Chapter 1

Introduction

1.1 On 1 June 2017, the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 (the bill) was introduced by the government into the House of Representatives.[1] On 15 June 2017, the Senate referred the provisions of the bill to the Senate Economics Legislation Committee for inquiry and report by 8 August 2017.[2]

1.2 The bill delivers on the government's commitments announced in December 2015, as part of its National Innovation and Science Agenda, to reform Australia's insolvency laws by introducing a safe harbour for directors from the insolvent trading provisions of the *Corporations Act 2001* and making ipso facto clauses unenforceable in certain insolvency procedures.[3] In implementing these reforms, the government aims to 'promote entrepreneurship and innovation to drive business growth, local jobs and global success'.[4]

1.3 The Minister for Small Business, the Hon Michael McCormack MP, summarised the benefits of the proposed safe harbour and ipso facto clause measures:

> Together, these amendments will reduce instances of a company proceeding to a formal insolvency process prematurely. Where companies do enter into particular formal insolvency procedures, they will have a better chance of being turned around or of preserving value for creditors and shareholders.
>
> This in turn will promote the preservation of enterprise value for companies, their employees and creditors, reduce the stigma of failure associated with insolvency and encourage a culture of entrepreneurship and innovation.[5]

Conduct of the inquiry

1.4 The committee advertised the inquiry on its website. It also wrote to relevant stakeholders and interested parties inviting written submissions by 12 July 2017. The committee received 19 submissions, which are listed at Appendix 1. The committee thanks all individuals and organisations that took the time to make a written submission.

1.5 The committee did not hold any public hearings for the inquiry.

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1 *Votes and Proceedings*, No. 57, 1 June 2017, p. 810.

2 *Journals of the Senate*, No. 44, 15 June 2017, p. 1433.

3 See *National Innovation and Science Agenda*, December 2015, p. 7.

4 The Hon Michael McCormack MP, Minister for Small Business, *House of Representatives Hansard*, 1 June 2017, p. 6011.

5 The Hon Michael McCormack MP, Minister for Small Business, *House of Representatives Hansard*, 1 June 2017, p. 6012.

Overview of the bill

1.6 The bill amends the *Corporations Act 2001* (Corporations Act) and contains one schedule and two parts:

- Schedule 1, Part 1 will create a safe harbour for company directors from personal liability for insolvent trading under subsection 588G(2) of the Corporations Act if the company is undertaking a restructure outside of formal insolvency.[6] Part 1 will also provide for a safe harbour for holding companies.[7]
- Schedule 1, Part 2 will make certain contractual rights that amend or terminate and agreement (ipso facto clauses) unenforceable when a company is undertaking a formal restructure except in certain limited circumstances.[8]

Scope, limits and safeguards on the application of safe harbour

1.7 The safe harbour proposed in Part 1 to the bill will protect a director in relation to debts that a company incurs directly or indirectly in connection with developing and taking a course of action that is reasonably likely to lead to a better outcome for the company.[9]

1.8 A 'better outcome' for the company is defined in the bill as 'an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company'.[10]

1.9 The protection of safe harbour does not extend beyond the civil liability set out in subsection 588G(2) of the Corporations Act. During safe harbour, directors must continue to comply with all their other obligations under the law, including their director's duties and any continuous disclosure obligations.[11]

1.10 The safe harbour is intended as a protection for competent directors who are acting honestly and diligently. Consequently, the safe harbour is only open to directors who comply with certain formal obligations. Specifically, directors will:

- be prevented from using books and information about a company as evidence that they took a course of action as part of the safe harbour if they have previously not provided these materials to a liquidator or administrator following an appropriate request for the materials.
- not be able to rely on the safe harbour in circumstances where the company is not meeting its obligations in relation to reporting to the controller of the

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6 Explanatory Memorandum, p. 10.

7 Explanatory Memorandum, p. 22.

8 Explanatory Memorandum, p. 27.

9 Explanatory Memorandum, p. 11.

10 See proposed ss. 588GA(7).

11 Explanatory Memorandum, p. 11.

> company, employee entitlements (including superannuation) and its taxation reporting obligations.[12]

Background

1.11 Under section 588G of the Corporations Act, a director of a company may be personally liable for debts incurred by the company if:

- they are a director of a company at the time when the company incurs a debt;
- the company is insolvent at that time, or becomes insolvent by incurring that debt; and
- at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent.[13]

1.12 As the Explanatory Memorandum articulates, under the current provisions, 'this duty to prevent insolvent trading is framed as a default contravention' and focus is 'on the timing of when debts are incurred by a company rather than the conduct of the directors in incurring that debt'.[14]

1.13 The current focus on the solvency of the company and the time at which debts are incurred can lead to potentially undesirable outcomes. In his second reading speech, the Minister for Small Business, the Hon Michael McCormack MP, commented that 'our current insolvent trading laws put too much focus on stigmatising and penalising failure', further explaining that:

> The threat of Australia's insolvent trading laws, combined with uncertainty over the precise moment a company becomes insolvent have long been criticised as driving directors to seek voluntary administration even in circumstances where the company may be viable in the longer term. Concerns over inadvertent breaches of insolvent trading laws are frequently cited as a reason that early stage—angel—investors and professional directors are reluctant to become involved in a start-up.[15]

1.14 In addition to the threat of personal liability for insolvent trading under section 588G of the Corporations Act, a lack of protection from the operation of ipso facto clauses has been a key criticism of Australia's insolvency regime.

