Partner: James Marshall
Contact: Vincent Jewell
[redacted]

Ashurst Australia
Level 11
5 Martin Place
Sydney NSW 2000
Australia

GPO Box 9938
Sydney NSW 2001
Australia

Tel +61 2 9258 6000
Fax +61 2 9258 6999
DX 388 Sydney
www.ashurst.com

27 May 2016

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

ashurst

Dear Sir/Madam

Treasury Proposals Paper: Improving bankruptcy and insolvency laws

This submission comments on the safe harbour and ipso facto clause aspects of the Treasury Proposals Paper released at the end of April 2016, *Improving bankruptcy and insolvency laws* (the 2016 Treasury Paper).

It does not comment on the proposal to reduce the default bankruptcy period.

1. Summary of Ashurst Submission

1.1 Safe harbour

Ashurst sees a need for directors to have a safe harbour from liability for insolvent trading, to enable them to pursue corporate restructuring.

Ashurst favours a modified liability approach based on Model B in the Proposals Paper, rather than the restructuring adviser defence proposed in Model A. However, Ashurst proposes varying the elements of Model B so that they refer to a director's overall course of conduct, rather than the incurring of a particular debt, as follows:

> Section 588G does not apply:
>
> (a) if ***the director's course of conduct around the time the*** debt was incurred ***was*** part of reasonable steps to maintain the company's solvency or return the company to solvency within a reasonable period of time; and
>
> (b) the person held the honest and reasonable belief that the ***course of conduct*** was in the best interests of the company and its creditors as a whole; and
>
> (c) ***it was reasonable to expect that the course of conduct would*** not materially increase the risk of serious loss to creditors.

Ashurst also draws attention to the United Kingdom wrongful trading approach as a possible model for reform in this area.

1.2 Ipso facto clauses

Ashurst supports a restriction on ipso facto clauses that would operate on:

- appointment of an administrator

- a company undertaking a scheme of arrangement to avoid administration or insolvent liquidation
- a company entering a deed of company arrangement.

Ashurst queries whether the restriction should apply in a receivership or controllership.

The restriction should apply automatically, without the need for a court order. It should apply to any type of contract (including those entered into before enactment of the legislation), other than those that come within the specified exceptions. It should prohibit:

- termination of the contract (or any term of the contract)
- amendment of the contract (or any term of the contract)
- the acceleration of payments
- the imposition of new arrangements for payment
- a requirement to provide additional security for credit.

There should be an anti-avoidance provision (any potential overreach of which would be counteracted by appropriate exceptions and a court power to override the ipso facto clause restrictions).

For the sake of commercial certainty, the legislation should explicitly acknowledge that the restriction on ipso facto clauses does not affect other contractual obligations.

There should be exceptions from the restrictions on ipso facto clauses for:

- secured and unsecured lending and associated security arrangements (including leasing)
- rights of set-off
- securitisation structures
- the current right of a creditor with a security interest over the whole, or substantially the whole, of the property of a company under administration to take enforcement action
- the current rights of a secured creditor to enforce the security interest prior to the commencement of an administration (otherwise the anti-avoidance provision may affect these rights)
- lessors' rights (the current limitations on the rights of a lessor upon an insolvency that are already included in *Corporations Act* s 440B are sufficient).

If credit sales contracts come within the restriction on ipso facto clauses, the legislation should ensure that external administrators have personal liability for obligations arising under those contracts.

The court should have the power to override ipso facto clause restrictions in appropriate circumstances.

2. Safe harbour

2.1 Overview

This section summarises the current Australian law on insolvent trading and examines four approaches to providing a safe harbour from insolvent trading liability for directors:

- **Approach 1:** potential procedural restructuring alternatives
- **Approach 2:** defences to insolvent trading liability
- **Approach 3:** court power to protect directors from insolvent trading liability
- **Approach 4:** modification of the liability elements of the insolvent trading provisions.

It concludes with Ashurst's view on the best approach to director safe harbour.

2.2 Current law on insolvent trading

Under the current law, directors of a company who allow the company to trade while it is insolvent can be liable to pay for the loss or damage caused by the company's insolvent trading. If the directors act dishonestly, they commit an offence.

There is currently no safe harbour defence to this potential liability that would leave directors in control of the company and protect them while they seek to develop and implement a restructuring for the company.

A director of a company is civilly liable for insolvent trading if, when the company incurs a debt:

- the company is insolvent or becomes insolvent by incurring that debt and any other contemporaneous debts
- the director is aware at that time of reasonable grounds for suspecting that the company is already insolvent, or would by incurring the debt become insolvent, or a reasonable person in a like position in a company in the company's circumstances would be so aware.[1]

Once a director concludes that the company is insolvent, the only course of action to avoid liability is to cause the company to cease trading (where trading involves the incurring of debts) or appoint a voluntary administrator.

There are the following defences to civil liability for insolvent trading:[2]

- reasonable grounds to expect that the company was solvent when the debt was incurred and would remain solvent even if it incurred that debt and any other contemporaneous debts
- reasonable reliance on a competent and reliable person who is responsible for providing adequate information about the company's solvency
- non-participation in the management of the company because of illness or for some other good reason
- taking all reasonable steps to prevent the company from incurring the debt, including by the appointment of an administrator under Part 5.3A of the *Corporations Act* (the reasonable steps defence).

A director can also seek whole or partial relief from this civil liability if the director has acted honestly and, having regard to all the circumstances, ought fairly to be excused,[3] though the grant of this relief is at the court's discretion.

