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Senate Economics Legislation Committee
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12 July 2017

By Email

Dear Mr Mark Fitt

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

Thank you for the opportunity to respond to the inquiry into the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017*. We attach the submission of Herbert Smith Freehills.

If you would like to discuss any aspect of the submissions, please do not hesitate to contact us.

Yours sincerely

[redacted]

Paul Apáthy
Partner
Herbert Smith Freehills

[redacted]

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Inquiry into the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* – Submission to the Senate Economics Legislation Committee from Herbert Smith Freehills

12 July 2017

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Submission from Herbert Smith Freehills

1 Introduction

This submission has been prepared by Herbert Smith Freehills in response to the invitation for submissions on the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* (the **Bill**) issued by the Senate Economics Legislation Committee (the **Committee**). The Bill was read for a first time in the House of Representatives on 1 June 2017 and in the Senate on 22 June 2017. It was referred to the Committee on 15 June 2017 and an invitation for submissions was sent to Herbert Smith Freehills on 21 June 2017.

The Bill seeks to introduce two major reforms to Australia's insolvency laws – an insolvent trading safe harbour and *ipso facto* restrictions on the exercise of contractual rights. It follows the Australian Federal Government's release of the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 Exposure Draft* (the **Exposure Draft)** on 28 March 2017, which was subject to a public consultation process. Herbert Smith Freehills made submissions to Treasury in response to the Exposure Draft on 24 April 2017 (**Previous Submission**).

We are pleased to see that many of the matters raised in our Previous Submission have been addressed in the drafting of the Bill. However, there are still some matters which we submit should be given further consideration. Set out below in this submission are our observations, comments and recommendations on the Bill and those matters.

2 Basis for our submission

Herbert Smith Freehills is a top tier international law firm with market-leading commercial and restructuring, turnaround and insolvency practices both nationally and globally. Our submission and observations are based on our extensive experience acting on both:

- the 'front end' of large, complex financial and other commercial transactions in which the risks of potential insolvencies must be considered and satisfactorily negotiated in order for the transactions to be successfully concluded; and
- a large number of significant corporate restructuring, distressed debt and formal insolvency transactions in Australia and in other jurisdictions around the world.

In Australia, our national team has advised on a number of the significant corporate restructuring transactions and complex insolvencies in the last 10 years, including advising:

- TPG on the restructuring and recapitalisation of the Alinta Energy Group;
- Centro Properties Group on its restructuring;
- the senior lending syndicate on the fully consensual restructuring and recapitalisation of the I-MED Network group;
- Goldman Sachs, as holder of mezzanine bonds, on the restructuring of Nine Entertainment Group;
- the administrators and liquidators of the Retail Adventures Group in relation to its administration and subsequent liquidation;

- Seven Group Holdings in respect of its acquisition of debt interests in Nexus Group and the subsequent ‘DOCA takeover’ of the Nexus Group;
- the receivers of SubZero Group Limited;
- Liberty Metals & Mining LLC in relation to the administration of, and deed of company arrangement for, Cockatoo Coal Limited;
- Arrium Limited in relation to its proposed restructuring and recapitalisation and advising the initial administrators to Arrium Limited in relation to the administration of the Arrium group;
- the senior lenders to, and receivers of, the Keystone Group;
- the Administrators and now liquidators appointed to the Careers Australia Group; and
- the senior lenders to Bis Industries.

A number of members of our restructuring, turnaround and insolvency team in Australia have also practised in other jurisdictions, including the United Kingdom and the United States of America, and have accordingly had significant experience with the restructuring and insolvency systems in those jurisdictions.

3 General comments

We welcome the Government’s initiative to introduce legislation to improve Australia’s insolvency law regime and enhance the landscape for turnarounds and restructuring. We are supportive of reforms that allow greater flexibility to restructure businesses and encourages corporate rescue.

We are pleased to see that the Bill addresses a number of the concerns and recommendations raised in our Previous Submission in response to the Exposure Draft. There are however a number of matters raised in our Previous Submission which have not been addressed in the drafting of the Bill and warrant further consideration.

4 Insolvent trading safe harbour

(a) A better outcome for the ‘company’ (s 588GA(1)(a), (7))

The Bill requires directors to develop a course of action which is reasonably likely to lead to a better outcome for ‘*the company*’. While this is an improvement over the wording of the Exposure Draft, it still remains unclear how the reference to ‘*the company’* is to be construed.

In our view, the reference to the company should be replaced by a reference to the company’s creditors as a whole. This reflects that where a company is unable to pay its debts, it is creditor recoveries that are in immediate jeopardy. In our experience, in most cases shareholders will no longer have an economic interest in a company at such time.

