Enquiry by the Senate Economics Legislation Committee into the provisions of Treasury Laws Amendment (2017 Enterprise Incentives No.2) Bill

Referred to committee 15 June 2017

Submission by SV Partners Pty Ltd
ABN 63 103 951 819

Email submissions to the committee by 12 July 2017
economics.sen@aph.gov.au

SV House
138 Mary Street
BRISBANE QLD 4000
p 07 3310 2000
f 07 3229 7285
e brisbane@svp.com.au
w svpartners.com.au

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

1. Introduction

SV Partners Pty Ltd provides professional corporate and personal insolvency advice to accountants, financial institutions, corporations, financial and legal advisors, and individuals. With a team of over 100 insolvency specialists across the eastern seaboard, our expert advisors focus on recovery, reconstruction advice and formal insolvency appointments. We also operate one of the largest private bankruptcy practices in Australia.

1.1 Our previous submissions to treasury on the proposed bill

Our submission on Treasury's consultation paper[1] dated 27 May 2016 favoured model A [safe harbour model A] (**attachment A**)and our submission on the exposure draft dated[2] 24 April 2017 (**attachment B**) commented that the proposed bill went too far in carving out insolvent trading provisions, failing to strike the balance between creditors rights and responsible business risk taking activities.

1.2 Executive summary

Whilst we are not qualified lawyers, we have extensive experience in interpreting, complying with and enforcing statute and common law judgments which affect the insolvency industry. We welcome safe harbour provisions as we acknowledge formal insolvency can erode an entity's value, which carries implications far beyond the entity's demise.

However, our opinion is that the proposed bill's current form does not provide an adequate balance to allow for genuine recovery action and continued protection for creditors. Reverting to, or adopting key aspects of the safe harbour model A would rectify this imbalance.

2. Comments at the second reading of the proposed bill

At the second reading of the proposed bill Julie Owens, MP made the following statements[3]:

> *"....While the industry as a whole believes that the intent of this bill is very good, not everybody believes that it is in its best form at the moment. The Shareholders' Association, for example, has concerns for its members, who are shareholders in some of the companies that will be affected by this bill. The Productivity Commission has made a number of recommendations, none of which are in this bill. So there is another course of action recommended by the Productivity Commission, and we need to consider whether we are looking at an exemption or a defence model. So there are things for us to work through, and it will be great to watch the Senate inquiry take place. It will be good to see the submissions so that we can fully understand exactly how this works......"*

Further Terri Butler, MP made comments relating to the enforcement of insolvent trading provisions, being[4]:

> *"....When we are dealing with this specific bill, this proposal for a safe harbour, we are really talking about creating a safe harbour in respect of a provision that prohibits insolvent trading by corporations. It is worth noting that the proceedings concerned are very rarely actually brought. The Productivity Commission dealt with this point before recommending a safe harbour defence when they said:*
>
> *... the spectre of action looms larger than the actual (likely) consequence. The rate of successful enforcement of insolvent trading actions is low. There were only 103 insolvent trading cases between the law's introduction in 1961 and 2004.*

[1] http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Improving-bankruptcy-and-insolvency-laws/Submissions
[2] http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2017/NISA-Improving-corporate-insolvency-law/Submissions
[3] http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=CHAMBER;id=chamber%2Fhansardr%2F7940dba6-3d49-4d38-811f-42e1e50c1e3c%2F0074;query=Id%3A%22chamber%2Fhansardr%2F7940dba6-3d49-4d38-811f-42e1e50c1e3c%2F0077%22
[4] http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;db=CHAMBER;id=chamber%2Fhansardr%2F7940dba6-3d49-4d38-811f-42e1e50c1e3c%2F0074;query=Id%3A%22chamber%2Fhansardr%2F7940dba6-3d49-4d38-811f-42e1e50c1e3c%2F0077%22

> *.....The commission went on to say: While the court ordered that compensation be paid in three quarters of those cases, more serious sanctions were extremely rare. Only 15 per cent of cases involved criminal proceedings, and only two cases involved an order banning directors from managing companies.*
>
> *.....The commission went on to say: Since 2004, ASIC reports that they have commenced action for insolvent trading for circumstances involving five companies only between 2005 and 2011.*
>
> *.....Of course, this bill is concerned with the civil proceedings under the insolvent trading provisions of the Corporations Legislation, and it follows on from the Productivity Commission recommendation for the creation of a safe harbour defence. The Productivity Commission recommended that the Corporations Act should be amended to allow for a safe harbour defence to insolvent trading. It went on to suggest some conditions for the availability of the defence, saying that defence would only be available when directors of a company have made and documented a conscious decision to appoint a safe harbour advisor with a view to constructing a plan to turn around the company; the advisor was presented with proper books and records; the adviser had at least five years' experience; the directors were able to demonstrate they had taken all reasonable steps to pursue restructuring; and the advice had to be proximate to the specific circumstance of financial difficulty, not a set of advice much earlier in relation to something else. There are some other components of the recommendation that are relevant, but readers can have a look at the report themselves."*

These comments are at the heart of our submission to the committee. We believe the impact of the proposed bill should be assessed to ensure the rights and obligations of both directors of companies in distress and the stakeholders those directors' decisions affect are not adversely impacted.

We acknowledge whilst the rate of insolvent trading action is low[5] the threat ensures responsible director behaviour, which we believe currently curbs the already high negative impact of company insolvency. We do not believe that removing the stick, just because it is rarely used, is a suitable argument to support the implementation of protection provisions.

3. Practical implications of the proposed Bill | Liquidators perspective

The stringency of Australian insolvent trading laws has been debated for well over 25 years. Legislative changes in 1993 (off the back of the Harmer Report[6]) lead to:

- the introduction of the Voluntary Administration regime[7]; and
- repositioned[8] the obligation of insolvent trading provisions outlined in section 588G of the [now] *Corporations Act 2001 (Cth)* (the Act).