A director is criminally liable for insolvent trading if, when the company incurs a debt:

---

1 *Corporations Act 2001* (Cth) (*Corporations Act*) s 588G(1), (2).

2 *Corporations Act* s 588H.

3 *Corporations Act* ss 1317S, 1318.

- the company is insolvent or becomes insolvent by incurring that debt and any other contemporaneous debts (this element is identical to the equivalent civil liability element)
- the director suspected the company's insolvency
- the director's failure to prevent the company incurring the debt was dishonest.[4]

The court can order a person found guilty of this offence to pay compensation.

The amount for which a director can be liable, whether the relevant contravention is civil or criminal, is an amount equal to the amount of the loss or damage suffered in relation to the debt because of the company's insolvency.[5] This amount can be recovered by the liquidator[6] or by a creditor who has obtained the liquidator's consent or the leave of the court.[7]

The insolvent trading provisions are based on a recommendation of the *General Insolvency Inquiry* report of the Australian Law Reform Commission, popularly known as the Harmer Report, after the Commissioner-in-charge of the review, Ron Harmer.[8]

A similar provision was recommended by one of the major reviews of insolvency law in the United Kingdom, *Insolvency Law and Practice: Report of the Review Committee* (1982),[9] popularly known as the Cork Report after the Committee's Chairman Sir Kenneth Cork. However, this recommendation was not adopted. Instead, the United Kingdom Parliament enacted the wrongful trading provision discussed below in Section 2.6.2.

2.3 Approach 1: procedural restructuring alternatives

2.3.1 Inadequacy of VA as a safe harbour

While the current law protects the directors of a company from ongoing liability for insolvent trading when they place the company into voluntary administration (VA), it requires them to surrender control of the company to an independent administrator.

Also, there is a perceived stigma associated with the initiation of VA, as well as the possible incurring of significant administrative costs.

An additional problem with reliance on VA as a safe harbour is that the commencement of a VA can trigger the operation of ipso facto clauses. This problem could be resolved to a significant degree by the adoption of restrictions on the operation of ipso facto clauses, as proposed in the 2016 Treasury Paper.

2.3.2 Moratorium unconnected with external administration

A Treasury options paper published in 2010, *Insolvent trading: A safe harbour for reorganisation attempts outside of external administration* (the 2010 Treasury Paper), sought views on a procedure whereby a company could invoke a moratorium from civil liability under the insolvent trading laws by informing the market (including existing creditors and potential new creditors) that the company was insolvent and intended to pursue a workout outside of external administration.

The paper suggested the following possible preconditions for declaring a moratorium:

---

4 *Corporations Act* s 588G(3).

5 s 588M.

6 *Corporations Act* s 588M(2).

7 *Corporations Act* ss 588M(3), 588R, 588S, 588T.

8 ALRC 45 (1988), paras 283-325.

9 Cmnd 8558. See the proposed draft clause at para 1806.

- the company is currently, or is in imminent danger of becoming, insolvent (or its current or imminent solvency cannot reasonably be ascertained), and

- it is in the interests of creditors as a whole that an attempt be made to reorganise the affairs of the company outside of, rather than under, external administration.

2.3.3 Formal safe harbour procedure

The Productivity Commission Draft Report *Business Set-up, Transfer and Closure* (May 2015) proposed a formal safe harbour procedure that would allow directors to retain control of the company while receiving formal advice about restructuring options from registered advisers.

The duty of directors not to trade while insolvent would be considered to be satisfied during the period of advice and for actions directly related to implementing the advice, provided that, in informing themselves and the adviser and determining whether to act on any restructuring advice, the directors exercised their business judgment in the best interests of the company's creditors as a whole, as well as of the company's members.[10]

As mentioned in Section 2.4.4 below, the Productivity Commission subsequently recommended a safe harbour defence instead of this formal procedure.

2.4 Approach 2: defences

2.4.1 Business judgment rule

The 2010 Treasury Paper also raised the option of adding a business judgment rule (BJR) to the insolvent trading provisions.

Directors would be taken to have satisfied their duty not to trade while insolvent if they satisfied the proposed BJR, which would contain the four BJR elements that currently apply to the director's duty of care and diligence,[11] as well as four additional elements.

The current BJR elements are that the director:

- makes the judgment in good faith for a proper purpose

- does not have a material personal interest in the subject matter of the judgment

- informs himself or herself about the subject matter of the judgment to the extent he or she reasonably believes to be appropriate

- rationally believes that the judgment is in the best interests of the corporation.

The proposed additional insolvent trading BJR elements were:

- the financial accounts and records of the company presented a true and fair picture of the company's financial circumstances

- the director was informed by restructuring advice from an appropriately experienced and qualified professional, with access to those accounts and records, as to the feasibility of and means for ensuring that the company remained solvent or that it was returned to a state of solvency within a reasonable period of time

- it was the director's business judgment that the interests of the company's body of creditors as a whole, as well as of members, were best served by pursuing restructuring

---

10 Draft Recommendation 15.2.

11 *Corporations Act* s 180.

- the restructuring was diligently pursued by the director.

