and complex, or other, enterprises'[8]

Most recently the ASIC inquiry made this recommendation:

> Recommendation 61
>
> 27.52 The committee recommends that the government commission a review of Australia's corporate insolvency laws to consider amendments intended to encourage and facilitate corporate turnarounds. The review should consider features of the chapter 11 regime in place in the United States of America that could be adopted in Australia.

Given the extensive historical consideration of this matter, ARITA does not propose to revisit the question of the fulsome adoption of a Chapter 11 style regime. ARITA has given specific consideration of the current Australian Schemes of Arrangement process detailed in Part 5.1 of

[8] Corporations and Markets Advisory Committee *Rehabilitating large and complex enterprises in financial difficulties* October 2004

the *Corporations Act 2001* and aspects of Chapter 11, and other foreign restructuring mechanisms in developing our proposals.

9.3

Issue	• Critical supplier contracts automatically terminated on appointment of an external administrator, inhibiting formal restructure
Solution	• Extension of moratorium to *ipso facto* clauses

An ipso facto contractual clause allows one party to terminate a contract by reason only of the fact (ipso facto) of the insolvency of the other party. These clauses are found in the majority critical supplier contracts, franchise and license agreements as well as leases for land and equipment. Ipso facto clauses have played a pivotal role in the shutdown of major organisations that were in financial distress (examples such as the carrier contracts of One.Tel being terminated soon after the company entered voluntary administration resulting in One.Tel being unable to provide services to its customers, are obvious). It is ARITA's view that voluntary administrations are not as successful in restructuring businesses as they could be due to the fact that the moratorium in a voluntary administration does not extend to ipso facto clauses.

Under s 301 of the *Bankruptcy Act 1966*, ipso facto clauses are rendered void if the relevant obligor becomes bankrupt. However, there is no such prohibition in relation to corporate insolvency, and more particularly voluntary administration, under the *Corporations Act 2001*.

As a result, if a financially distressed but viable business that is reliant on essential contracts continuing enters into voluntary administration, it is likely that:

- contracts will immediately be terminated
- there will no longer be any business to restructure, and
- there will no longer be any value for creditors.

In some cases, directors may in fact be reluctant to place their companies into voluntary administration because of concern that this may result in creditors exercising their right to terminate under an ipso facto clause and in effect terminate the company's business. This delay may weaken the company's chance of financial recovery.

The justification for such a moratorium being extended to cover ipso facto clauses is to ensure that important contracts of the business are maintained such that goodwill is preserved while the company is under administration. This serves to maximise the chances of the company and its business continuing as a going concern or otherwise maintaining its value to third parties. This is currently not the case in Australia and the experience of our members is that where the

business is reliant on maintenance of contracts, voluntary administration sees the swift demise of the business due to termination of these contracts.

The Harmer Report recommended that any contractual provision such as those discussed above be void against a liquidator or administrator[9]. The reasoning for the Report's recommendation was that there has been a similar provision in the *Bankruptcy Act 1966* (s 301) since 1968. The bankruptcy provision was recommended by the 1965 Clyne Committee on the basis that to permit such an agreement to be terminated merely because of insolvency may sometimes have the effect of depriving the trustee of a bankrupt person of an opportunity to deal with the property comprised in such an agreement to the advantage of the creditors[10]. The ALRC adopted that reasoning and considered that it should apply with equal force to a company and recommended legislation to bring this into effect[11]. It is ARITA's opinion that this position is still correct, including in the corporate insolvency context.

Voluntary administration provides a limited and temporary moratorium against ipso facto clauses in some types of contracts once a company enters voluntary administration. Section 440B restricts the rights of landlords, secured creditors, and others during the voluntary administration process, but not contracts generally. We see the need for a restriction on the right to exercise rights under all ipso facto clauses at least for the period of the administration, which is generally some few weeks, with court approval for any extension of that period generally required.

The law in favour of the validity of ipso facto clauses is inherently counterproductive and contrary to the spirit of the Part 5.3A regime. We consider that the law should apply in the same way to contracting parties, subject to court leave, and subject to distinctions as may be necessary between different types of contracts. In our view, in cases where such contracts are in issue, that would be a very significant improvement in the effectiveness of Part 5.3A.

The US has a prohibition against contractors terminating a supply contract when a company enters Chapter 11. This is one element of Chapter 11 that ARITA has consistently supported[12]. ARITA has long recommended the law in Australia adopt this US approach as one way of countering the reduction in value of a business on its entering insolvency.