These changes were the first step towards corporate rescue and shifted the personal penalties of a director from a criminal offence[9] to a civil one (in the absence of dishonesty)[10] by allowing a Liquidator to pursue a director, on behalf of the company's creditors.

---

[5] Compared with the number of Corporate insolvencies

[6] Australian Law Reform Commission General Insolvency Inquiry, Report No.45 (1988) (commonly known as the 'Harmer Report' after Ron Harmer who headed up the commission) chapter 7 and the resulting *Corporate Law Reform Act 1992* which commenced on 23 June 1993

[7] Part 5.3A of the *Corporations Act 2001 (Cth)* (the Act)

[8] From s592 and 593 of the *Corporations Law* (derived from ss.556 & 557 of the *Companies Code*)

[9] s.592 created a criminal offence which carried maximum penalty of $5,000 or one year imprisonment, or both. If convicted, ASIC or a creditor could then, pursuant to s593, apply to Court for a declaration that the convicted person pay whole or part of the debt. The liquidator had not means to pursue a civil remedy on behalf of the company for the benefit of creditors as a whole (http://www.austlii.edu.au/au/journals/BondLawRw/1993/11.pdf)

[10] Harris, J. Article: Director Liability for Insolvent Trading: Is the Cure Worse than the Disease? Reference 22 page 4

The debate then evolved from 'how directors should be held responsible' to 'does it impact entrepreneurial activity'.

Formal consultation on the later occurred in January 2010[11], ARITA's whitepaper providing thought provoking solutions followed in October 2014[12], the Productivity Commissions report No.75 addressed the issue in December 2015[13] and now, through the Government's National Innovation and Science Agenda, the proposed bill has been tendered. This ongoing debate identifies getting the balance right is not easy.

We submit the following negative implications are likely to impact the effective use of a safe harbour if the proposed bill were to become law and raise these for the Committee's consideration:

- **Absence of a Chief Restructuring Officer [CRO]:** as aptly stated in ARITA's feature article in their September 2016 journal[14], the problem with phoenix activity has been linked to the rise of the pre-insolvency advisors, which has had the effect of increasing controls on Liquidators, as the gatekeeper, and facilitating data sharing between government agencies. However, these measures address the symptoms rather than the cause as pre-insolvency advisors fall into a regulatory 'black hole'. Using the proposed Bill to ensure only adequately skilled advisors can provide genuine restructuring options would reduce the proliferation of pre-insolvency advisors and illegal phoenix activity.

  A CRO position could also provide reasonable protection from shadow director implications in the event a company fails to execute a restructuring plan, but seeks safe harbour once the company fails. The advisor, who had no control over the company, may become potentially liable in these circumstances however, holding the CRO position would provide adequate protections.

- **Phoenix activity and the impact of NOCLAR:** Non-compliance with laws and regulations (NOCLAR) comes into effect on 1 January 2018 and requires professional advisors to consider their obligations to report clients who have (or appear to have) committed illegal acts. Whilst we agree whistle-blowing is required to maintain adequate systems, the concern we hold is how NOCLAR's will co-exist with the proposed bill.

- **Access to funding:** is generally the key obstacle with informal restructuring as a distressed company attracts a higher risk rate, making access to funding more expensive. If the proposed Bill included more rigour, as initially proposed in the consultation paper, and specifically safe harbour model A, a CRO could (through the restructuring plan) help reduce the risk and cost associated with obtaining finance for restructuring.

- **Absence of reasonable timeframes:** whilst no two companies are the same and are likely to require different timeframes to return to a viable trading position, the absence of a reasonable timeframe leaves the proposed new laws open to abuse. An accountability mechanism should be included to ensure that both objective and subjective aspects of what 'a reasonable person, in the company's circumstances would have done' occurs in a reasonable timeframe. Our concerns arise due to the increased obligations of a liquidator to prove the safe harbour protection is not available should restructuring attempts fail.

- **Providing for Employee Entitlements:** if a company 'provides' for entitlements by taking up an accrual in the company's accounts and ensuring capacity to meet this liability when called upon should be more clearly defined in the proposed bill.

In the article titled 'Harmer Report – 20 years on'[15] produced in 2007, Richard Fisher[16] commented as follows when asked if he believed the Australian insolvent trading laws were too inflexible:

---

[11] Insolvent Trading: A safe harbour for reorganising attempts outside of external administration

[12] Australian Restructuring, Insolvency and Turnaround Association (ARITA) whitepaper: A Platform for Recovery 2014: Dealing with Corporate Financial Distress in Australia

[13] Productivity Commission Inquiry Report No. 75: Business Set Ups, transfers and Closures, 30 September 2015 (the PC report)

[14] Pre-Insolvency Advisors Behaving Badly: The profession's view on the pre-insolvency phenomenon ARITA Journal Volume 28 # 3 p15-17

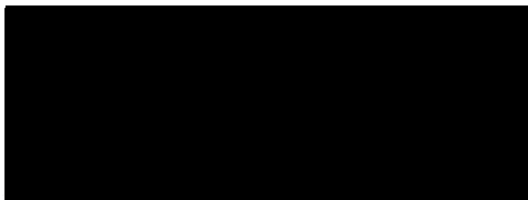
[15] Murray, M. Australian Insolvency Journal October – December 2007, Vol 19, No.4 4-6, 8-9: An interview with Richard Fisher

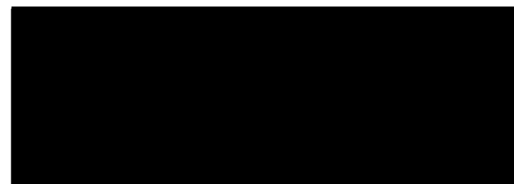
[16] A commissioner on the then Law Reform Commission's General Insolvency Inquiry (which produced the Harmer report)