In addition, we consider that the use of the words ‘*the company*’ are unnecessarily restrictive. In our Previous Submission, we observed that:

- in restructuring, the fundamental question is whether *the business* (or a substantial part of it) is viable on a going concern basis, rather than the company itself;

- this requires consideration as to whether *the business* itself is, or can be, feasibly restructured to become profitable;
- viability and restructuring of *the business* may not necessarily involve the continuation of the company itself; and
- accordingly, the ability to return the company to solvency may not always be the correct measure of a successful restructuring. Rather, it may be more appropriate to consider the treatment of the company's creditors as a whole, and whether the restructuring offers creditors a better outcome regardless of what form it takes.

We reiterate those submissions. In our view the reference to '*the company*' in determining a better outcome does not factor in the realistic possibility that in many cases the corporate entity itself may not survive the restructuring. That possibility is already recognised for the purposes of administration,[1] and should also be recognised in the safe harbour provisions and related explanatory statements.

We therefore submit that the test of a better outcome should focus on the '*company's creditors as a whole*', which in turn will turn the focus on the company's business itself and open up a broader range of restructuring options.

We also note that some commentary when making submissions on the better outcome test have referred to, or sought alignment with, general law director duties owed to the company, and in particular how that duty should be interpreted under the general law in the context of a company approaching insolvency. Whilst there are some broad similarities between the concepts, in our view it is a mistake to conflate these concepts for a number of reasons.

The general law directors' duty is rather vague and not well understood (there being limited and somewhat controversial case law on the topic). Such an approach is therefore likely to give rise to uncertainty. Further, the directors' duties test has a much broader purpose – it is intended to guide the directors' decision making more generally, and applies when a company is both solvent and insolvent.

In contrast, the better outcome test is intended to simply provide a means of determining whether the safe harbour from potential insolvent trading liability is available to a director. Importantly, it does not impose any obligations on directors – it is not a duty. Furthermore, satisfaction of the test does not require maximisation of creditor returns, it only requires a better outcome than immediate formal insolvency. It only needs to apply where the company actually *is* insolvent, and therefore the main focus in that scenario should simply be on creditor outcomes.

We also note that a reference to creditors (rather than the company) would be consistent with the defence to 'wrongful trading' under section 214(3) of the UK Insolvency Act 1986, which applies where a person 'took every step with a view to minimising the potential loss to the company's creditors'.

Recommendation 4(a): *The reference to 'the company' in the definition of a better outcome is removed and replaced with 'the company's creditors as a whole' in the Bill and in the accompanying legislative documents.*

(b) A better outcome than immediate liquidation or administration (s 588GA(7))

The Bill requires that the '*better outcome*' be reasonably likely to be better than the immediate appointment of a liquidator or administrator. This test creates uncertainty as to

1 s 435A, *Corporations Act 2001* (Cth).

how and when the broad range of potential outcomes under a Deed of Company Arrangement (**DOCA**) must be taken into account.

When a company enters into administration, DOCA proposals may be submitted by any number of persons including shareholders, creditors, speculators and 'white knight' third parties. In some circumstances, it may be impossible for directors to foresee the range of potential DOCA proposals that may be forthcoming should their company immediately enter into administration. It may also be impossible for them to assess the viability and credibility of any such proposals which may be made.

We therefore recommend that the comparison should be limited to liquidation only. Administration is not an end itself and must inevitably lead to a further outcome.[2] Requiring a comparison to administration outcomes therefore invites uncertainty and risk which may deter the pursuit of genuine turnaround and restructuring opportunities.

In our submission, directors should only be required to compare the outcome of the courses of action they are developing to an immediate liquidation, rather than to an immediate liquidation or administration. This would also harmonise the safe harbour provisions with the comparative requirements which already apply in the assessment of a proposed DOCA.[3]

Recommendation 4(b): *The words 'the immediate appointment of an administrator, or liquidator, of the company' be amended to read 'the immediate appointment of a liquidator of the company'.*

(c) Explanatory Memorandum error (Chapter 1, para 1.7)

The Explanatory Memorandum, at Chapter 1, para 1.7 first bullet, suggests that insolvent trading liability can commence prior to actual insolvency – when there are 'reasonable grounds' for suspecting insolvency. This is incorrect – section 588G(2) of the *Corporations Act 2001* (Cth) requires the company to be insolvent at the time of incurring, or by reason of incurring, the debt. The threshold for potential liability for insolvent trading is therefore triggered only once both requirements are met.

5 Ipso facto clauses

(a) Administration stay extends to liquidation but not DOCA (s 451E(2))

Under the Bill, the *ipso facto* restriction that applies if a company enters into administration continues if the company is wound up until its affairs have been '*fully wound up*'. However, there is no corresponding extension of the stay where the company enters into a DOCA as a result of the administration instead of liquidation.