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[9] ALRC 45, vol 2, s AT10. See also vol 1, paras 703 – 705.
[10] Clyne Committee Report, para 383.
[11] The recommended legislation was: Certain provisions in agreements to be void
AT10.
(1) Where a company is a party to an agreement (other than a charge) that contains a provision to the effect that, if the company commences to be wound up in insolvency or becomes a company under administration, then
(a) the agreement is to terminate or may be terminated
(b) the operation of the agreement is to be modified, or
(c) property to which the agreement relates may be repossessed by a person other than the company,
the provision is void, unless the Court otherwise orders, as against the liquidator or administrator.
(2) This section extends to agreements made before the commencement of this section.
[12] ARITA's first submission regarding the need for a moratorium on ipso facto clauses was it submission (then as the IPAA) in April 2003 to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into Australia's Insolvency Laws.

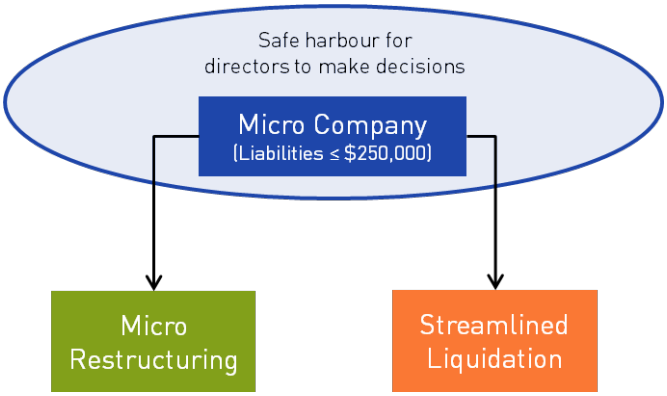
The UK is presently considering extending the avoidance of such clauses in telecommunications collapses[13], an area where our experience in Australia shows such a law is particularly needed.[14]

10 Small/medium enterprises, including micro companies

As mentioned earlier, ARITA has partnered with Chartered Accountants Australia and New Zealand and CPA Australia to co-sponsor empirical research on SME insolvency. This work is running concurrently with the consultation on this discussion paper and will be used to hone policy in this area at its completion.

Notwithstanding the specific SME considerations from the joint initiative, the ipso facto concepts detailed at section 9.3 above would equally apply to the SME market, although it is envisaged that this would more commonly be via a voluntary administration than a scheme of company arrangement due to the size of the enterprises.

The safe harbour concepts outlined in section 8 of this Discussion paper do not differentiate based on the size of an organisation and would also equally apply to SMEs and its subset of micro companies. We envisage that companies would engage advisers appropriate to their business size but we do not see this as a limiting factor for eligibility for the safe harbour protection.



Micro companies, as we have chosen to define them[15], form the vast majority of insolvencies in Australia. ASIC's statistics report that 43% of insolvencies have liabilities of less than $250,000 while some 40% of insolvencies are assetless[16] at the time of insolvency. In the case of assetless insolvencies, there are, by definition, no available funds to support the work of a liquidator and, in particular, to fund the investigations work of liquidators. The latter is of particular concern, with much anecdotal evidence that companies are often wound down to this point specifically to avoid investigations work. It is noted that ASIC operates an Assetless Administration Fund. However, practitioners are placed in the invidious position of needing to undertake unfunded work in order to access this, with little certainty of it being made available at the end of that work

[13] Continuity of supply of essential services to insolvent businesses, UK Government, Open Consultation, 8 July 2014, closing 8 October 2014.
[14] ARITA is working with the Communications Alliance in Australia to address this issue in the telecommunications sector.
[15] Less than $250,000 in liabilities to unrelated entities
[16] ASIC Report 371 *Insolvency Statistics: External Administrators' Reports* for the period July 2012 to June 2013

ARITA has previously supported research that reported on the extent of unfunded work undertaken by insolvency practitioners and valued it at $48 million per annum[17]. This is obviously unsustainable for the profession.

In recent times, there has been significant political discourse around the need to provide a 'streamlined' process for SME insolvencies. Given the lack of funding available for SME insolvencies, ARITA concurs that a reduced process option should be made available in certain circumstances.

For companies where the micro criteria is not meet or creditors elect for a creditors voluntary liquidation with the current investigation requirements, there should be more ready access for practitioners to an enhanced Assetless Administration Fund-style arrangement.

This is driven home by recent ASIC statistics that show that of the 10,073 reports submitted by practitioners in the last year, 7,218 identified misconduct by directors alongside 43% of all insolvencies having estimated liabilities of $250,000 or less.[18]

10.1

Issue	• Maximising the chance of continuing the operations of fincially distressed but viable small companies
Solution	• Micro Restructuring

Section 185C of the *Bankruptcy Act 1966* provides a mechanism for individual debtors who meet specific eligibility criteria to enter a binding agreement with their creditors to accept a sum of money that the debtor can afford, more commonly referred to as a Part IX Debt Agreement.

We propose that a similar mechanism be implemented to deal with micro companies. It is envisaged that this process would be more streamlined and cost effective than the compromise alternatives that are available under the existing Voluntary Administration/Deed of Company Arrangement provisions of the *Corporations Act 2001*.