> *" I am certainly aware of the debate and of the claims, for example, that directors are reluctant to take on that role for fear of personal liability. That said I would stand by the present insolvent trading regime which seeks to avoid a circumstance where unsecured creditors are called upon, to assume the* 'equity capital' *risk of the company's ongoing trading. The duty to prevent insolvent trading already imposes on a director some expectation of foresight and planning, to anticipate when things are going wrong and to seek advice accordingly. I appreciate, though, that some in the insolvency profession quite properly raise the need for flexibility in the process, short of Part 5.3A being invoked. It may well be that some* 'fine tuning' *of this aspect of our insolvency law is appropriate. One such proposal has been to extend the defence provided by the* 'business judgment rule' *to an insolvent trading claim on which I am aware the IPA* [now ARITA] *has made submissions."*

We conclude our submission to the committee by reiterating that safe harbour model A, proposed through the National Innovation and Science Agenda on 29 April 2016[17], would enable a balance to be achieved over the proposed bill in its current form. This model, or an iteration of it, deals with the use of appropriately qualified advisors and provides clear obligations for directors to make responsible risk-taking decisions in their attempt to return the company to a viable position within a reasonable timeframe.

We thank you for taking the time to consider our submission. Should you have any queries or wish to discuss this further, please contact us.

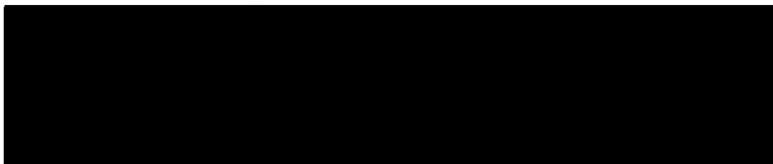




Nicky Lonergan
Chief Operations Officer & Author

Anne Meagher
Director

Yours faithfully,



Terry van der Velde
Managing Director
SV Partners

[17] http://www.treasury.gov.au/ConsultationsandReviews/Consultations/2016/Improving-bankruptcy-and-insolvency-laws

Improving bankruptcy and insolvency laws: submission to Treasury's proposal paper

Dated 26 May 2016

Submission by SV Partners Pty Ltd
ABN 63 103 951 819

Email submissions to:
Treasury: insolvency@treasury.gov.au by 27 May 2016

SV House
138 Mary Street
BRISBANE QLD 4000
p 07 3310 2000
f 07 3229 7285
e brisbane@svp.com.au
w svpartners.com.au

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

Contents

1. Introduction 8
1.1 Who we are 8
1.2 Our experience 8
1.3 Disclaimer 8
1.4 Executive summary 8
2. Reducing the default bankruptcy period 9
2.1 Misconduct: objection to discharge 9
2.2 Ongoing obligations for a bankrupt 9
2.3 Restrictions imposed on a bankrupt 11
3. Safe harbour provisions 11
3.1 Model A 12
3.1.1 The director's obligations 12
3.1.2 The Restructuring Advisor's obligations 13
3.1.3 Timeframes 13
3.2 Other features of safe harbour 13
3.2.1 Another suggested feature – access to finance 14
3.3 Model B 14
4. Ipso facto clauses 15
4.1 The Ipso Facto model 15
Annexure A: Our responses to your queries detailed in the proposals paper 16

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

1. Introduction

1.1 Who we are

SV Partners Pty Ltd (SV Partners) provides professional corporate and personal insolvency advice to accountants, financial institutions, corporations, financial and legal advisors, and individuals.

With a team of over 100 insolvency specialists across the eastern seaboard, our expert advisors focus on recovery, reconstruction advice and formal insolvency appointments. We also operate one of the largest private bankruptcy practices in Australia.

1.2 Our experience

Our executive team has extensive experience in the insolvency and turnaround industry and hold memberships with: Australian Restructuring, Insolvency and Turnaround Association (ARITA), Chartered Accountants Australia and New Zealand (CAANZ), Certified Practicing Accountants Australia (CPA), Institute of Public Accountants (IPA), Australian Institute of Credit Management (AICM), Turnaround Management Association (TMA), Australian Institute of Company Directors (AICD) and the QLD Master Builders Association (QMBA). They also hold positions on the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office (ATO) Liquidator panels.

1.3 Disclaimer

This submission has been prepared based on the proposed reforms as they were presented for comment, as at the date of this submission.

1.4 Executive summary

The proposals submitted by Treasury are:

- reduction of the default bankruptcy period from three years to one;
- introduction of a 'safe-harbour' for directors and approved advisors from personal liability for insolvent trading, when undertaking genuine restructuring; and
- ensuring 'ipso facto' clauses are unenforceable against a company undertaking genuine restructuring.

These proposed reforms are intended to promote entrepreneurial activity, whilst retaining protection mechanisms for creditors. A summary of our comments on the proposals are:

Reduction of bankruptcy term: we are undecided if reducing the term of bankruptcy to one year will achieve an increase in entrepreneurial activity. However, should the period be reduced there are a number of concerns we have expressed within this submission that will need to be addressed.

Safe Harbour provisions: Model A is preferred for the following reasons:

- it deals with the concerns surrounding the conduct of "pre-insolvency advisors" who currently do not have obligations to be registered with a regulatory body, hold a minimum standard of education or be bound by any professional and ethical standards;

- it can be codified to ensure that directors have a clear obligation to act when a company is in financial distress, accessing professional assistance and working with the company's stakeholders in an informal capacity to return the company to a solvent position;
- the assessment by a restructuring advisor is likely to assist with the ability to access additional funding; and
- the alternative Model B is too relaxed and places the obligation on the Liquidator to prove that the director has breached one of the three limbs (proposed to replace existing insolvent trading provisions). Model B shifts the responsibility away from the director to act at the time the company is in financial distress to the Liquidator after the company has failed and will lead to more litigation. If a director has the ability to make responsible risk-taking decisions which lead to informal restructuring of a company, they generally do this without the need for professional assistance.

Ipso facto clauses: have often interfered with the process of formal restructuring and we welcome the reforms as they have been proposed.

2. Reducing the default bankruptcy period

During the three year term of bankruptcy, a bankrupt is restricted to a capped amount of credit, cannot travel overseas without permission, cannot hold a directorship of a company and may have some licencing or employment restrictions.