This approach was generally supported by the Law Council of Australia, the Australian Restructuring Insolvency & Turnaround Association (ARITA) (including in its publication *A Platform for Recovery 2014: Dealing with Corporate Financial Distress in Australia: A Discussion Paper*) and the Turnaround Management Association Australia, subject to deletion or modification of the second s 180 element (absence of material personal interest) to take account of the situations of directors who are also employees, shareholders, creditors on director loan accounts or sources of fresh capital for a corporate restructuring.[12]

2.4.2 Honest and reasonable director defence

In *The Honest and Reasonable Director Defence: A proposal for reform* (2014), the Australian Institute of Company Directors proposed a more general "honest and reasonable director" defence to any statutory liability (including, but not limited to, liability for insolvent trading) or its general law equivalent. The defence would apply where "a director acts (or does not act) and does so honestly, for a proper purpose and with the degree of care and diligence that the director rationally believes to be reasonable in all the circumstances".

2.4.3 Amended reasonable steps defence

It has been suggested that the reasonable steps defence (taking all reasonable steps to prevent the company from incurring the debt, including by the appointment of an administrator[13]) could be amended to provide a clearer due diligence defence.[14] This defence could be amended to make it clear that debts incurred during a good faith attempt to save the business will not contravene the insolvent trading prohibition. For instance, it might be a defence if it is proved that, when the debts were incurred:

- the person took all reasonable steps to ensure that the debts incurred were necessary in order to allow the company to restructure its affairs for the purposes of returning to a solvent state within a reasonable amount of time; and

- in seeking to restructure the company's affairs, the person acted in good faith in the best interest of the company and with due care and diligence.

2.4.4 Restructuring adviser (Model A)

Model A in the 2016 Treasury Paper is a defence to insolvent trading liability.

The Model A defence moves away from the broader BJR elements contained in the 2010 Treasury Paper discussed in Section 2.4.1 of this submission and focuses on the obtaining of advice from a restructuring adviser as the primary consideration, rather than as one of a number of relevant considerations. The defence proposed in the 2016 Treasury Paper would be available if the following elements were satisfied:

- a reasonable director would have an expectation, based on advice provided by a restructuring adviser, that the company can be returned to solvency within a reasonable period of time

---

12 Law Council of Australia, Insolvency Practitioners Association of Australia [now ARITA] and Turnaround Management Association Australia, *Joint Submission in relation to Insolvent Trading Safe Harbour Options Paper* (2 March 2010), para 5.3. The inapplicability in the context of insolvent trading of the requirement to have no material personal interest was also noted by J Harris, "Director liability for insolvent trading: Is the cure worse than the disease?" (2009) 23 *Australian Journal of Corporate Law* 266 at 282.

13 *Corporations Act* s 588H(5), (6)(a).

14 J Harris, "Director liability for insolvent trading: Is the cure worse than the disease?" (2009) 23 *Australian Journal of Corporate Law* 266 at 283.

- the director who is relying on the defence is taking reasonable steps to ensure that the company returns to solvency within a reasonable period of time

- the restructuring adviser:

    - is appropriately experienced, qualified and informed (the onus would be on the company's directors to ensure that the adviser's qualifications and experience were appropriate for the nature and circumstances of the company)

    - is provided with appropriate books and records within a reasonable period of his or her appointment to enable him or her to form a view about the viability of the business

    - 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 (that is, that the company is "viable").

This defence is based on a recommendation of the Productivity Commission Report *Business Set-up, Transfer and Closure* (September 2015, released in December 2015 with the Government's National Innovation and Science Agenda) (the Productivity Commission Report).[15]

2.5 Approach 3: court power

2.5.1 Current court power (Corporations Act ss 1317S, 1318)

Under the current law, a director can seek whole or partial relief from civil liability for insolvent trading if the director has acted honestly and, having regard to all the circumstances, ought fairly to be excused.[16]

Relief from civil liability on this basis has been successfully sought.[17] However, this relief is at the court's discretion and in practice the discretionary nature of the relief does not give directors sufficient confidence to risk liability for insolvent trading in pursuing a restructuring.

Also, the court powers only operate retrospectively, not prospectively.[18] However, a prospective court relief power may not be workable. Courts may be reluctant to make what are effectively commercial decisions. The Cork Report, even though it favoured a court discretion to permit insolvent trading in appropriate circumstances, recognised that "the Courts, chary of being found to have condoned what later proves to have been insolvent trading, may, by refusing the relief sought, bring about the closure of businesses which might otherwise have survived".[19]

2.5.2 Cork Report

The Cork Report proposed a court exoneration power along the lines of the Australian provisions.[20]

However, the Cork Report also proposed[21] that the company concerned or any person who considers that he or she is or may become party to its wrongful trading should be able to apply to the Court in Chambers for relief in advance. The Report gave the following examples of the sort of declarations that the Court might make:

---

15 Recommendation 14.2.

16 *Corporations Act* ss 1317S, 1318.

17 *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* [2009] FCA 1415. The provision relied on in that case was s 1317S, which is in substantially the same terms as s 1318.

18 *Edwards v Attorney General (NSW)* (2004) 60 NSWLR 667; 50 ACSR 122; 22 ACLC 1177; [2004] NSWCA 272 at [22]–[28].

19 para 1800.

20 para 1793.

21 para 1798.

- that trading for a specified period should not be wrongful;
- that unless or until a certain level of borrowing has been reached trading should not be wrongful;
- that trading with a view to completing certain existing or prospective contracts only should not be wrongful;
- that trading provided that the directors or others postpone loans or other accounts owing to them should not be wrongful;
- that trading on a cash basis should not be wrongful; and
- that if agents were under instructions to effect a sale of the company's premises trading pending the sale should not be wrongful.[22]

2.6 Approach 4: modified liability elements

Model B in the 2016 Treasury Paper is one example of a modified liability approach.

