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Mr Mark Fitt
Committee Secretary
Senate Economics Legislation Committee

ashurst

Dear Mr Fitt

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

Thank you for your invitation to make a submission to the Senate Economics Legislation Committee Inquiry into the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 (the Bill).

The Bill deals with many of the points raised in Ashurst's submissions on the consultation documents that preceded the Bill (the Government Proposals Paper released at the end of April 2016, *Improving bankruptcy and insolvency laws*, and the Exposure Draft of the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017). Those submissions are forwarded with this submission.

This submission reiterates specific matters about which I continue to have concerns.

1. Summary of Submission

1.1 Safe harbour

I support measures to ameliorate the risk that directors may incur liability for insolvent trading while making bona fide attempts to pursue corporate restructuring.

I have the following specific comments on the safe harbour provisions in the Bill.

- I strongly support the Bill's approach of making the safe harbour provisions a carve-out rather than a defence.
- To promote certainty for directors, the safe harbour should require that the debt be incurred during the safe harbour period, with the words "directly or indirectly in connection with any such course of action" being deleted.
- There should be a definition of "entitlements" of an employee that is directly applicable to s 588GA(4).

1.2 Ipso facto clauses

I support restrictions on ipso facto clauses, with appropriate exceptions and other safeguards.

I have the following specific comments on the ipso facto provisions in the Bill.

- In order to ensure that the benefit of the ipso facto stay is available in the medium term, the legislation should extend to all contracts, agreements and arrangements, not just those entered into at or after the commencement of the amending legislation.

- The legislation should extend to ipso facto clauses that come into effect automatically on the happening of a specified triggering event, not just ipso facto clauses that confer rights on a counterparty.

- There should be an automatic stay on ipso facto clauses when a company is subject to a deed of company arrangement (DOCA), without the need to apply for an order to extend the stay period. The contract can only continue if the company is otherwise still performing its obligations post-DOCA. That should be sufficient protection for the other party.

- When a company is in transition from a scheme of arrangement or a voluntary administration (VA) to a winding up, the end of the stay on ipso facto clauses should be the date the liquidator is appointed, rather than when the company's affairs have been fully wound up.

2. Safe harbour

2.1 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 2001* (Cth) (the *Corporations Act*) (the reasonable steps defence).

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

2 *Corporations Act* s 588H.

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:

- 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]

2.2 Safe harbour provisions in the Bill

2.2.1 Elements of the safe harbour

The Bill proposes a safe harbour from civil liability for insolvent trading having the following features (s 588GA(1)):

- it will apply where directors start developing one or more courses of action that are reasonably likely to lead to a "better outcome" for the company
- the debt must have been incurred directly or indirectly in connection with the course of action
- the safe harbour period will start when the director starts to develop one or more courses of action after starting to suspect that the company may become or be insolvent
- the safe harbour period will end at the earliest of the following times:
  - the end of a reasonable period after a person starts to suspect the company's insolvency if the person fails to take the required course of action within that period
  - when the person ceases to take the course of action
  - when the course of action ceases to be reasonably likely to lead to a better outcome for the company
  - the appointment of an administrator or a liquidator of the company.

2.2.2 Better outcome

A "better outcome" means an outcome that is better for the company than the immediate appointment of an administrator or a liquidator (s 588GA(7)).

2.2.3 List of factors

The Bill sets out an indicative, but not exhaustive, list of factors that may (not must) be considered in determining whether a course of action is reasonably likely to lead to a better outcome for a company, namely whether the directors:

- properly informed themselves about the company's financial position

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3 *Corporations Act* ss 1317S, 1318.
4 *Corporations Act* s 588G(3).
5 *Corporations Act* s 588M.
6 *Corporations Act* s 588M(2).
7 *Corporations Act* ss 588M(3), 588R, 588S, 588T.

- took steps to prevent misconduct by the company's officers and employees
- took appropriate steps to ensure that the company is keeping appropriate financial records
- obtained advice from an appropriately qualified entity who was given sufficient information to give appropriate advice
- developed or implemented a plan for restructuring the company to improve its financial position (s 588GA(2)).

2.2.4 Onus of proof

The directors will have the evidential onus of demonstrating that the safe harbour exception is available (s 588GA(3)).