Eligibility criteria to undertake a micro restructuring agreement would include:

- must meet the definition requirements for a micro company
- company must be insolvent, and

[17] *An analysis of official liquidations in Australia*, Amanda Phillips (ARITA Terry Taylor Scholarship Recipient), February 2013
[18] ASIC Report 412 Insolvency Statistics: external administrators' reports (July 2013 to June 2014) September 2014

- not available to companies who, or companies whose directors, have previously done a micro restructuring agreement. Such protection would be available under our Safe Harbour proposal detailed at section 8.

Although we do not propose to go into operational detail in this paper, we would recommend that any micro restructuring mechanism would require:

- The company to prepare a Report as to Affairs (RATA) to be provided with the proposal[19].A Registered Liquidator to oversee the development and implementation of the proposal, possibly referred to as a Restructuring Monitor:
  - who examines and approves the proposal[20]
  - issues the proposal to creditors, and
  - may set fixed or other fee basis for creditor consideration and approval at same time as proposal.
- Creditors vote to accept or to put the company into liquidation:
  - no need for physical meeting, with resolution able to be considered by circulation
  - if they vote for liquidation then the company proceeds to liquidation immediately
  - related parties cannot vote, and
  - if debt is purchased then purchase only entitled to vote for amount for which debt purchased.
- An accepted proposal would be put into effect by the Liquidator/Restructuring Monitor and would be subject to the following provisions:
  - no requirement to call or hold further meetings
  - if debts to unrelated entities exceed $250,000 then appointment would automatically convert to a Voluntary Administration with full investigation and reporting requirements (if directors wish to continue to put a Deed of Company Arrangement proposal to creditors), or creditors voluntary liquidation (if there is no Deed of Company Arrangement proposal)
  - streamlined proofs of debt process for debts under $10,000
  - no tax clearance from Australian Taxation Office required where dividend is less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
  - a default longer than 6 months automatically results in the company being placed into liquidation.
- Creditors may apply set aside the proposal if there is a lack of full disclosure in the proposal or injustice provisions, similar to the current requirements in a Part IX Debt Agreement.

[19] S185D of the *Bankruptcy Act 1966* requires that a Statement of Affairs (the personal insolvency equivalent of a RATA)be given with a debt agreement proposal
[20] For Part IX Debt Agreements this is currently done by debt agreement administrators are not registered trustees. We propose that debt agreements for companies be undertaken by registered liquidators.

10.2

Issue	• Maximising the return to creditors where companies with minimal liabilties fail
Solution	• Streamlined Liquidation

The current requirements of Australia's liquidation processes impose a number of statutory reporting and process obligations on liquidators, which have the effect of increasing the costs of the liquidation and reducing, or eliminating, the return to creditors

We propose that, where a company meets the micro company criteria (i.e. liabilities to unrelated entities less than $250,000) the new streamlined liquidation process automatically apply.

A new streamlined liquidation process would differ from the current liquidation requirement as follows:

- removal of requirement to call meetings, report to creditors, undertake investigations into the company and officers' conduct and complete statutory reporting (e.g. s 533 report)
- expedited dividend process[21]:
  - Streamlined proofs of debt dealing process for debts under $10,000
  - No tax clearance required from the Australian Taxation Office where the dividend is less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
  - Streamlined advertising and notice requirements for dividends less than $25,000 (10% of maximum liability amount) or 10 cents in the dollar, and
- fixed fee set by government for this type of liquidation, no remuneration accounting or approval.

In order to protect the rights of creditors and the integrity of the regime, the streamlined liquidation process would incorporate provisions whereby:

- the liquidator would report to creditors on appointment and gives them the option of converting the streamlined liquidation into a full creditors' voluntary liquidation (i.e. where normal investigating and reporting obligations apply and remuneration of liquidator is given priority in the normal way)[22]

[21] Note that ASIC statistics show that of the 43% of liquidations with less than $250,000 of debt, 97% receive 0-11 cents in the $ dividend which should mean that the majority of these liquidations will fit within the streamlined process

[22] Section 545 of the *Corporation Act 2001* which provides that a liquidator does not have to undertake work if there is insufficient funds, would also apply

- if a majority of creditors (excluding related party creditors) vote for this to occur then it converts and the Liquidator does not have the power to convert to a full liquidation without this consent
- if the liquidator subsequently becomes aware of a matter which may warrant investigation, they can again seek creditor directions (including resolution by circulation, if appropriate) as to whether the liquidation should convert to a full liquidation, and
- if liabilities at any time in the process exceed $250,000 to unrelated entities the streamlined liquidation process would no longer be available and the existing creditors' voluntary liquidation requirements would apply.