In our view, this is an anomalous result and is likely to be counterproductive in terms of encouraging restructuring. A DOCA is the primary mechanism for implementing a restructure through the administration process. It should be encouraged as the preferred outcome of administration in appropriate cases if restructuring is to be supported.

The Bill as currently drafted creates an unusual situation where a company has the benefit of a stay on the exercise of *ipso facto* rights during its administration, but has no corresponding protection if it then enters into a DOCA. This may lead to liquidation being the preferred outcome of administration in some circumstances.

2 s 439C, *Corporations Act 2001* (Cth).

3 s 439A(4)(b), *Corporations Act 2001* (Cth).

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We therefore submit that the stay that applies in administration should be continued for as long as a DOCA remains on foot following that administration.

Recommendation 5(a): *The stay in section 451E continue in operation throughout the interim period between a company's creditors resolving that it enter into a DOCA and the period allowed in section 444B(2) for the DOCA to be executed, and where the DOCA is executed by the company within that period, until that DOCA is wholly effectuated, terminated or otherwise comes to an end.*

(b) Why the need for a stay in some liquidations? (s 415D(2)(b)(iv) and 451E(2)(c))

Where the stay on *ipso facto* rights arises in relation to a scheme or administration, it continues to apply where the company enters into liquidation until its affairs '*have been fully wound up*'. There is no corresponding stay where a company enters into liquidation without first being subject to a scheme or administration. Accordingly, some liquidations attract the benefit of the stay while others do not.

It is unclear how the extension of the stay into some liquidations meets the policy purpose of the regime of encouraging turnaround and restructure. It is also unclear why the stay applies in some liquidations but not others.

We submit that the stay on the exercise of *ipso facto* rights should not apply in any liquidations, noting that liquidation is not a recognised mechanism for implementing a restructure.

Recommendation 5(b): *We recommend that the stay on the exercise of ipso facto rights should not apply in any liquidations, no matter how commenced.*

(c) Grandfathering provision (Item 17 of the Bill)

Item 17 of the Bill operates so that the *ipso facto* regime does not apply to contracts entered into before the commencement of the Bill. This creates different regimes in relation to contracts entered into at different times which gives rise to potential fairness issues. This could lead to materially different outcomes amongst these stakeholders, as in a formal insolvency counterparties often use the existence of *ipso facto* termination rights as leverage to negotiate payment of indebtedness or other improved terms (which ultimately comes at the expense of the general estate and therefore other creditors).

We assume the reason for including grandfathering provisions was a concern that persons who entered into contracts prior to the law change might have done so on the assumption that their *ipso facto* rights in such contracts were effective. We think in most cases *ipso facto* rights are unlikely to be a significant determinant in whether parties decide to enter into commercial contracts. Where *ipso facto* rights are most likely to prove a significant factor is where the counterparty is under an obligation to extend credit on an on-going basis, or in the case of certain specialised financial arrangements (e.g. derivatives netting). Generally, these types of arrangements are excluded from the operation of the *ipso facto* restrictions in any case under the proposed legislation.

Recommendation 5(c): *We recommend that the ipso facto regime should apply in relation to contracts entered into before, as well as after, the commencement of the Bill.*

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(d) The extent of the *ipso facto* regime

Under the current wording in the Bill, the *ipso facto* regime provides that *'a right cannot be enforced against a company… if the right arises for [a prescribed reason] by express provision of a contract, agreement or arrangement.'*

This wording could be interpreted as *only* prohibiting the *enforcement by a counterparty* against the company of *rights that arise* for the prescribed reason. If so, then it might not prohibit the *termination of existing rights* that the company has *against the counterparty* (for the prescribed reason). This could perhaps depend on the drafting employed (for example whether the rights against the counterparty are considered inherently flawed, or whether the counterparty has a new right to bring its existing obligations to an end). There could also be debate as to whether a provision that provides that the entire contract automatically terminates (such that neither party has any rights) is effective or not.

In light of these uncertainties, we think there is merit in further consideration of the wording used to describe the extent of the *ipso facto* prohibition. As noted in our Previous Submission, in this regard there is merit in considering the wording of the United States Chapter 11 automatic stay (although in doing so it is important not to simply lift the wording verbatim but have regard to the differing context of the relevant Australian regimes).

Recommendation 5(d): *We recommend that further consideration be given to the precise drafting of the ipso facto prohibition language, and whether it is sufficiently broad to cover termination of existing rights.*

6 Concluding remarks

If you have any queries in respect of the content of this submission, please contact:

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[redacted]