2.2.5 Governance prerequisites

The safe harbour will not be available to directors where:

- employee entitlements have not been paid by the time they fall due; and
- tax returns or other documents required by taxation laws have not been given;

where the relevant governance failure:

- amounts to less than substantial compliance; or
- is one of 2 or more failures during the previous 12 months (s 588GA(4)).

The safe harbour will also not be available to directors who fail to provide information or documents to controllers of company property or liquidators if the failure amounts to less than substantial compliance (s 588GA(5)).

The court will have a power to order that a failure to satisfy these governance prerequisites does not preclude safe harbour if:

- the failure was due to exceptional circumstances, or
- it is otherwise in the interests of justice to make the order (s 588GA(6)).

Further, directors may not be entitled to rely on books and records in supporting their entitlement to use the safe harbour if the directors:

- fail to provide administrators or liquidators with access to books or other material following an appropriate request, unless:
  - they did not have the materials and there were no reasonable steps that they could have taken to obtain them, or
  - they were not notified of the consequences of failure to provide them
- have concealed, destroyed or removed books of the company (s 588GB).

The court can also override this restriction where there are exceptional circumstances or it is otherwise in the interests of justice.

2.3 My comments on the Bill

2.3.1 Support for carve-out rather than defence

I note that one of the concerns giving rise to the Committee's inquiry was the Bill's approach of making the safe harbour a carve-out rather than a defence.[8]

I strongly support the approach in the Bill of making the safe harbour a carve-out.

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[8] Second reading speech of the Hon. Christopher Bowen, *House of Representatives Hansard*, 22 June 2017, p 23.

A defence would mean that directors continued to have prima facie liability for insolvent trading in the specified circumstances, subject to their being able to establish the elements of the defence.

By contrast, a carve-out would mean that a director would not be liable for insolvent trading unless the liquidator or other person taking action could establish that the director had failed to satisfy the safe harbour prerequisites. A carve-out would therefore provide an extra level of protection for directors who are making honest and diligent attempts to restore a company to solvency.

2.3.2 "in connection with" the course of action

The safe harbour requires that the debt be incurred "directly or indirectly in connection with" the course of action.

The equivalent requirement in the Exposure Draft of the Bill released for public comment in March this year was that the debt be incurred "in connection with" the course of action: the words "directly or indirectly" did not appear in the Exposure Draft. Their addition was recommended in submissions on the Exposure Draft.[9]

Ashurst's submission on the Exposure Draft said that:

- it is not clear what the phrase "in connection with" was intended to convey
- the phrase is potentially quite limiting, as it is possible that most debts would be considered to be incurred in the ordinary course of the company's business, rather than specifically "in connection with" the course of action.

I remain concerned about the phrase "in connection with", even with the qualifying words "directly or indirectly".

Debts incurred in the ordinary course of the company's business may not even indirectly be "in connection with" the course of action.

I acknowledge that the Explanatory Memorandum states that "incurred directly or indirectly in connection with" "would include ordinary trade debts incurred in the usual course of business" (para 1.48) and that the *Acts Interpretation Act 1901* (Cth) (AIA) s 15AB(1), (2)(e) permits Explanatory Memoranda to be used in the interpretation of legislation.

However, I am concerned that the conditions in the AIA for reliance on the Explanatory Memorandum may not be satisfied, as:

- incurring of ordinary trade debts in the usual course of business may not fall within "the ordinary meaning conveyed by" a debt "incurred directly or indirectly in connection with" a course of action that is "reasonably likely to lead to a better outcome for the company" (AIA s 15AB(1)(a))
- the phrase "incurred directly or indirectly in connection with" is not "ambiguous or obscure" (even if its application to debts incurred in the ordinary course of business is uncertain) (AIA s 15AB(1)(b)(i))
- it would not be "manifestly absurd" or "unreasonable" to interpret the phrase "incurred directly or indirectly in connection with" as not covering the incurring of ordinary trade debts in the usual course of business (AIA s 15AB(1)(b)(ii)).

I continue to hold the view stated in the Ashurst submission on the Exposure Draft that it should be sufficient that the debt is incurred while the course of action is being taken. This approach would be more certain, simpler and more direct than requiring reliance on the Explanatory Memorandum.