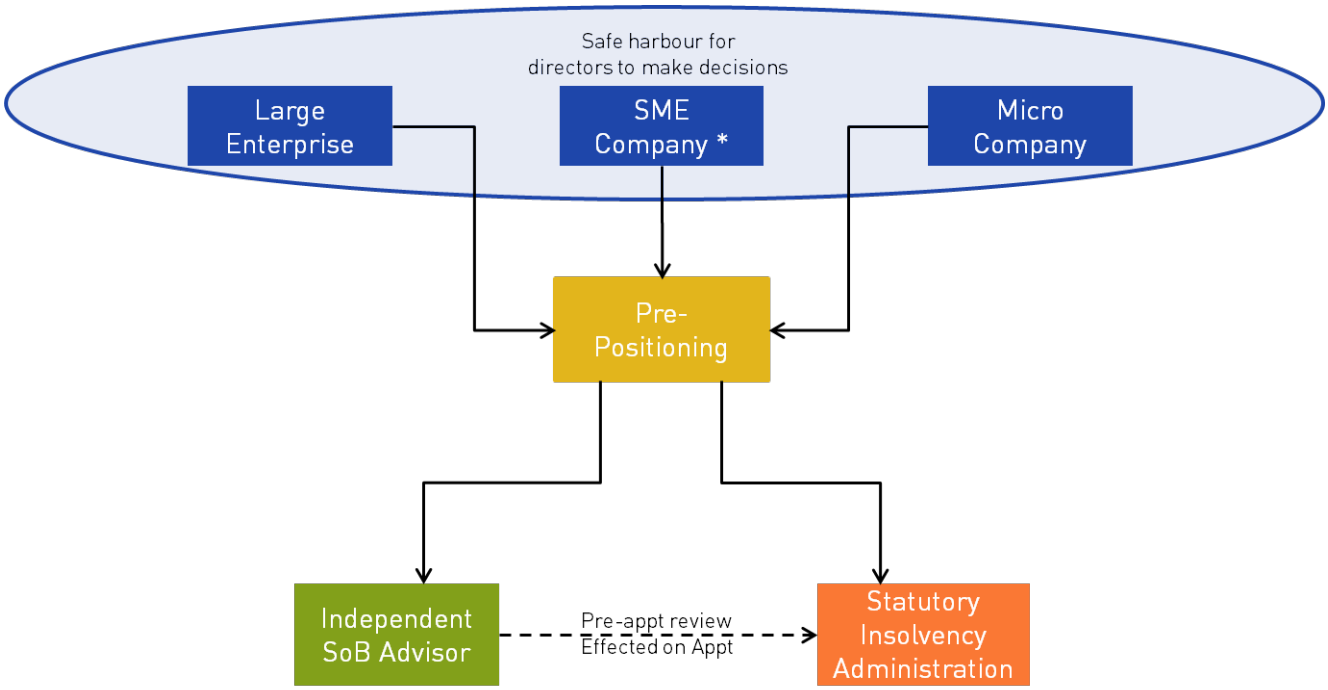
11 Pre-positioned sales

Issue

- Enabling viable businesses to continue and maximise return for creditors, via a sale of business negotiated prior to the appointment

Solution

- Pre-positioning



As a general position, ARITA supports the restructuring and turnaround of viable businesses suffering financial distress. A key aspect of this is an economic and legal environment that supports business restructuring and turnaround. ARITA's safe harbour proposals are a fundamental part of developing that environment.

There has been some call to 'legalise' or promote UK style pre-packs within Australia as another restructuring / turnaround tool in the toolkit of the restructuring specialist.

As part of our consideration of what should be done to promote restructuring and turnaround in Australia, ARITA has given detailed consideration to whether a pre-pack style arrangement should be introduced into Australia.

For a number of reasons, including independence, whether the sale is for value and the lack of creditor involvement, which are discussed in more detail at Appendix B, we do not consider that a UK pre-pack process would be suitable for Australia. However, we see that there is a role for 'pre-positioning' in the Australian insolvency context. What do we mean by pre-positioning? Pre-positioning is work done prior to a statutory insolvency appointment, with directors taking advantage of the safe harbour protections, subject to meeting the criteria for eligibility, to undertake an orderly wind down of the company's operations – that is a well-managed process where assets may be realised for market value in a non-distressed sale – prior to making a formal insolvency appointment. Directors may obtain the assistance of advisors, including insolvency practitioners, during this process.

The main differences between the UK's pre-packs and ARITA's proposed pre-positioning are:

- Any advisor retained by the directors in the pre-positioning phase cannot subsequently be appointed in any formal insolvency administration. This is consistent with the current and appropriate, independence requirements for insolvency practitioners in Australia.
- Any sales that occur in the pre-positioning phase must be for value and would be subject to review in any subsequent statutory insolvency administration.
- Any sale of assets undertaken during the statutory insolvency administration, where the terms of sale were negotiated in the pre-positioning phase, would be subject to review by the external administrator prior to being effectuated and the external administrator would be subject to the currently existing statutory and professional requirements regarding the sale of assets.