1.15 As noted in the explanatory memorandum:

> An ipso facto clause creates a contractual right that allows one party to terminate or modify the operation of a contract upon the occurrence of some specific event. In the current insolvency context, such rights may allow one party to terminate or modify the contract solely due to the

12 Explanatory Memorandum, p. 9.

13 *Corporations Act 2001*, s. 588G.

14 Explanatory Memorandum, p. 5.

15 The Hon Michael McCormack MP, Minister for Small Business, *House of Representatives Hansard*, 1 June 2017, pp. 6011–6012.

> financial position of the company (including insolvency) or due to the commencement of formal insolvency proceedings, such as on the appointment of an administrator. This type of termination can occur regardless of the counterparty's continued performance of its obligations under the contract.[16]

1.16 The operation of ipso facto provisions can therefore reduce the scope for a successful restructure, destroy the enterprise value of a business entering formal administration or prevent the sale of the business as a going concern.[17]

Productivity Commission report

1.17 In November 2014, the government requested that the Productivity Commission (PC) undertake an inquiry into barriers to business entries and exits. Under the scope of the inquiry, the PC was required to identify appropriate options for reducing these entry and exit barriers. This included providing advice on the potential impact of regulations affecting the ease of starting, operationalising or closing a business, and of corporate insolvency regimes on business exits.

1.18 The PC's final report for the inquiry (PC Report)—Business Set-up Transfer and Closure—was submitted to government in September 2015. The PC Report identified a range of reforms to improve the effectiveness of Australia's corporate insolvency regime, including measures to remove impediments to effective and successful corporate restructuring.

1.19 In this regard, the PC Report included recommendations that the Corporations Act be amended to:

- allow for a safe harbour defence to insolvent trading, framed around the appointment by a director of a professional restructuring advisor;[18] and
- make ipso facto clauses that have the purpose of allowing termination of contracts solely due to an insolvency event unenforceable if the company is in voluntary administration or the process of forming a scheme of arrangement.[19]

1.20 The government released its response to the PC inquiry in May 2017, noting that it had already initiated reforms in line with the PC's recommendations relating to a safe harbour from insolvent trading and the operation of ipso facto clauses.[20]

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16 Explanatory Memorandum, p. 25.

17 Explanatory Memorandum, p. 25.

18 Productivity Commission, *Business Set-up, Transfer and Closure*, No. 75, September 2015, p. 387.

19 Productivity Commission, *Business Set-up, Transfer and Closure*, No. 75, September 2015, p. 398.

20 See *Australian Government response to the Productivity Commission inquiry into Business Set-up, Transfer and closure*, May 2017, p. 23.

1.21 Of importance to this inquiry, it is noted that the safe harbour model adopted in the bill contemplates safe harbour as a legislative carve out, rather than a defence, and is not framed around the appointment by a director of a professional restructuring advisor as recommended in the PC Report.

National Innovation and Science Agenda

1.22 In December 2015, the government launched the National Innovation and Science Agenda (the Agenda), a landmark new plan to capitalise on the nation's strengths and turn Australia into an innovation leader.

1.23 The Agenda focuses on measures in four areas: culture and capital; collaboration; talent and skills; and Government as an exemplar. Under the culture and capital area, the government committed to reform Australia's insolvency laws through measures including the introduction of a safe harbour for directors from personal liability for insolvent trading and the banning of ipso facto contractual clauses in certain insolvency procedures.[21]

Consultation

1.24 Following the launch of the Agenda, in April 2016, the government released for consultation a discussion paper containing various proposals for improving bankruptcy and insolvency laws, including on the safe harbour and ipso facto clause measures. The exposure draft legislation was released for consultation in March 2017.

Human rights implications

1.25 The safe harbour for company directors and holding companies imposes an evidential burden on company directors and holding companies to adduce or point to evidence that suggests a reasonable possibility that they have been acting under the safe harbour.[22]

1.26 As outlined in the Explanatory Memorandum, this application of an evidential burden on directors and holding companies:

> …is appropriate and consistent with human rights because in both cases the approach is consistent with the Commonwealth Guide to Framing Offences, Infringement Notices and Enforcement Powers as:
>
> - the information about the course of action taken and the thought process underpinning it are peculiarly within the knowledge of each respective director or holding company; and
> - it is significantly more difficult and costly for the opposing party to disprove the fact that:
>   - for a company director, the director developed a course of action reasonably likely to lead to a better outcome for the company; or
>   - for a holding company, the directors of the subsidiary had the benefit of safe harbour and the holding company took reasonable

21 See *National Innovation and Science Agenda*, December 2015, p. 7.

22 Explanatory Memorandum, p. 43.

steps to ensure the directors of the subsidiary had the benefit of safe harbour.[23]

1.27 The Parliamentary Joint Committee on Human Rights found that the bill did not raise human rights concerns.[24]

Financial Impact

1.28 The amendments in the bill do not have a direct and measurable financial impact.[25]

23 Explanatory Memorandum, p. 45.

24 Parliamentary Joint Committee on Human Rights, *Human rights scrutiny report: Report 5 of 2017*, June 2017, p. 49.

25 Explanatory Memorandum, p. 4.