The purpose of these reforms is to reduce these restrictions in order to encourage future business activity[18]. Over the past decade other countries, such as the United Kingdom and Germany, have implemented more lenient bankruptcy laws which resulted in a marginal increase in self-employment[19].

2.1 Misconduct: objection to discharge

The trustee's ability to object to the discharge, extending the bankruptcy term up to eight years, would be retained. We are concerned that one year will be insufficient time to gather an appropriate level of evidence to support lodging an objection, if deemed appropriate.

2.2 Ongoing obligations for a bankrupt

1.2.1 Requirement to assist trustee

The *Bankruptcy Act 1966 (Cth)* (the BA) currently provides for trustees to perform specific functions relating to asset recovery post discharge, being:

Section of BA	Relevant powers post discharge	Penalty
152	Bankrupt to give assistance, even though discharged, as the trustee reasonably requires in the realisation and distribution of property vested in the trustee	Imprisonment for six months

[18] Inquiry Report Business Set-up, Transfer and Closure August 2015
[19] Inquiry Report Business Set-up, Transfer and Closure August 2015

Section of BA	Relevant powers post discharge	Penalty
153	Bankrupt not released from liability to pay: • income contributions; or • a debt resulting from fraud; or • obligation to pay a maintenance order.	Can be sequestrated if fail to pay
139 & Reg 6.18	Discharged bankrupt to give information if contribution unpaid and the liability is not affected by discharge	10 penalty units

A practical issue occurs when a bankrupt is discharged and fails to give assistance as required by section 152 of the BA within a reasonable period of time. The penalty for failure to comply costs funds that are rarely held or retained by the trustee. This issue will be more prevalent if the bankruptcy term is reduced to one year.

1.2.2 Income contributions

This proposal intends on making the Bankrupt liable to pay income contributions for a period of three years, even though the bankruptcy term would be reduced to one. This liability will also continue for the entire bankruptcy period should an objection to discharge be lodged.

Whilst it is beneficial for creditors to have access to income for three years rather than one, the mechanisms obligating the discharged bankrupt to comply post discharge will have to be effective and carry heavy penalties to enable trustees to perform the functions.

Practical concerns for trustees carrying out this obligation are:

- when a discharged bankrupt is liable for income contributions for the entire three year period, how is the former trustee required to handle these funds? Ie. the account cannot be titled 'John Smith (A bankrupt) Estate No. xxxx/16';
- what powers do we have, as a former trustee, to ensure the contributions are paid? Is a former trustee imbued with the powers pursuant to sections 139ZL and 139ZIA of the BA?; and
- is the trustee required to obtain approval for future remuneration pursuant to section 162 of the BA prior to the Bankrupt's discharge? If so, a process must be determined to allow for further approvals if the prospective remuneration was underestimated.

The former trustee of the discharged bankrupt must have relevant powers to make income assessments, collect liabilities determined under section 139 of the BA, hold creditor meetings (if required) pursuant to section 64, gain remuneration approvals, account for realisation charges and pay dividends.

Additionally, we expect that windfall gains; such as funds bequeathed from a deceased estate within the three year period, should be a divisible asset within the bankrupt estate.

2.3 Restrictions imposed on a bankrupt

2.3.1 Credit

Access to credit is limited during the bankruptcy term, pursuant to sections 269 and 304A, and amounts exceeding these restrictions must be disclosed. A record of bankruptcy remains on credit records for two years post discharge or five years from the date of Bankruptcy, whichever is later, which may affect the Bankrupt's access to credit. Rather than reducing the period of time the bankruptcy event remains on the credit record, a classification system to identify high risk clients for credit providers would be preferable.

2.3.2 Overseas travel

Restricting overseas travel for the period of bankruptcy seems reasonable. However, if the bankrupt is high risk and conducts business overseas, the former trustee should be provided with the ability to extend this restriction (without the requirement to lodge an objection) to ensure the Bankrupt is compliant with the income contribution requirements.

2.3.3 Licences

We acknowledge that the Government intends to consult with relevant industry and licencing associations with a view to aligning these restrictions to the one year bankruptcy term, should this be introduced. Given the strong stance of regulators in the building industry, we think this will be an enormous task.

3. Safe harbour provisions

There are many obligations and duties of a director in operating a company responsibly, one of which is the requirement to ensure the company does not continue to trade whilst it is insolvent (unable to meet its debts as and when they fall due[20]). These provisions are designed to penalise a director that has taken unreasonable trading risks. However, it is argued they have the undesired effect of restricting responsible risk-taking activity[21].

The discussion paper, *Insolvent Trading: A safe harbour for reorganisation attempts outside of external administration*, issued in January 2010, submitted three options which were considered to address the issue that insolvent trading provisions were stifling entrepreneurial activity. These options were:

- no change to the *Corporations Act 2001 (Cth)* (the CA) insolvent trading provisions;
- additional defence available to directors based on the *'business judgement rule'* in section 180 of the CA; or
- ability of the director, in agreement with creditors, to invoke a moratorium for the purpose of reorganising the company outside of external administration.

The first recommendation was adopted and no change to the provisions were made.

---

[20] Section 95A of the CA

[21] Insolvent trading: A safe harbor for reorganisation attempts outside of external administration: January 2010

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

In response to several related Government inquires, the Australian Restructuring Insolvency and Turnaround Association (ARITA) released a discussion paper titled *A Platform for Recovery: Dealing with Corporate Financial Distress in Australia* in October 2014, which provided further discussion on the benefits of safe harbour provisions.

In essence, when directors seek genuine restructuring, it is argued they should have a defence based on the business judgement rule[22]. This, coupled with the guidance of an adequately experienced professional, termed a Chief Restructuring Officer (CRO), would allow directors to access adequate informal restructuring services when a company is in financial distress situations.