It is ARITA's view that consideration should be given to restricting the sale of company assets/business to related entities during this pre-positioning phase. Rather where the sale of a business or the assets to a related entity is contemplated, and the company is insolvent, that sale must be undertaken under the control of an independent insolvency practitioner through a statutory insolvency regime – either a VA (subject to ARITA's recommendations for improvements), a Micro restructuring (refer to section 10.1 above) or liquidation.

Annexure A - Restructuring Mechanisms – Overview

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Main objectives	A reorganization plan proposed by a debtor to keep its business alive and pay creditors over time	A regime whereby the principals of a company (owing its creditors in excess of $5 million) and its creditors are brought together under the supervision of the court to attempt a reorganization or compromise or arrangement under which the company could continue in business	A procedure that allows a company: • To settle debts by paying only a proportion of the amount that it owes to creditors. • To come to an arrangement with its creditors over the payment of its debts.	Binding, court-approved agreements that allow the reorganisation of the rights and liabilities of members and creditors of a company	Binding, court-approved agreements that allow the reorganisation of the rights and liabilities of members and creditors of a company	Provide a mechanism to maximise the chances of a business continuing in existence or at the very least, provide a better return to creditors	Generally the main objectives of the different mechanisms are substantially similar. However it should be noted the USA and Canadian models reflect the prioritisation business rehabilitation over the ultimate return to creditors, which remains a key focus in Australia. Promotion of Schemes as a viable and functional reorganisation tool, requiring a shift in the current focus.

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Director liability	No exposure to insolvent trading offences	Initial stay orders can be sought indemnifying directors so that those who are important to the restructuring will stay during the restructuring period	Offences for trading while insolvent – duty/responsibility to prioritise the interests of creditors		Offences for trading while insolvent	Offences for trading while insolvent	Early intervention would increase the likelihood of return to creditors – safe harbour provisions required where company acts in good faith to reorganise and meets criteria. Current necessity for precursor administration. Safe harbour provisions necessary to make Schemes a more useful restructuring tool for large enterprise

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Who is appointed/ oversees the process	Debtor in possession appointment - overseen by Bankruptcy Court Lawyers & other professionals (Insolvency Professionals) engaged, usually separate set of lawyers/IPs per stakeholder group: • Debtor company • Secured creditor(s) • Creditor committee • Employees	Debtor in possession appointment - overseen by monitor	Directors remain in control but supervised by nominee (IP)		Optional to appoint a Scheme Administrator, but if one is appointed they must be a Registered Liquidator or a person approved by the Court, i.e. CRO, (cannot be a director/manager/snr manager/employee) Debtor led administration - Scheme Administrator oversees scheme and does not run the business	Registered Liquidator – known as Voluntary Administrator /Deed Administrator	

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Stay of proceedings	As prescribed by law	Within the court's discretion Expressly prohibits enforcement of ipso facto clauses	If requested by the directors to the court	No moratorium but Scheme doesn't commence until approved by the Court after the meeting of creditors. This means that the Scheme needs to operate within the protection of another insolvency process to be used to restructure an insolvent company (due to insolvent trading laws).	Currently no moratorium but Scheme doesn't commence until approved by the Court after the meeting of creditors. This means that the Scheme needs to operate within the protection of another insolvency process to be used to restructure an insolvent company (due to insolvent trading laws).	As prescribed by law but does not extend to ipso facto clauses	Ipso facto clauses can have a detrimental impact on the ability of a business to continue (e.g. telecommunication businesses). The extension of the VA moratorium to ipso facto clauses would help preserve business viability. Application to the Court for Scheme to have standalone moratorium (incl. restriction on termination of contracts) so that undertaken outside of a VA/Liq process, but still have protection from creditor recovery action and preserve value

	Chapter 11 (USA)	CCAA (Canada)	CVA (UK)	Scheme of Arrangement (UK)	Scheme of Arrangement (Aus)	Voluntary Administration/ Deed of Company Arrangement (Aus)	ARITA Position/ Recommendation
Voidable Transactions	Unfair preferences: • Undo a transfer of money or property within 90 days before filing petition (subject to defences) • Transfers to relatives, general partners, directors/officers within 1 year before filing	Preferential transactions and transactions at undervalue recoverable	Not available	Not available	Not available	Not available	Extend director related payment recoveries to Schemes and VA/DOCAs– reduces misuse by directors to protect their own interests, but can be contracted out of
Financing	Debtor-in-possession allowed	Debtor-in-possession allowed	Not available		Subject to approval of the Court	Has been considered and approved by the Courts but no specific statutory provisions	We accept that cases have allowed third party financing in a VA/DOCA, but we believe there should be a recognised process for prioritising funding to enable a restructure via a Scheme or VA/DOCA.

Annexure B

What are 'pre-packs'?