Under this approach, the elements of insolvent trading are modified, so that directors have more room to allow a company in financial difficulties to continue trading while they attempt an informal workout.

2.6.1 Model B in 2016 Treasury Paper

Model B would modify the insolvent trading prohibition by including additional elements. Under this model, the prohibition would not apply if:

- the debt was incurred as part of reasonable steps to maintain solvency or return the company to solvency within a reasonable period of time;
- 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
- incurring the debt does not materially increase the risk of serious loss to creditors.

The Treasury Paper states that these elements would modify the liability provision, rather than constitute a defence, and that a liquidator would have the burden of proving that none of these elements applied to a director.

2.6.2 UK wrongful trading provision

The United Kingdom has a wrongful trading provision, but its elements differ from those in the Australian insolvent trading provisions.

A director can be found liable for wrongful trading where:

- the company has gone into insolvent liquidation
- at some time before the commencement of the winding up, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation; and
- that person failed to take every step with a view to minimising the potential loss to the company's creditors.[23]

---

22 ibid.

23 *Insolvency Act 1986* (UK) s 214(2), (3).

For the purpose of a court's decision on whether a person is liable for wrongful trading:

> the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both—
>
> - the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and
>
> - the general knowledge, skill and experience that that director has.[24]

The wrongful trading provision therefore applies both an objective standard, thus setting a basic standard of conduct, and a subjective standard.

The application of the legislative standard was illustrated by the judgment in *Re Produce Marketing Consortium Ltd (No 2)*, in which the court commented:

> the requirement to have regard to the functions to be carried out by the director in question, in relation to the company in question, involves having regard to the particular company and its business. It follows that the general knowledge, skill and experience postulated will be much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures.
>
> Nevertheless, certain minimum standards are to be assumed to be attained. [The court went on to refer to certain requirements relating to accounting records and financial documentation.][25]

The UK wrongful trading provision is potentially broader than the Australian insolvent trading provisions and can encompass a greater range of conduct, because liability does not depend just on the incurring of debts: all sorts of activity can lead to liability, such as selling company assets at an undervalue and the payment of excessive remuneration to directors, as well as inactivity.[26]

The UK formulation would not impose liability simply for the incurring of debts while a company was insolvent, provided that the directors could reasonably expect that the company would trade out of its difficulties and avoid insolvent liquidation.[27] Even then, directors will not be liable if they "took every step with a view to minimising the potential loss to the company's creditors" as "they ought to have taken".[28] For instance, directors might be able to continue to incur debts on behalf of the company where they reasonably believed that, if there were a halt to business and a forced sale of assets, creditors would be prejudiced and it would be better to go on and either take action to rescue the company's business or sell assets in an orderly and beneficial fashion.[29]

Where a director is liable, the liability is effectively limited to the net loss suffered by the company between "the date at which it was contended that trading should have ceased and the date as at which trading did in fact cease".[30] The wrongful trading liability does not make a director liable for

---

24 *Insolvency Act 1986* (UK) s 214(4).

25 [1989] BCLC 520 at 550.

26 A Keay & M Murray, "Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) 14 *International Insolvency Review* 27 at 34.

27 id at 37.

28 id at 37-38.

29 A Keay & M Murray, "Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) 14 *International Insolvency Review* 27 at 34.

30 *Re Marini Ltd* [2004] BCC 172 at [68], approving the decision of Park J in *Re Continental Assurance Company of London plc* (24 October 2000, unreported).

all the qualifying debts incurred after a company becomes insolvent, as the Australian provision does.

Overall, the UK wrongful trading provision is more conducive to informal workouts than the Australian insolvent trading provisions.

2.6.3 New Zealand reckless trading provision

Another model for a director liability provision is the New Zealand reckless trading provision,[31] which states:

> A director of a company must not:
>
> (a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
>
> (b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

Reservations have been expressed about the drafting of this provision.[32]

2.7 Ashurst view on safe harbour

The key policy goal in reforming the insolvent trading provisions is to remove impediments to corporate restructuring by providing directors with sufficient confidence to be able to develop and implement corporate restructuring strategies (and sufficient certainty in relation to their risk of liability) where this is appropriate, whilst maintaining proper director conduct. Greater ease in achieving a successful restructuring to assist a company through a difficult period would, in turn, promote innovation.

While both Models proposed in the 2016 Treasury Paper would promote these goals better than the current insolvent trading provisions, Ashurst prefers Model B.

Model A has the following drawbacks.

- Although the model is formally expressed as an obligation on directors, it runs the risk of outsourcing the directors' responsibility to the restructuring adviser. Once a restructuring adviser has been appointed, directors may consider that effective responsibility for the company's affairs has passed to the adviser. However, the responsibility for the conduct of the company's affairs should always remain squarely with its directors.

- When a company gets into financial difficulties, a full view of the steps involved in restructuring the company's affairs requires legal advice as well as accounting advice. A legislative defence that referred only to a restructuring adviser may risk the focus being on accounting considerations only, rather than the full range of considerations that are relevant to a successful restructuring.

- Even though a company's directors may often seek professional advice when the company is experiencing financial difficulties, it seems unnecessarily restrictive to make the appointment of a restructuring adviser a compulsory element of a safe harbour. It would also potentially be unreasonably expensive for small business.