The only clue given by the Explanatory Memorandum about why it was thought necessary to limit the safe harbour to debts "incurred directly or indirectly in connection with" the course of action is

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9 Australian Institute of Company Directors *Submission*, Law Council of Australia *Submission*.

that safe harbour would not apply to "debts incurred where they are not for a proper purpose" (para 1.51). However, as the Explanatory Memorandum points out (paras 1.14, 1.36), during safe harbour directors would have to comply with their directors' duties, including the duty to exercise their powers and discharge their duties "for a proper purpose" (*Corporations Act* s 181(1)(b)).

Another possible reason for requiring that debts be incurred "directly or indirectly in connection with" the course of action might be to ensure that a company does not enter into major new commitments that jeopardise the company's solvency under the protection of the safe harbour.[10] However, the requirement that the courses of action adopted "are reasonably likely to lead to a better outcome for the company",[11] as well as the continued application of the other duties of directors, should be sufficient to ensure that the safe harbour is not available in these circumstances.

2.3.3 Employee entitlements

There should be a substantive provision incorporating the *Corporations Act* s 596AA(2) definition of "entitlements of an employee", as that definition only applies to entitlements of an employee protected under Part 5.8A of the *Corporations Act* and would not automatically apply to the new s 588GA.

The current draft Bill merely contains a note stating that "Employee entitlements are defined in subsection 596AA(2)".

3. Ipso facto clauses

3.1 Overview of the Bill's provisions

3.1.1 Types of external administration affected

There will be a stay on enforcement of contractual rights in:

- schemes of arrangement that are proposed to avoid the company being wound up in insolvency (schemes);
- managing controllerships over the whole or substantially the whole of a company's property
- voluntary administrations (VAs).

3.1.2 Affected agreements

The restrictions would apply to any type of contract, agreement or arrangement,[12] subject to the specified exceptions.[13]

However, the restrictions will only apply to rights arising under contracts, agreements or arrangements entered into at or after the commencement of the amending legislation.[14]

3.1.3 Triggering events

Enforcement of contractual rights against a company will be stayed if it is for the reason that:

- the company, being a disclosing entity, publicly announces that it will apply to the court for an order to convene a meeting to consider a scheme of arrangement,[15] or the company

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10 For instance, the ARITA *Submission* on the Exposure Draft considered that "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".

11 s 588GA(1)(a).

12 ss 415D(1) (scheme), 434J(1) (controllership), 451E(1) (VA).

13 s 415D(6), (8) (scheme), s 434J(5), (7) (controllership), s 451E(5), (7) (VA).

14 Schedule 1, Part 2, Item 17.

(whether or not it is a disclosing entity) applies to the court for an order convening a scheme meeting[16] or is the subject of a compromise or arrangement approved by the court[17] (but only where the company's application to commence the scheme states that it is being made to avoid being wound up in insolvency[18]); or
- a managing controller of the whole or substantially the whole of the company's property is appointed or exists[19]
- the company is in VA.[20]

A stay will also apply if the company is under one of the stipulated forms of external administration and enforcement of a right would be:

- because of the company's financial position[21]
- for a prescribed reason.[22]

3.1.4 Beginning and end of stay

In the case of a **scheme**, the stay:

- begins (in the case of a disclosing entity) when the public announcement is made or (for any type of company) when the scheme application is made
- ends:
  - if the company (being a disclosing entity) fails to make the announced application – at the end of the longer of three months after the announcement or any period ordered by the court
  - when the application is withdrawn or is dismissed by the court
  - when the compromise or arrangement finishes, unless this occurs because of a winding up resolution or order, in which case
  - when the company's affairs have been fully wound up.[23]

In the case of a **managing controllership**, the stay:

- begins when the managing controller is appointed
- ends when:
  - the managing controller's control ends (in the event of one or more changes of managing controller, the end of the stay is when the control of the last managing controller ends), or
  - the last of any court orders extending the stay ceases to be in force.[24]

In the case of **VA**, the stay:

- begins when the company enters into administration
- ends at the latest of:
  - when the administration ends

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15 s 415D(1)(a).

16 s 415D(1)(b).

17 s 415D(1)(c).

18 s 415D(5).

19 s 434J(1)(a).

20 s 451E(1)(a).

21 s 415D(1)(d)(i) (scheme), s 434J(1)(b)(i) (controllership), s 451E(1)(b)(i) (VA).

22 s 415D(1)(d)(ii) (scheme), s 434J(1)(b)(ii) (controllership), s 451E(1)(b)(ii) (VA).