A pre-pack administration occurs when an administrator sells the business at or soon after his or her appointment, often to the existing owners/directors. All the preparatory work for the sale is carried out in advance of formal administration and before the creditors have been told about the failure of the business.

UK Experience

The Graham Report into pre-packs has recently been released in the UK. This is timely to our consideration of pre-packs for Australia. The information in the Graham Report has been utilised when developing this paper.

In the UK pre-packs are undertaken through the Administration process, whereby an administrator can be appointed by the company, the directors or by the holder of a qualifying floating charge out of court. Immediately after appointment, the administrator transfers the business for a pre-agreed price without the need for a creditors' meeting to be called to consider the terms of the deal. The administrator then distributes the proceeds of sale. If there is no money for unsecured creditors, the administrator can immediately file for the dissolution of the company. If there are funds for the unsecured creditors, the administrator will usually be appointed as liquidator to make the distribution to unsecured creditors and then dissolve the company. In either situation, there is no independent insolvency practitioner undertaking a review of the steps taken.

Differences between the Australian and UK markets

A very different insolvency approach exists in the UK and Australia, where in the UK, in an Administration, if a creditor is 'out of the money[23]' they are essentially precluded from any decision making about the assets. In Australia, under current government policy, creditors (even those unlikely to receive any dividend) are entitled to be involved in the insolvency process and have a voice. Certainly the proposed Insolvency Law Reform Bill from 2013 proposes to further increase the role and powers of unsecured creditors in insolvency processes. ARITA has questioned whether this is a position that we should seek to lobby to change to align Australia with the approach taken in the UK. However, the view that we have taken is that it is appropriate for creditors to have a role in insolvencies as it is their money that has been lost and effectively the assets of the company are held for their benefit once the company is insolvent. Whether creditors wish to exercise that right and participate in the process is up to them; however it is important that they have that right.

Unlike Australia, the UK no longer has a receivership mechanism. Often pre-packs undertaken through an Administration are effectively quasi receiverships in that the only creditors receiving a payment are secured creditors as the remaining creditors are out of the money. Therefore it is largely the secured creditors driving the decision making during the pre-

[23] The creditor is not going to receive a dividend – the debt is worthless. Where the administrator believes that no payment will be made to the unsecured creditors, there is no requirement for a meeting of creditors to be held at all in the administration.

pack. ARITA does not propose the abolition of receiverships in Australia at this time, therefore Receiverships work as a viable formal insolvency appointment for secured creditors. Alternatively, in the proposed safe harbour environment[24], secured creditors would be able to work with their clients to restructure or turnaround the business (which may involve a sale of the business for value) in a safe environment.

Independence of insolvency practitioners appointed in a formal insolvency in Australia has a test of real and reasonably perceived independence which is incompatible with the UK system of practitioner involvement in the sale process prior to appointment. Whilst the UK also has independence requirements, it is a system of threat identification and management which allows for practitioner pre-appointment involvement in the pre-pack process.

Key risks with UK pre-packs

- Lack of independence of the practitioner involved – usually it is the same practitioner advising pre-appointment and appointed in the subsequent formal insolvency.
- Lack of transparency in the pre-pack process and guidance such as SIP16 does not seem to resolve creditor concerns in respect of this issue.
- Valuations are of dubious value to the process with sales made at the same $ as valuation particularly when sales are to related parties, and valuations often being only of real assets and not taking into account intangibles such as value of the business name, goodwill, intellectual property.
- Sale for undervalue as the business may not be appropriately marketed.
- Sale to a related party, often with deferred consideration – resulting in relatively high failure rate of the 'newco' (92 out of 310 connected sales in the UK study had failed within 36 months – 30%; increasing the 37% failure rate if there was also deferred consideration).
- The UK experience indicates that in 60% of pre-packs there was no distribution to unsecured creditors, so therefore in the majority of pre-packs there is no benefit of the process to unsecured creditors.
- Potential insolvent trading while the 'pre-pack' is being put together, though this is not as great a risk as if it were under the current Australian insolvent trading regime.

Key reported benefits

- Protects value of the business.
- Saves jobs.
- Pre-packs are cheaper than a formal insolvency process where the sale is undertaken.

Some comments on the UK Pre-packs report

- Pre-packs represent only 3.5% of insolvencies in the UK.
- Approximately 65% of all pre-packs resulted in sales to related parties.

[24] Subject to the company meeting the criteria to take advantage of the safe harbour protections.

- 60% of all pre-packs result in no dividend to unsecured creditors (though there may have been a payment to secured creditors).
- 86% of pre-packs with a sale to related parties result in no dividend to unsecured creditors (though there may have been a payment to secured creditors) – so essentially pre-pack sales to related parties return no value to unsecured creditors.
- 25.5% of all pre-pack sold businesses fail within 36 months of the purchase.
- Where it is a related party sale, this increases to 30% failure with 36 months (17.5% of business pre-pack sold to unrelated parties fail).
- Where there is a related party sale and deferred consideration the failure rate within 36 months increases to 37%.
- Deferred consideration generally results in higher failure rate with 36 months (nearly 39% failure).
- Of the 121 purchasers that failed within 36 months, 1/3 entered into a rescue procedure.