- As a matter of general principle, legislation should set goals without being unnecessarily prescriptive about how to meet those goals. Model A stipulates not only the goal (a return to solvency within a reasonable period of time), but also the only way of attaining the goal

---

31 *Companies Act 1993* (NZ) s 135.

32 See, for instance, "Directors' liability for reckless trading" (2004) 12 *Insolvency Law Journal* 121.

(the obtaining of advice from an appropriately experienced, qualified and informed restructuring adviser).

- Model A appears to provide directors with a safe harbour only if they follow the restructuring adviser's advice very closely, possibly to the letter. Directors may have good reasons for departing from the advice in various respects.

- The safe harbour will not be available if the directors fail to provide all "appropriate books and records", which may include documents that are only marginally relevant. In that event, the directors would remain exposed to insolvent trading liability.

- Model A contains various governance failures that would deprive a director of the safe harbour (acting while disqualified, being determined by ASIC or the court to be ineligible because of prior conduct, failure to lodge multiple Business Activity Statements, significant failure to pay employee claims, PAYG or employee superannuation). It seems inappropriate to make the safe harbour conditional on a director having met these governance requirements, which have their own enforcement regimes. Problems in these governance areas should be dealt with by improved enforcement and, if necessary, by amending the relevant provisions. It seems counterproductive to remove a director's safe harbour, in effect as an additional penalty for prior governance breaches that are unlikely to be related to the current circumstances, given that the safe harbour is aimed at preserving viable enterprises by promoting corporate restructuring.

In contrast with Model A, Model B would continue to place clear responsibility on directors.

In addition, Model B is an improvement on the current law, which favours the interests of new creditors of the company over those of existing creditors. It has the benefit that its element (c) (incurring the debt does not materially increase the risk of serious loss to creditors) directs the attention of directors to the overall financial position of the company from the time that it becomes insolvent. This is desirable, as directors should not be penalised if their course of conduct over a given period reduces the gap between the company's assets and its liabilities (whether by increasing the company's assets, by reducing its liabilities or by a combination of the two).

Another advantage of Model B is that, as pointed out in the Treasury Paper, it:

> contemplates safe harbour as a carve out, rather than a defence, and thus the burden of proof would lie on any liquidator bringing a claim to show that a director had breached any one of the three limbs of the provision.

Model B thereby provides an extra level of protection for directors who are making honest and diligent attempts to restore a company to solvency.

However, there is a potential problem with Model B. It is unclear how its element (c) fits in with its element (b). For instance, it may be necessary, as part of a corporate restructuring, to borrow further funds. This borrowing may harm creditors in the long run if the restructuring fails, even though the borrowing was reasonable in the circumstances.

A possible way to overcome this problem may be to vary the elements of Model B so that they refer to a director's overall course of conduct, rather than the incurring of a particular debt, as follows:

> Section 588G does not apply:
>
> (a) if ***the director's course of conduct around the time the*** debt was incurred ***was*** part of reasonable steps to maintain the company's solvency or return the company to solvency within a reasonable period of time; and
>
> (b) the person held the honest and reasonable belief that the ***course of conduct*** was in the best interests of the company and its creditors as a whole; and

(c) ***it was reasonable to expect that the course of conduct would*** not materially increase the risk of serious loss to creditors.

If Model B is adopted, either in its original form or as proposed by Ashurst, the legislation might direct the court to consider the company's balance sheet as an aid in determining whether there was a material increase in the risk of serious loss to creditors.

The United Kingdom wrongful trading provision, discussed in Section 2.6.2 of this submission, is similar to Model B in that it is based on the directors' overall course of conduct and does not place an onus on directors to make out a defence. The Government might have regard to that provision as a further option in deciding how to reform the insolvent trading liability. If an approach based on the UK provision finds favour, the element in the UK wrongful trading provision concerning the director's failure to take ***every step*** with a view to minimising the potential loss to the company's creditors might be replaced with an element that refers to a failure to take ***reasonable steps***.[33]

3. Ipso facto clauses

3.1 Conceptual framework

An analysis of current and proposed legislative restrictions on ipso facto clauses needs to cover the following matters:

- the types of contract affected by ipso facto clause restrictions
- the characteristics of ipso facto clauses that are targeted by the legislation, being:
  - the prohibited triggering events (for instance, insolvency of the company, entry of the company into external administration)
  - the prohibited contractual consequences (for instance, termination of the contract, modification of the contract, acceleration of a payment under the contract)
- the manner in which the legislative provision operates, in particular:
  - whether the provision operates automatically or, alternatively, empowers the court to make an order overriding the ipso facto clause[34]
  - whether the legislative restriction explicitly acknowledges that it does not affect other contractual obligations
- the circumstances in which a restriction would not apply, in particular:
  - what, if any, exceptions should there be to the legislative prohibition or restriction
  - whether the court has a power to override the restriction.

3.2 Current law

3.2.1 Australia

There are restrictions in Australia on the operation of ipso facto clauses in relation to individuals[35] and certain types of commercial entities.[36]

---

[33] See A Keay & M Murray, "Making Company Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia" (2005) 14 *International Insolvency Review* 27 at 45-46, 53.

[34] For instance, the report of the Parliamentary Joint Committee on Corporations and Financial Services *Corporate Insolvency Laws: A Stocktake* (2004) recommended (at para 12.34) that administrators have the right to apply to a court for an order that a party to a contract may not terminate the contract by virtue of entry by a company into voluntary administration. The court would be required to be satisfied that the contracting party's interests will be adequately protected.