The proposal paper issued in April 2016, currently being assessed, provides two options for safe harbour provisions. These are:

- Model A: additional defence to insolvent trading, provided genuine informal restructuring was pursued; or
- Model B: safe harbour acts to modify section 588G rather than providing a defence to it. This allows the director to retain control without the requirement to seek assistance from a restructuring advisor.

The two options are discussed below:

3.1 Model A

Based on the Productivity Commission's report on Business Set-up, Transfers and Closure, issued in September 2015, the recommendation for a director to access the advice of a restructuring professional and attempt informal restructuring should be available, without fear of personal liability should the restructuring fail.

This model is predicated on the following two conditions:

- that the company's records are adequate, up-to date and explain the company's transactions and financial position; and
- a restructuring advisor provides an opinion that the company may be able to avoid insolvent liquidation and be returned to solvency within a reasonable period of time.

This defence will be used by directors when a company has failed to return to a solvency position within a reasonable period of time, even though a restructuring advisor has provided an opinion that it was possible. To ensure both the director and the restructuring advisor act in good faith, we propose the following obligations be mandated through regulation:

3.1.1 The director's obligations

- the director must take all reasonable steps to implement the recommendations of the Advisor to achieve a solvency position within a reasonable period of time. Circumstances outside the control of the director or impossible to foresee would be sufficient to evidence the director took reasonable steps to try to return the company to a solvent position;

[22] ARITA discussion paper: A Platform for Recovery Dealing with Corporate Financial Distress in Australia: October 2014

- the director must provide the restructuring advisor with all specific industry knowledge, expertise and opinion of future trends known to the director at the time the opinion is being formed;
- failure to act in good faith constitutes a breach of the director's fiduciary duties detailed in section 180 – 185 of the CA.

3.1.2 The Restructuring Advisor's obligations

- the obligation to report any misconduct of the director or/and the company;
- the obligation to provide an honest and reasonably held opinion, exercising powers and discharging duties in good faith in the best interests of the company; and
- the obligation to provide relevant information on the safe harbour period to the key stakeholders of the company; such as the employees, parent company (if any), secured creditors and core suppliers.

3.1.3 Timeframes

The period of time that the company is going through an informal restructuring (the safe harbour period) should be defined. For example:

Stage 1: Restructuring advisors to produce an opinion by way of a report to the company within 28 business days of appointment.

Stage 2: The directors meet with key stakeholders within 14 days of the Advisor's report to implement changes to attempt to return the company to a solvent position.

Stage 3: If the safe harbour period is more than one year from the date of the Advisor's report, then a meeting of the company stakeholders should be held at the end of the year, at which the restructuring advisor should provide a supplementary report on any additional action that could be taken to expedite the path to solvency OR whether the company should be placed into insolvency.

3.2 Other features of safe harbour

We agree that whilst the company is operating during the safe harbour period, the following should be preserved:

- the future right to pursue voidable transactions and personal liability for employee liabilities, should the company fail to return to a solvent position within a reasonable period of time;
- the relation back date should coincide with the commencement of the safe harbour period. For some transactions, such as transfers to related parties which are designed to defeat creditors; and
- the company should retain the same obligations as a solvent company in terms of continuous disclosure, such as:
  - lodgement of business activity statements;
  - payment of employee superannuation, PAYG, employee claims; and
  - lodgement of income taxation return.

As previously stated in section 3.1.1, the director should be obligated to take all reasonable steps to implement the restructuring advisor's recommendations, to be eligible to access the safe harbour defence.

3.2.1 Another suggested feature – access to finance

A common requirement to cure a company's financial distress is the ability to obtain debt or equity funding whilst implementing restructuring recommendations[23]. The restructuring advisor could assist the Company to access an appropriate debt or equity funder.

3.3 Model B

Model B provides for the director of a company to continue to trade and incur debt whilst the company is in financial distress, and make decisions with a responsible level of risk, provided:

- the debt is incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and
- 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.

This model does not prescribe the use of a restructuring advisor, and directors can retain control without disclosing any financial distress.

Between 1961 (when the insolvent trading laws were introduced) and 2004 there has been, on average, less than three insolvent trading actions each year. Of these actions, 75% sought compensation and only 15% sought more serious sanctions[24].

Reasons why an insolvent trading claim would not be pursued are:

- the Liquidator's obligation to prove the director's state of mind, intent and personal knowledge as required can be very difficult;
- the costs to pursue the claims are high and unless a liquidator can be assured that a director holds substantial personal wealth to satisfy a future judgment debt, it is uncommercial and not in the best interests of the creditors of the company; and
- the reasonableness test in subsections 588G(1)(c) and 588G(2)(b) allows for a director to mount a defence based on the particular circumstances of the company.

For these reasons we do not believe Model B will encourage directors to voluntarily seek help at an earlier stage, or promote responsible corporate risk-taking to ensure continued trading and future solvency of a company.

[23] Insolvent trading: A safe harbour for reorganisation attempts outside of external administration January 2010
[24] Productivity Commission report Business Set-ups, transfers and Closures pg 378

4. Ipso facto clauses

An insolvency event of a company is likely to trigger an ipso facto clause in most contracts, allowing the other contracted party to terminate the agreement.

The appointment of a voluntary administrator is usually considered an insolvency event, even though the purpose of the appointment is to formally restructure the company. Section 440B of the CA was designed to restrict the rights of property lessors and secured creditors, however, it does not extend to general contracts with suppliers, franchisees etc.

By rendering ipso facto clauses void against an Administrator, Receiver, Controller or Deed Administrator, legislation could work in the way it is intended, allowing the appointee to retain and realise the value held in the business. We note that section 304 of the BA already renders ipso facto clauses void for Bankruptcy.

4.1 The Ipso Facto model

4.1.1 Anti-avoidance

To ensure that any provision in an agreement that has the *effect* of terminating a contract solely on the reason of a contracted party's insolvency being void is supported.

4.1.2 Exclusions

Prescribed financial contracts to be excluded from the model, as to include them could negatively affect capital markets.

4.1.3 Appeal

We agree that counterparties could apply to Court to vary contract terms in the event of hardship.