Alternatives in the Australian environment

1. Sale before formal insolvency – if the sale is 'for value' to a related party or via an arms-length sale during the pre-positioning phase, it will not result in the sale being challenged or recovery action by a subsequently appointed insolvency practitioner. It will however, provide opportunity for an independent review of the transaction with the benefit of creditors in mind. Practitioner appointed must be different to any practitioner advising the directors/company regarding the pre-appointment transaction to ensure independence in the review of the transaction.

   An issue with this approach is potential director liability for insolvent trading during the period of marketing and attempting to sell the business. ARITA's safe harbour proposal will resolve this issue for directors that meet the criteria to take advantage of the safe harbour protections. If the safe harbour proposals are introduced, it is difficult to argue that this will not provide sufficient protection for directors to allow them to achieve a sale. The safe harbour proposals provide protection for directors that are able to make informed decisions based on proper financial records and are getting appropriate professional advice. Should a business that cannot meet the basic requirements of proper financial records be able to be moved into another corporate entity, particularly where it is being controlled by the same parties?

   There may be an argument to say that related party sale (or restructure) should have to be undertaken through an appropriate formal insolvency process – see 2 below. Note that the UK has proposed legislation to ban related party pre-packs if the Graham report recommendation of the creation of a pre-pack pool to review related party sales is not implemented.

2. Formal insolvency administration – either VA (subject to ARITA's recommendations for improvements) or a Micro debt agreement (refer ARITA's SME thought leadership paper). If a sale to an entity controlled by the same parties is contemplated, then this can be achieved via the current VA regime or via the proposed new micro enterprise debt agreement regime. One argument is that where it is intended that related parties/the

company wants an opportunity for an insolvent business 'to have another go' it is appropriate that it is the creditors who should make the decision as to whether this is acceptable. When a company is insolvent, it is, in reality, the creditors' assets that are being dealt with and it should be their decision as to what happens with them.

Can the Australian options have the same benefits without the risks of the UK pre-pack system?

Benefit	Does the Australian pre-positioning alternative have the same benefits?
• Protects value of the business	Yes • Sale can occur pre-appointment as long as it is for value. • Safe harbour protections for informal restructuring/sale of business. • Improved VA process and new Micro Debt Agreement proposal.
• Saves jobs	• Business sales or restructures are able to be achieved with outside or within formal insolvency regime – saving jobs wherever there is a viable business to be saved.
• Pre-packs are cheaper than a formal insolvency process where the sale is undertaken	• Sale of business not limited to being undertaken via a formal insolvency. Where for value not subject to challenge. • Safe harbour proposals support directors where criteria met to support informal restricting/sale of viable businesses.

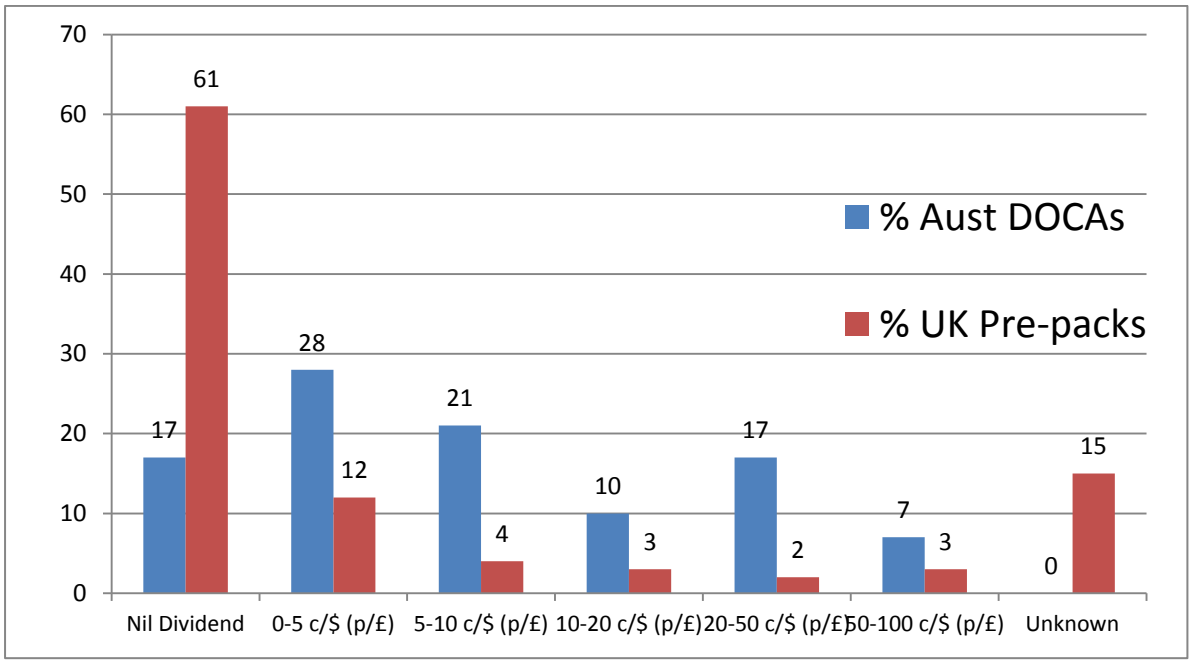
Risk	Does the Australian pre-positioning alternative address the risk?
• Lack of independence of the practitioner involved – usually it is the same practitioner advising pre-appointment and appointed in the subsequent formal insolvency.	• Independence of practitioner maintained as not involved in any pre-appointment sale or negotiation.
• Lack of transparency in the pre-pack process and guidance such as SIP16 does not seem to resolve creditor concerns in respect of this issue	• Independent practitioner will be reviewing any pre-appointment sales, or • creditors will have a right to have a say in any sales/restructuring occurring through a formal insolvency process.