There are no restrictions on ipso facto clauses in relation to companies generally: ipso facto clauses are enforceable when a company goes into voluntary administration[37] or liquidation. However, there are restrictions on the exercise of possessory rights (for instance, restrictions on a lessor repossessing equipment) when a company goes into voluntary administration,[38] as well as a limitation on the right of suppliers of essential services to insist on payment as a condition of supply in certain circumstances.[39]

3.2.2 Other jurisdictions

3.2.2.1 United Kingdom

The situation in the United Kingdom is similar to that in Australia. There is no general prohibition on ipso facto clauses, but there are restrictions on the exercise of possessory rights when a moratorium applies.[40] There is also a provision relating to essential services that is similar to, though broader than, the equivalent Australian provision, as well as an ipso facto limitation relating to those essential services.[41]

3.2.2.2 United States

The United States imposes restrictions on ipso facto clauses. The restrictions have the following features:

- they apply to any executory contract or unexpired lease[42]
- the prohibited triggering events are the insolvency or financial condition of the debtor, the commencement of a bankruptcy case (which need not relate to the company affected by the ipso facto clause) or the appointment of, or taking possession by, a trustee or a custodian[43]
- the prohibited contractual consequences are the termination or modification of the executory contract or unexpired lease or of any right or obligation under such a contract or lease[44]

---

35 *Bankruptcy Act 1966* (Cth) ss 301, 302. Similar provisions apply to superannuation funds, retirement savings accounts and trust deeds: ss 302A, 302AB, 302B.

36 Authorised deposit-taking institutions (ADIs), general insurers, life companies. See *Banking Act 1959* (Cth) ss 11CD, 14AC, 15C; *Insurance Act 1973* (Cth) ss 62V, 62ZB, 105; *Life Insurance Act 1995* (Cth) ss 165B, 168C, 230C; *Financial Sector (Business Transfer and Group Restructure) Act 1999* (Cth) s 36AA.

37 The matters covered by the moratorium provisions in Part 5.3A Div 6 do not include the enforcement of contractual rights generally. The moratorium only covers winding up the company, rights to sell property or otherwise enforce a security interest, rights to take possession of property, and beginning or proceeding with court proceedings or enforcement process.

38 *Corporations Act* s 440B.

39 *Corporations Act* s 600F.

40 *Insolvency Act 1986* (UK) Schedule A1.

41 *Insolvency Act 1986* (UK) ss 233, 233A. The scope of the UK provision was broadened from 1 October 2015.

42 Bankruptcy Code s 365(e). P Rubin, "Not every ipso facto clause is unenforceable in bankruptcy" (2013) *American Bankruptcy Institute Journal* 12, note 4 observes:

> The Bankruptcy Code does not define the term "executory contract". As noted in *In re Perm Traffic Co.* 524 F.3d 373, 379 (2d Cir. 2008), most courts and scholars look to the Countryman test, which defines an "executory contract" as a "contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." Vernon Countryman. "Executory Contracts in Bankruptcy: Part 1," 57 Minn. L. Rev. 439, 460 (1973). If the performance of one side of the contract has been completed, it is no longer executory.

43 Bankruptcy Code s 365(e)(1).

44 ibid.

- the ipso facto clause is rendered inoperative by force of the legislation, without any need for a court order
- there is no explicit statement that the legislative restriction does not affect any other contractual obligation
- the restrictions apply in any case that is under the Bankruptcy Code (which can include liquidations as well as reorganisations)
- there are exceptions for contracts to extend debt financing or financial accommodation[45] and various financial markets contracts[46]
- there is no court power to override these restrictions in particular cases.

3.2.2.3 Canada

Canada also imposes restrictions on ipso facto clauses.

The Canadian restrictions are contained in the *Bankruptcy and Insolvency Act*[47] and the *Companies' Creditors Arrangement Act*.[48]

The restrictions have the following features:

- they apply to any agreement, including a security agreement[49]
- the prohibited triggering events are that the company is insolvent, that certain proceedings have been commenced or (in the case of a lease) non-payment of rent[50]
- the prohibited contractual consequences are the termination or amendment of an agreement or a claim for an accelerated payment or forfeiture of a term[51]
- the ipso facto clause is rendered inoperative by force of the legislation, without any need for a court order
- there is no explicit statement that the legislative restriction does not affect any other contractual obligation
- corporate bankruptcies and receiverships are not affected by the legislative restrictions on ipso facto clauses[52]
- there are exceptions to enable a counterparty to require immediate payment for further supply,[53] to refuse to advance further money or credit[54] and to cease to act as a clearing agent or group clearer,[55] as well as to exclude various financial markets contracts[56]

---

45 Bankruptcy Code s 365(e)(2)(B).

46 Securities contracts (s 555), commodity contracts (s 556), forward contracts (s 556), repurchase agreements (s 559), swap agreements (s 560) and master netting agreements (s 561) (all provisions are in the Bankruptcy Code).

47 s 65.1.

48 s 34.

49 *Bankruptcy and Insolvency Act* s 65.1, *Companies' Creditors Arrangement Act* s 34.

50 *Bankruptcy and Insolvency Act* s 65.1(1), (2) (the latter provision also stipulates, in the case of a licensing agreement, non-payment of royalties), *Companies' Creditors Arrangement Act* s 34(1), (2).

51 *Bankruptcy and Insolvency Act* s 65.1(1), *Companies' Creditors Arrangement Act* s 34(1).