In summary, we agree with and endorse Treasury's efforts to encourage appropriate efforts from directors to engage in early attempts to avoid the insolvency of a company. Of the proposals put forward, we believe that the introduction of a 'safe harbour' for directors, using Model A, is likely to be the most productive solution, and we also agree that ipso facto clauses should be unenforceable against a company undertaking genuine restructuring. We do support the proposal to reduce the default bankruptcy period conditionally pending clarification on recovery mechanisms and the powers of former trustees to perform their duties.

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

Annexure A: Our responses to your queries detailed in the proposals paper

Proposal	Query No	Query	Response
Retain trustee's ability to object to discharge and extend the period up to eight years	1.1	Should the criteria for lodging an objection and the standard of evidence to support an objection be changed to facilitate a trustee's ability to object to discharge?	Yes. The criteria set out in s149C of *the Bankruptcy Act 1966 (Cth)* (the BA), being: able to identify the objection, ensuring sufficient evidence to prove the objection, having a valid reason to object and ensuring the Bankrupt does not have a reasonable excuse are simple at first glance. However, the evidence required to meet the criteria is onerous in practice, especially if the reason to object is to induce the Bankrupt to perform a duty not otherwise discharged [s.149B]. Reasons for this are: 1. the objection is not meant to be seen as a punishment even though its function is punitive; 2. creditors are disadvantaged and the delay of the Bankrupt's non-compliance does cause additional costs to the estate; and 3. the trustee must anticipate what effect the objection will have on the behaviour of the Bankrupt, and this is generally unknown or unpredictable. Evidence provided by the trustee should be reduced as the objection can always be withdrawn. One year is an inadequate period of time to produce the level of evidence currently required.
Change the BA to ensure the obligations on a bankrupt to assist in the administration of their bankruptcy remains after discharge	1.2.1a	Which particular obligations on a bankrupt should continue after a bankrupt is discharged?	All of the obligations detailed in sections 152 & 153 of the BA. Ensuring the Bankrupt provides assistance within 28 days of a trustee's reasonable request should be considered.
	1.2.1b	What incentives and mechanisms should be in place to ensure compliance with obligations after discharge?	If a bankrupt does not comply with a trustee's reasonable request within 28 days, the trustee should have the option of applying to AFSA for commencement of a subsequent bankruptcy term. We recommend retaining the penalty of six month's imprisonment, however we recommend that the process of application to the relevant Court is simplified/standardised so that a lawyer is not required to assist with this application. If the bankrupt does not meet income contribution obligations (provision of income information, payment of liability), the former trustee should retain the right to issue a garnishee notice on the discharged bankrupt's bank account. If the bankrupt conducts business overseas and is non-compliant (and trustee does not lodge an objection) the trustee should have the option to extend the restriction on overseas travel for the two year period post discharge.
	1.2.2	Continue to pay income contributions for three years and if objection is lodged for the entire term of the bankruptcy	The mechanism put in place to ensure a bankrupt provides evidence on income annually for two years after discharge will have to be effective and carry heavy penalties. Concerns include: what powers a former trustee would hold to collect the liability, how a former trustee would be remunerated, and any other tasks such as adjudication on creditor claims and dividend distributions at a time when the trustee is no longer the trustee.

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

Proposal	Query No	Query	Response
Reduction of credit, overseas travel and licence restrictions (subject to misconduct)	1.31	Appropriateness of reducing retention period for personal insolvency information in credit reports	Providing credit to a discharged bankrupt should be at the discretion of the financial institution (debt finance) or investor (equity finance). Recording the bankruptcy event should remain, however there should be the addition of a classification system to identify high risk clients.
Defence to section 588G of the CA (Model A)	2.2	Will model A provide an appropriate safe harbour for directors?	Yes, with the following changes/additions. It is insufficient for the requirement of relevant company records and the restructuring advisor's opinion to be the only determinants of the company's future viability. Directors must take reasonable steps to comply with the Advisor's recommendations to enable the company to be restructured in an informal capacity. If a director can evidence that the events that proceeded the insolvency of the company were unlikely to be predicted and outside of the director's control then the defence would be satisfactory.
	2.2.1a	What qualifications and experience should directors take into account when appointing a restructuring officer, & should this be set out in ASIC RG?	The recommended qualifications should be an external administrator or accountant and a member of ARITA and either the Institute of Charters Accountants Australia (ICCA) or CPA Australia. Yes, a regulatory guide specifying what qualifications are required should be produced by ASIC.
	2.2.1b	Which organisations, if any, should be approved to provide accreditation to restructuring advisors, if such approval is incorporated in the measure?	We recommended that the appropriate organisations should be the Australian Securities and Investments Commission (ASIC) and the Australian Restructuring Insolvency and Turnaround Association (ARITA).
	2.2.1c	Is the method of determining viability appropriate?	No. Currently the method is too broad. The method suggested is that the company can avoid insolvent liquidation and be returned to solvency within a reasonable period of time. This method very broad for the following reasons: 1. proving the insolvency or solvency of a company is a specialist's process which incorporates a large body of case law. The key principles are: insolvency as a cash flow test, use of balance sheet to supplement information, use of indicators of insolvency, how secured creditors and set off affects the assumptions, and access to debt/equity funding. These should be the bases of what is considered when assessing the company's current position. 2. providing an opinion that a company can avoid an insolvency event takes into consideration many forward looking statements that are affected by unknown factors occurring in the future. The Advisor would seek reliance on the statements of the directors (with their specific industry knowledge) and/or historical relationships.