Risk	Does the Australian pre-positioning alternative address the risk?
• Valuations are of dubious value to the process with sales made at the same $ as valuation particularly when sales are to related parties, and valuations often being only of real assets and not taking into account intangibles such as value of the business name, goodwill, intellectual property	• Independence of the insolvency practitioner undertaking the sale process (must comply with common law obligations), or • independent practitioner reviewing the sale that was undertaken prior to appointment – will have power to overturn sale if not for value.
• Sale for undervalue as the business may not be appropriately marketed	• Independence of the insolvency practitioner undertaking the sale process (must comply with common law obligations), or • independent practitioner reviewing the sale that was undertaken prior to appointment – will have power to overturn sale if not for value.
• Sale to a related party, often with deferred consideration – resulting in relatively high failure rate of the 'newco' (92 out of 310 connected sales in the UK study had failed within 36 months – 30%; increasing the 37% failure rate if there was also deferred consideration)	• Independence of the insolvency practitioner undertaking the sale process (must comply with common law obligations) and will assess the virtue of the offer. Creditors will also have a chance to be involved in the process, or • independent practitioner reviewing the sale that was undertaken prior to appointment.
• The UK experience indicates that in 60% of pre-packs there was no distribution to unsecured creditors, so therefore in the majority of pre-packs there is no benefit of the process to unsecured creditors	• The role of creditors in Australia means that a DOCA proposal is unlikely to be accepted if creditors don't get offered some type of return (refer to comparison table below). • Independent practitioner reviewing the sale that was undertaken prior to appointment – will have power to overturn sale if not for value.
• Potential insolvent trading while the 'pre-pack' is being put together, though this is not as great a risk as if it were under the current Australian insolvent trading regime	• Safe harbour proposals will resolve this issue for directors that can meet the criteria.

Compare returns in Australian DOCAs vs. UK Pre-packs

The Australian voluntary administration/deed regime is criticised for providing low returns to creditors. Mark Wellard has recently undertaken research for ARITA under the Terry Taylor Scholarship on returns from DOCAs in Australia. The results of this research were released around the same time as the Graham Report into Pre-packs. Subsequent to the release of his

findings, Mr Wellard has prepared an addendum which compares the returns in pre-packs with the returns in DOCAs. The findings are as follows:



It should be noted that the returns in Administrations in the UK not involving a pre-pack sale are similar to that for pre-packs[25].

Mr Wellard made the following observations in his addendum:

Australian DOCAs and UK pre-packs cannot purely be compared on a 'like-with-like' basis due to inevitable differences in the features and nuances of the respective regimes and legal frameworks operating in each jurisdiction. For example, I understand that significant or 'substantial' secured creditors (charge holders) are more prevalent stakeholders in UK pre-packaged administrations due to the inability of a UK secured creditor to appoint an 'administrative receiver' (the UK equivalent to Australia's 'receiver and manager'). In Australia, secured creditors invariably 'stand outside' a DOCA (indeed, in the cases of Australian SME companies it appears that often there is no substantial charge holder involved at all).

Notwithstanding the imperfections of jurisdictional comparisons, it does appear that Australian DOCAs perform relatively well for unsecured creditors in comparison with the UK 'pre-pack' procedure.

This demonstrates that although the regime in Australia could be improved to better facilitate the restructuring and turnaround of viable businesses, it may not be as unsuccessful as first thought.

[25] The Wolverhampton report concludes section B2.5 by stating that '[t]he data available does not show a substantial difference between the levels of distributions to unsecured creditors, as a proportion of overall debts, made in either pre-pack or trading administrations.'