52 The ipso facto clause restrictions in the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act* apply only in relation to statutory restructuring procedures that serve the same purpose as the Australian scheme of arrangement and deed of company arrangement procedures.

- the court has a power to override the ipso facto clause restrictions in the case of "significant financial hardship".[57]

Canada also has separate ipso facto-type restrictions relating to essential services.[58]

3.3 The Treasury Paper Ipso Facto Model

3.3.1 Affected agreements

3.3.1.1 Treasury Paper approach

The proposed restrictions would apply to any type of contract or agreement.

3.3.1.2 Ashurst view

Ashurst agrees that there should be no limitations on the type of contract or agreement to which the restrictions would apply, other than those that come within the exceptions discussed in Section 3.3.5.2 of this submission.

While the agreements covered by the *Bankruptcy Act 1966* (Cth) restrictions in relation to individuals are limited to sale or lease of property, hire-purchase agreements and various types of security agreements, Ashurst does not consider that it is appropriate for there to be any similar limitation in relation to companies. Limitations, where necessary, should be contained in the specified exceptions discussed in Section 3.3.5.2 of this submission, rather than in the description of the type of affected agreement.

We note that the Australian Law Reform Commission, in its General Insolvency Inquiry, had initially proposed preventing the operation of ipso facto clauses in agreements for the sale or lease of property, in line with the *Bankruptcy Act* provision.[59] In response to submissions, the Harmer Report extended the proposed prohibition to cover any agreement (other than a charge) to which an insolvent company is a party.[60] The report referred, by way of example, to building contracts, which:

> invariably provide that if an event of insolvency affects the builder then the contract may be forthwith terminated. Many commentators have pointed out that an event of insolvency does not necessarily imply that the builder cannot complete contracts. But because of the usual termination provisions in building contracts there is little prospect of being able to continue with those contracts which might be profitable and which might be completed to the advantage of the parties to the contract and the creditors.[61]

3.3.2 Prohibited triggering events

3.3.2.1 Treasury Paper approach

The model proposes restrictions on ipso facto clauses that apply by reason only that an "insolvency event" has occurred. In the model, "insolvency event" would include:

---

53 *Bankruptcy and Insolvency Act* s 65.1(4)(a), *Companies' Creditors Arrangement Act* s 34(4)(a).

54 *Bankruptcy and Insolvency Act* s 65.1(4)(b), *Companies' Creditors Arrangement Act* s 34(4)(b).

55 *Bankruptcy and Insolvency Act* s 65.1(7)(b), *Companies' Creditors Arrangement Act* s 34(7)(b).

56 *Bankruptcy and Insolvency Act* s 65.1(7)(a), (9), (10), s 2, *Companies' Creditors Arrangement Act* s 34(7)(a), (8)-(10), s 2.

57 *Bankruptcy and Insolvency Act* s 65.1(6), *Companies' Creditors Arrangement Act* s 34(6).

58 Canadian *Bankruptcy and Insolvency Act* s 65.1(3), Canadian *Companies' Creditors Arrangement Act* s 34(3)).

59 Australian Law Reform Commission *General Insolvency Inquiry* Discussion Paper 32 (1987) (DP 32) para 462.

60 ALRC 45 vol 1 at paras 704-705.

61 id at para 704.

- appointment of an administrator
- a company undertaking a scheme of arrangement to avoid administration or insolvent liquidation
- appointment of a receiver or controller
- a company entering a deed of company arrangement.

3.3.2.2 Ashurst view

A restriction on ipso facto clauses is sensible for a collective procedure such as a voluntary administration, a deed of company arrangement or a scheme of arrangement. However, Ashurst queries the inclusion of the appointment of a receiver or a controller in the proposed insolvency events. Receivership and controllership are generally related to debt recovery, rather than restructuring. Also, a receiver or a controller can be appointed to some only of a company's property. At the very least, the relevant insolvency event should be limited to the appointment of a receiver or a controller over all, or substantially all, of a company's property.

Ashurst agrees with the other proposed triggering events.

Ashurst notes that the Harmer Report recommendation would also have rendered ipso facto clauses void against the liquidator in a winding up[62] and that the restrictions in the United States apply in corporate bankruptcies as well as corporate restructurings.

Also, some liquidations may result in the sale of a company's business as a going concern. Where this is a possibility, it could be seen as desirable to prevent the company's counterparties from terminating ongoing contracts, to maximise the value to be derived from the sale of the business.

However, liquidations usually last far longer than restructurings. It would be an unreasonable imposition to require continued performance for this extended period of contracts that counterparties would have preferred to terminate.

3.3.3 Prohibited contractual consequences

3.3.3.1 Treasury Paper approach

The proposed model would affect any contractual term that would:

- terminate the contract (or any term of the contract)
- amend the contract (or any term of the contract).

The Treasury Paper also asks if there should be any other prohibited contractual consequences and suggests the following possibilities:

- the acceleration of payments
- the imposition of new arrangements for payment
- a requirement to provide additional security for credit.

The proposed model would also contain an anti-avoidance provision that renders ineffective any provision in an agreement that has the effect of providing for, or permitting, anything that in substance is contrary to the primary ipso facto clause prohibition.

---

62 ALRC 45, vol 1 para 705, vol 2 draft s AT10.

3.3.3.2 Ashurst view

Ashurst agrees that restrictions should be placed on ipso facto clauses that terminate or amend a contract. It also supports the proposed anti-avoidance provision.