23 s 415D(2), (3).

24 s 434J(2), (9).

- when the last of any court extension orders made in the interests of justice ceases to be in force (any application for an extension order must be made before the administration ends)
- if the administration ends because of a winding up resolution or order, when the company's affairs have been fully wound up.[25]

3.1.5 Extension of restrictions after the end of the stay

A right will remain unenforceable indefinitely after the end of the stay period where the reason for enforcing the right is:

- the company's financial position before the end of the stay period, or
- the company's commencement of the relevant form of external administration before the end of the stay period, or
- a prescribed reason relating to circumstances in existence during the stay period.[26]

3.1.6 Court power to override the stay

The court will have the power to override the stay and allow enforcement of the right (whether in relation to a scheme, a controllership or a VA) if satisfied that it is appropriate in the interests of justice.[27]

The court will also have this power in relation to a scheme if the scheme was not to avoid the company being wound up in insolvency.[28]

3.1.7 Court anti-avoidance power

The court will also have, in effect, an anti-avoidance power to order that rights (not expressed as ipso facto rights) are only enforceable with leave of the court and in accordance with such conditions as the court imposes, if:

- the court is satisfied that exercise of the rights is because of a reason that would render an ipso facto clause unenforceable,[29] and
- the rights are not of a type that would fall within the ipso facto clause exceptions.[30]

The court must specify a period for which the order is to apply, having regard to:

- the provisions governing the length of the ipso facto stay, and
- the interests of justice.[31]

Before deciding an application for such an order, a court will be able to give an interim order but not require an undertaking as to damages as a condition for granting the interim order.[32]

3.1.8 Exceptions

The stay will not apply to rights:

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25 s 451E(2).

26 s 415D(4) (scheme), s 434J(4) (controllership), s 451E(4) (VA).

27 s 415E (scheme), s 434K (controllership), s 451F (VA).

28 s 415E(1)(a).

29 s 415F(1), (2) (scheme), s 434L(1), (2) (controllership), s 451G(1), (2) (VA).

30 s 415F(4) (scheme), s 434L(4) (controllership), s 451G(4) (VA).

31 s 415F(3) (scheme), s 434L(3) (controllership), s 451G(3) (VA).

32 s 415F(5), (6) (scheme), s 434L(5), (6) (controllership), s 451G(5), (6) (VA).

- prescribed by the regulations
- declared in a Ministerial determination
- in agreements made after the commencement of a scheme, managing controllership or VA.[33]

The stay will also not apply where the relevant external administrator has consented to enforcement of the right.[34]

A contractual counterparty will not be forced to provide additional credit while its right to enforce ipso facto clauses is suspended.[35]

The Bill will amend the VA provisions to make clear that the ipso facto restrictions do not change the exemptions from the VA moratorium for particular types of enforcement action[36] (enforcement by the holder of a substantial security interest, enforcement that began before the beginning of a VA, enforcement of a security over perishable property, giving notices[37]).

3.1.9 Inconsistency with other legislation

The *Payment Systems and Netting Act 1998* (Cth) and the *International Interests in Mobile Equipment (Cape Town Convention) Act 2013* (Cth) prevail over the ipso facto restrictions to the extent of any inconsistency.[38]

3.1.10 Commencement date

The date for the commencement of the ipso facto restrictions is the day after the later of:

- 30 June 2018 and
- the last day of the period of 6 months beginning on the day the amending Act receives Royal Assent. [39]

However, the Governor-General may proclaim an earlier commencement date.[40]

3.2 My comments on the Bill

3.2.1 Support for restrictions on ipso facto clauses

I strongly support the introduction of restrictions on ipso facto clauses.

Such restrictions were an integral part of the seminal reforms to Australia's insolvency law recommended by the *General Insolvency Inquiry* report of the Australian Law Reform Commission (the Harmer Report) (ALRC 45, 1988).

However, I have the following specific concerns about the Bill and the Explanatory Memorandum.

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33 s 415D(6) (scheme), s 434J(5) (controllership), s 451E(5) (VA).

34 s 415D(8) (scheme), s 434J(7) (controllership), s 451E(7) (VA).

35 s 415D(9) (scheme), s 434J(8) (controllership), s 451E(8) (VA).

36 Schedule 1 Part 2 Items 9 to 13.

37 *Corporations Act* ss 441A - 441C, 441E.