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

Proposal	Query No	Query	Response
Defence to section 588G of the CA (Model A)	2.2.1d	What factors should a restructuring advisor take into account when determining viability? Should these be set out in regulation or left to the discretion of the advisor?	The factors we recommend are: • there should be a base level requirement to perform specific tests based on the above points in 2.2.1c, but the overall opinion should be left to the discretion of the Advisor. • the Advisor could assist the company in obtaining further funding if required to return the company to solvency within a reasonable period of time.
	2.2.1e	Are the protections and obligations for the restructuring advisor appropriate, and what other protections and obligations should the law provide for?	The proposed protections and obligations for the restructuring advisor are logical. Two of these protections that should remain are that the restructuring advisor: • is not a shadow or de facto director; and • is not able to be appointed to any subsequent insolvency without leave of the Court, which is in line with Corporations and Bankruptcy statute and section 6 of ARITA Professional Code of Conduct. Obligations of the director have not been addressed. The director should take all reasonable sets to implement the recommendations of the Advisor, provide all reasonable assistance as requested and act in good faith. All obligations of the restructuring advisor and the director should be set out in the regulations.
Other features of safe harbour	2.2.2a	Do you agree that safe harbour would not prevent voidable director related transactions or personal liability for specific employee liabilities incurred during the safe harbour period (if company is subsequently liquidated)?	Voidable antecedent transactions predicated on determining a date of insolvency prior to or as a result of entering into the transaction are likely to be affected by the opinion of the restructuring advisor stating the company's ability to be solvent within a reasonable period of time. The impact of this depends on the timing of when the restructuring advisor's opinion was provided, and if the informal workout occurred. The current provisions of section 588 of the Act should all remain in the event of an insolvent liquidation, provided that all elements of voiding the transaction can be met. Yes, safe harbour provisions should not prevent voidable recoveries or absolve the director from personal liability associated with employee liabilities, if the company is liquidated due to a failure of the informal workout.
	2.2.2b	Company continuous disclosure requirements would remain during the safe harbour period, which may impact privacy. Do you agree?	Yes, continuous disclosure should occur, together with a defined timeframe for the process of "informal restructuring" to ensure that a company does not stay in the "safe harbour period" indefinitely. It is also recommended that key stakeholders be involved in this process as they should have the right to withdraw their support.
Where safe harbour is not available	2.2.3	In what other circumstances should the safe harbour defence not be available?	If the director does not take all reasonable steps to implement the Advisor's recommendations, they should not be afforded the defence.
Section 588G of the CA does not apply (Model B)	2.3	What are the merits and drawbacks of this model?	The drawback of this model is that is shifts the responsibility of the director to ensure the company not trading insolvently or will return to solvency within a reasonable timeframe to the Liquidator, in their obligation to pursue the director with creditors' funds. We are of the view that this is unlikely to have a positive effect in director dealings.

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

Proposal	Query No	Query	Response
Any term of a contract or agreement which terminates or amends any contract or agreement by reason only that an 'insolvency event' has occurred would be void. Any provision that has the effect of providing for, or permitting, anything that in substance is contrary to the above provision would be of no force or effect	3.2a	Are there other specific instances where the operation of ipso facto clauses should be void?	We agree that counterparties to a contract with an insolvent party should not be allowed to amend, accelerate or vary an agreement for the sole purpose of insolvency.
	3.2b	Should any legislation introduced which makes ipso facto clauses void have retrospective operation?	No
	3.2.b	Are there any other circumstances to which a moratorium on the operation of ipso facto clauses should also be extended?	Yes. Liquidators that are converting a business sale or who have a genuine reason should also have the capacity to void an ipso facto clause. It is agreed that any other type of ipso facto clause that varies the terms or terminates a contract that would be detrimental to a company undertaking restructuring should be void.
	3.2.1	Does the mechanism of any provision in an agreement that has the effect of providing for, or permitting, any that in substance is contrary would be of no force or effect constitute adequate anti-avoidance?	Yes
	3.2.2	What contracts or classes of contracts should be specifically excluded from the operation of the provision?	We agree with prescribed financial contracts.
	3.2.3	Do you consider appeal on the grounds of hardship to be a necessary and appropriate safeguard? If no, what mechanism would be?	Yes

Attachment B Submission to Treasury on proposed bill

Innovation Statement Law Reform: Safe Harbour and Ipso Facto

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

Dated 24 April 2017

Submission by SV Partners Pty Ltd
ABN 63 103 951 819

Email submissions to:
Treasury: insolvency@treasury.gov.au by 24 April 2017

SV House
138 Mary Street
BRISBANE QLD 4000
p 07 3310 2000
f 07 3229 7285
e brisbane@svp.com.au
w svpartners.com.au

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

Contents

1. Introduction 22

1.1 Who we are 22

1.2 Our experience 22

1.3 Executive summary 22

2. Safe harbour provisions 22

2.1 Determining what is 'reasonably likely' to lead to a 'better outcome' 23

2.2 Our concerns 23

2.3 Potential impact of the Bill on voidable transactions 24

3. Ipso facto clauses 24

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

1. Introduction

1.1 Who we are

SV Partners Pty Ltd (SV Partners) provides professional corporate and personal insolvency advice to accountants, financial institutions, corporations, financial and legal advisors, and individuals. With a team of over 100 insolvency specialists across the eastern seaboard, our expert advisors focus on recovery, reconstruction advice and formal insolvency appointments. We also operate one of the largest private bankruptcy practices in Australia.

1.2 Our experience

Our executive team has extensive experience in the insolvency and turnaround industry and hold memberships with Australian Restructuring, Insolvency and Turnaround Association (ARITA), Chartered Accountants Australia and New Zealand (CAANZ), Certified Practicing Accountants Australia (CPA), Institute of Public Accountants (IPA), Australian Institute of Credit Management (AICM), Turnaround Management Association (TMA), Australian Institute of Company Directors (AICD) and the QLD Master Builders Association (QMBA).

We also hold positions on the Australian Securities and Investments Commission (ASIC) Liquidator panel, the Australian Taxation Office (ATO) Liquidator panel and Department of Employment Fair Entitlements Guarantee (DoE FEG) panel.

1.3 Executive summary

The proposed Bill goes too far in carving out insolvent trading provisions. Main concerns involve 'pre-insolvency advisors' potential abuse of the provisions, increased obligations on the Liquidator to prove that safe harbour protection is not available when pursuing an insolvent trading action and that the proposed bill does not achieve the objective of balancing creditors rights with responsible business risk taking.