Furthermore, Ashurst supports the proposed additional prohibited contractual consequences (payment acceleration, new payment arrangements, additional security requirements). These additional matters are likely to have a similar effect on the continued operation of a company as termination or amendment of a contract and therefore to be caught by the proposed anti-avoidance provision. Given this, it would be better for the legislation to refer to them explicitly.

Any potential overreach arising from this approach should be counteracted by appropriate exceptions (discussed in Section 3.3.5 of this submission) and a court power to override the ipso facto clause restrictions (discussed in Section 3.3.6 of this submission).

3.3.4 Effect of ipso facto clause restriction

3.3.4.1 Treasury Paper approach

The proposed legislative restriction would render the ipso facto clause void, without the need for a court order.

The Treasury Paper stipulates that the proposal would not extend the operation of the legislative provision beyond ipso facto clauses, so that counterparties would maintain their rights to terminate, amend, accelerate or vary their agreements for any reason other than the stipulated insolvency events, such as for a breach involving non-payment or non-performance.

The Paper also asks whether any such legislation should have retrospective operation.

3.3.4.2 Ashurst view

Ashurst agrees that the legislation should (subject to the exceptions discussed in Section 3.3.5.2 below) render ipso facto clauses void, without the need for a court order.

For the sake of commercial certainty, the legislation should also explicitly acknowledge that the restriction on ipso facto clauses does not affect other contractual obligations.

The legislation should apply to contracts entered into before enactment of the legislation as well as subsequent contracts (unless the contracts are excluded from the operation of the ipso facto clause restriction under the exceptions discussed in Section 3.3.5 of this submission). In many cases, this approach should involve little or no consequential risk, as the proposed restriction would not affect contractual rights arising from failure to perform. Also, the right to seek a court order to vary contractual terms could be used where, for instance, one of the prohibited triggering events affected the counterparty's credit risk rating or the cost of finance.

3.3.5 Exceptions

3.3.5.1 Treasury Paper approach

The Paper states that the Government intends to carve out certain "prescribed financial contracts" where uncertainty around the ability to enforce that type of contract represents a material risk to the efficiency, stability and liquidity of the capital markets which depend on them. These contracts would include swaps, certain derivatives and close-out netting arrangements under close-out netting contracts protected under the *Payment Systems and Netting Act 1998* (Cth) or its foreign equivalents.

The Paper also states that:

> Nothing in the operation of the provision would require any creditor to provide a further advance of money or credit.

3.3.5.2 Ashurst view

Ashurst supports the exception for prescribed financial contracts.

The legislation should also provide for the following carve-outs from the ipso facto clause restriction.

- There should be an exception for any secured and unsecured lending and associated security arrangements (including leasing), so that lenders can exercise their rights (for instance, to accelerate and enforce the payment of loans). This exception would include, but be wider than, an exception to permit a creditor not to provide a further advance of money or credit. The Treasury Paper states that nothing in the operation of the provision would require these advances. It is a matter for concern that this statement appears in the section of the Treasury Paper that deals with anti-avoidance. It should be covered by a clearly stated exception.

- The legislation should not interfere with rights of set-off.

- The legislation should exempt securitisation structures.

- The legislation should not interfere with the current right of a creditor with a security interest over the whole, or substantially the whole, of the property of a company under administration to take enforcement action. The ability of that type of creditor to stand outside the voluntary administration procedure is an important feature of that regime. It is aimed at ensuring the continued availability of reasonably priced secured credit, particularly from banks, by preserving their ability to move quickly to take control of secured property and minimise the risk of an erosion in the value of their security.

- The legislation should not interfere with the rights of a secured creditor to enforce the security interest prior to the commencement of an administration (widely drafted anti-avoidance language would be of concern).

- Legislation prohibiting ipso facto clauses should not restrict lessors' rights more than the existing legislation: the current limitations on the rights of a lessor upon an insolvency that are already included in *Corporations Act* s 440B are sufficient.

Furthermore, the US financial accommodation carve-out does not cover ordinary credit sales contracts (under which goods and/or services are supplied, with payment to be made later). This type of contract is therefore subject to the restriction on ipso facto clauses, even though such contracts technically involve a credit element. If the Australian financial accommodation carve-out takes the same approach, a supplier under a credit sales contract would only be protected by personal liability of the administrator or receiver under the Corporations Act if the relevant external administrator had taken some action to require supply: an external administrator has no personal liability if that person took no such action.[63] It may be necessary to extend the current personal liability to ensure that all suppliers under credit sales contracts are adequately protected, whether or not an external administrator has taken any further action to require supply.

3.3.6 Court power to override restriction

3.3.6.1 Treasury Paper approach

The Paper proposes a provision enabling affected counterparties to apply to the court to vary contract terms if they can show that they have suffered hardship.

3.3.6.2 Ashurst view

Ashurst supports a court power to override the ipso facto clause restrictions in appropriate circumstances.

---

63 *McMahon's (Transport) Pty Ltd v Ebbage* [1999] 1 Qd R 185, *AGL Victoria Pty Ltd v Lockwood* [2003] VSC 453.

However, it queries whether "hardship", which may be based on the "significant financial hardship" criterion in the Canadian legislation, is a sufficient criterion for exercise of the court power. For instance, a contractor in a public-private partnership may need to terminate or vary the contract where the assumptions underlying the contract no longer apply as a result of the insolvency of its counterparty. Circumstances such as this should be covered by the proposed court power.

Yours faithfully

Ashurst Australia