38 s 415G (scheme), s 434M (controllership), s 451H (VA).

39 s 2.

40 ibid.

3.2.2 Application only to contracts etc after commencement of legislation

The fact that the restrictions on ipso facto clauses will only apply to contracts, agreements or arrangements entered into at or after the commencement of the amending legislation means that there will be a lengthy period during which the restrictions will only have a very limited effect on corporate reconstructions.

It will also distort commercial dealings, as suppliers will seek to amend existing contracts rather than enter into new contracts.

I support the recommendation of the Harmer Report that the ipso facto restrictions extend to agreements made before the commencement of the amending legislation.[41]

3.2.3 Ipso facto clauses not involving enforcement of rights

The Explanatory Memorandum states that "[t]he stay applies regardless of whether the right is self-executing or triggered by one of the parties to an agreement".[42]

However, the provisions in the Bill may not catch all self-executing ipso facto provisions. They cover self-executing provisions that permit the enforcement of rights by a counterparty against a company, but do not seem to cover those that result in a company's loss of rights against a counterparty.

Take, for instance, a contract for essential supplies to a company.

An ipso facto clause that gave the company's counterparty an automatic right to increased payments from the company would clearly be covered by the proposed restrictions.

However, it seems likely that an ipso facto clause that automatically terminated the contract, without the need for any action by the counterparty, would not be covered by the proposed restrictions. The counterparty would not be enforcing a contractual right, yet the company's right to continued supply would disappear with the termination of the contract.

The legislation should cover all ipso facto clauses, whether they operate automatically or on the taking of action by a counterparty.

3.2.4 Application of the stay to DOCAs

I note that one of the stipulated end-dates for the stay in relation to a scheme is "the end of any compromise or arrangement approved under this Part [that is, Part 5.1] as a result of the application" (s 415D(2)(b)(iii)). The compromise or arrangement is the equivalent of a DOCA that follows a VA.

By contrast, in the ipso facto restrictions relating to VA, the stay only extends past the end of the VA into the period when the company is subject to a DOCA if the court makes an order extending the stay (s 451E(2)(b)).

The reason for this difference in approach is not clear.

I consider that ipso facto restrictions should apply to DOCAs without the need to seek an extension order.

3.2.5 Application of stay to a company being wound up

I do not favour restrictions on ipso facto clauses where a company is in liquidation, even though the Harmer Report recommended rendering ipso facto clauses void against the liquidator in a

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41 ALRC 45, vol 2 draft s AT10(2).

42 para 2.17.

winding up[43] and the United States Bankruptcy Code restrictions apply in corporate bankruptcies as well as corporate restructurings. In my view, it would be an unreasonable imposition on contractual counterparties to require continued performance of contracts with companies in liquidation for an extended period.

The Bill, while not introducing a stay on ipso facto clauses into the winding up provisions of the *Corporations Act*, provides for a stay in winding up when corporate reconstruction has been tried and has failed. Where a scheme or a VA ends because of a resolution or order that the company be wound up, the Bill provides for the scheme or VA stay to continue until the company's affairs "have been fully wound up".[44]

There seems to be no good reason for the ipso facto stay to continue where corporate reconstruction has been tried but has not succeeded. In that situation, the stay should end on the date the liquidator is appointed.

It seems particularly anomalous for a stay on ipso facto clauses to continue automatically throughout a winding up that follows a scheme or a VA, while those clauses will only be stayed while a company is subject to a DOCA if there is a court order to that effect.[45]

3.3 Comment on the Explanatory Memorandum (Period of stay for VAs)

Para 2.35 does not accurately reflect s 451E(2)(b) in the Bill, as it has not been updated to reflect the change in approach between the Exposure Draft and the Bill.

The provision in the Exposure Draft (on which para 2.35 is based) required that an application for extension of the VA stay be made within 7 days after the end of the administration and provided that the stay would end:

- when the application was withdrawn or was dismissed by the court, or
- when any court order ceased to be in force.

By contrast, the Bill requires an application for an extension of the VA stay to be made before the administration ends and stipulates that, if such an application is made, the stay ends when the last of any court orders ceases to be in force. This is the law that should be reflected in para 2.35.

Yours faithfully

[redacted]

James Marshall

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

44 ss 415D(2)(b)(iv), 451E(2)(c).

45 s 451E(2)(b), (3).