2. Safe harbour provisions

Australian insolvent trading laws have been debated often.

In January 2010, a discussion paper[25] assessed if Australia's insolvent trading laws were stifling entrepreneurial activity and provided three options to resolve any concern. An additional defence for directors or allow for flexible reorganising the company outside of external administration were considered, but resulted in no change.

In October 2014, the Australian Restructuring, Insolvency and Turnaround Association (ARITA) released a discussion paper[26] which championed the removal of the insolvent trading provisions to allow directors to have a safe harbour to make decisions on potential restructuring in conjunction with a formal restructuring adviser.

[25] Insolvent Trading: A safe harbour for reorganising attempts outside of external administration
[26] A Platform for Recovery 2014: Dealing with Corporate Financial Distress in Australia

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

In December 2015, the Productivity Commission's report (No. 75[27]) recommended a 'safe harbour defence' to allow directors to obtain independent advice without the threat of insolvent trading penalties.

Based on the Productivity Commission's recommendation, a proposal paper[28] for safe harbour provisions was released for comment in April 2016. Model A provided for an additional defence to insolvent trading and model B carved out insolvent trading provisions, focusing on the director retaining control without the requirement to seek assistance from a restructuring advisor. Following that consultation, the proposed Bill was released in March 2017.

The Bill proposes a modified version of model B through the creation of new sections to the *Corporations Act 2001 (Cth)* (the Act) which will create a safe harbour for directors' from personal liability for contravention of the civil penalty provisions of section 588G(2), through the:

- development and application of a recovery plan that is <u>*reasonably likely*</u> to lead to a <u>*better outcome for the company and its creditors*</u> than the alternative (being voluntary administration or liquidation);
- ensuring employee entitlements (including Superannuation) pursuant to section 596AA(2) of the Act are provided for;
- company continues to meet reporting obligations in the *Income Tax Assessment Act 1997*; and
- maintenance of company records that are adequate (and must be provided to an administrator or liquidator on appointment).

2.1 Determining what is 'reasonably likely' to lead to a 'better outcome'

In the initial proposal, model B required the director to '*take reasonable steps to maintain or return a company to solvency within a reasonable period of time*[29]', however, this has been removed in the proposed Bill. Further, initial indications that legislation would flesh out what 'reasonable steps' and what 'a reasonable period of time' would entail have also been overlooked.

Reasonableness is determined on an objective standard and whilst the proposed Bill attempts to provide guidance at 588GA(2) by listing five *general factors* to be considered; the explanatory memorandum[30] renders them ineffective by stating it is not necessary for all five factors to apply for reasonableness to be demonstrated, however, in the alternative, if they did, one cannot ensure that the course of action can be deemed reasonable.[31]

2.2 Our concerns

The productivity commission's recommendation for a safe harbour for directors was made on the basis that the '*restructuring advisers be registered, that the company be solvent at the time of the adviser's appointment and that the adviser is presented with complete books and records on their appointment*'[32]. The report goes onto discuss implementation, disclosure concerns, timing and coverage and the overall operation of potential safe harbour provisions.

---

[27] Productivity Commission Inquiry Report No. 75: Business Set Ups, transfers and Closures, 30 September 2015 (the PC report)
[28] Improving bankruptcy and insolvency laws
[29] Improving bankruptcy and insolvency laws Proposals Paper April 2016 (National Innovation and Science Agenda)
[30] Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Explanatory Memorandum (EM)
[31] Points 1.32 – 1.35 of EM
[32] Page 373 of the PC report

Submission on the Senate Economics Legislation Committee on the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill (the proposed bill)

Our responses to the questions in the proposal paper (submitted on 26 May 2016) are included at attachment A and in our 2016 submission we favoured model A as it:

- dealt with concerns surrounding the conduct of 'pre-insolvency advisors', who do not have obligations to be registered with a regulatory body, do not hold a minimum standard of education and are not bound by any professional and ethical standards;
- could be codified to ensure directors have a clear obligation to act when a company is in financial distress, accessing professional assistance and working with the company's stakeholders in an informal capacity to return the Company to a solvent position; and
- required the involvement of a qualified professional – termed a 'restructuring advisor', who could potentially assist with access to additional funding.

Model B shifted the responsibility from a director to act when a company is in financial distress to the Liquidator (after the Company has failed) to prove that a director committed an offence.

The proposed Bill fails to achieve the objective of balancing creditors' rights with responsible business risk taking by failing to address the negative implications on existing and new creditors, relevant timeframes and the basic obligation to ensure the Company becomes viable within a reasonable period of time.

Liquidators pursing insolvent trading claims are currently required to undertake substantial investigations, incur legal expenses and their own expenses with the anticipation that recoveries from a successful judgment will provide reimbursement of these expenses as well as a return to creditors. Providing such a flexible carve out of the provisions without obligations imposed on directors to achieve a result will increase the burden on liquidators to bring recalcitrant directors to account, and when they do, the higher costs are likely to be borne by creditors.

2.3 Potential impact of the Bill on voidable transactions

The implications of directors seeking relief from insolvent trading actions may have an adverse impact on the recovery of voidable transactions (in the event the company is liquidated) as the proposed Bill fails to address any of the following:

- the *Insolvency Law Reform Act 2016* introduced in March 2017 clarifies relation back date in specific circumstances, a scenario involving a failed attempt to claim safe harbour should also be addressed to coincide with the commencement of the safe harbour period;
- presumptions of insolvency specified in section 286 of the Act should be extended to include a failed attempt at safe harbour;
- clarification that safe harbour protection only extends to a director for offences pertaining to insolvent trading; and
- there does not appear to be any protection for new creditors incurred during the 'safe harbour period' in terms of voidable preference recoveries.

3. Ipso facto clauses

Part 2 of the proposed Bill codifying a stay on enforcing rights merely because of arrangements or restructures appears reasonable with the types of contracts proposed to be excluded logical.