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Australian Insolvency Reforms – Is the Harbour Safe Yet?

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On 28 March 2017, the Federal Government released its long awaited draft legislation for reforms to insolvency laws in Australia. The changes focus on providing a safe harbour for directors of distressed companies and a stay on the enforcement of ipso facto clauses in contracts.

The draft provisions have been introduced to facilitate and encourage informal restructuring efforts where, as a result of the current insolvent trading regime, potentially viable companies prematurely enter voluntary administration. The reforms also focus on preserving value and increasing the chances of a successful turnaround if a company does enter into voluntary administration or a scheme of arrangement. If enacted, the legislation would result in some of the most substantial changes to the Australian insolvency landscape in several decades.

The draft legislation is open for consultation with submissions due by 24 April 2017, and the finalised legislation is expected to come into effect on 1 January 2018.

Safe Harbour

Australia has one of the strictest insolvent trading regimes in the world with directors of insolvent companies facing personal liability and even criminal sanctions for continuing to trade an insolvent company. This regime has been cited as a potential reason for viable Australian companies being prematurely placed into a formal insolvency process. By introducing a 'safe harbour' the Government is hoping that directors of distressed companies will be able to pursue viable informal restructuring options. It is also hoped that the reforms will enable more risky start-up companies to attract professional directors, thereby encouraging innovation and entrepreneurship in Australia.

We expect that the current drafting may attract attention in submissions as a result of ambiguity in the opening words of the key safe harbour provision which shows an intent to provide directors with a "carve out" to the insolvent trading regime (rather than a defence to breaching the regime). The ambiguity is created in the proposed provisions which follow in that the word "defence" is used. Unfortunately the Explanatory Memorandum adds to the ambiguity by stating in the early part of its explanation that the provisions are a "carve out" yet later on referring to the "safe harbour defence".

While people might say what is the difference? In our view, a director might feel more comfortable with a carve out in the true sense of the word as they do not "commit the offence" per se. Being characterised as a carve out or a defence might also impact on who has the onus of proof in any action that is brought for insolvent trading. The wording in all of the proposed changes needs to be reviewed to make the intent clearer for all.

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Having said that, under the proposed changes, directors of companies undertaking a restructure will be protected from personal liability for debts incurred where they take a course of action that is "reasonably likely" to lead to a better outcome for the company and its creditors in comparison to putting a company into voluntary administration or liquidation.

Importantly, as currently drafted, the protection is stated to apply only to debts incurred "in connection with that course of action". Is it therefore arguable that directors will not have the benefit of the safe harbour for debts incurred in the ordinary course while the restructuring course of action is undertaken, like wages and inventory purchases? While this is clearly not the intention of the legislation, the drafting will need to be clarified if the safe harbour provisions are to provide meaningful protection for directors of distressed companies.

The draft provisions set out some indicators to determine whether a course of action is reasonably likely to lead to a better outcome. These indicators (not exhaustive) include obtaining advice from an appropriately qualified entity and developing or implementing a plan for restructuring the company to improve its position.

The proposed changes can be contrasted with the "wrongful trading" regime in the United Kingdom which imposes liability on directors only when the relevant directors incurred a debt in circumstances in which they knew or ought to have known that there were no reasonable prospects for the company to avoid insolvency. This more subjective test arguably gives a director of a distressed company more comfort in pursuing various informal restructuring solutions so long as they hold the belief that the company has a chance of survival.

Under the proposed Australian formulation, the director would have to be confident that their actions are "reasonably likely" (and continue to be so over time) to lead to a better outcome. This, on its face, appears to be a more objective standard without much clear guidance. Indeed, the explanatory memorandum to the proposed legislation states that the safe harbour protection may arise even if none of the indicators listed are present. Furthermore, there may potentially be a situation where all the indicators are present but a court decides that the safe harbour will not apply. The legislation envisages that each circumstance will be judged on its own facts. It may therefore be a brave director who seeks to rely on this provision before there is sufficient precedent on how a court will interpret and apply the safe harbour carve-out.

It is also important to note that the safe harbour protection will not apply if the company is not providing for employee entitlements (including superannuation) or lodging necessary returns with the Australian Tax Office.

One positive note for directors is that, while the directors will be required to provide evidence of the "course of action" they undertook to fall within the safe harbour, in any action for insolvent trading, the onus of proof will lie with a liquidator (or other party suing the director) to establish that the course of action taken by the director was not reasonably likely to lead to a better outcome.

Ipso Facto

Ipso facto clauses typically allow a counterparty to terminate or exercise another right (such as accelerate the due date for payments) under a contract on the occurrence of an insolvency event, such as the appointment of an administrator. For some companies, the most significant assets they have will be their contracts with customers. The loss of those contracts can have catastrophic impacts on a company's business. The existence and prevalence of ipso facto clauses in Australia has been cited as a reason for why many companies struggle (and indeed fail) to trade out of voluntary administration.

The proposed legislation will prevent parties contracting with a company which enters into a restructuring arrangement from amending, terminating or exercising a right under the contract with the company solely due to it entering into a scheme of compromise or arrangement, or administration. The contracting party's rights will be stayed until the restructuring application is withdrawn or rejected by the court or the compromise, arrangement or administration concludes. It is worth noting that the stay will not apply to rights that arise as a result of the appointment of a receiver.

Certain types of contracts will be excluded from the legislation including contracts entered into after the restructuring is commenced and contracts that manage financial risk where the ipso facto clause would be commercially necessary for the provision of a financial product (for example swaps and hedging contracts). A list of excluded contracts will be prescribed by regulation.

If enacted, the legislation will only apply to rights arising under contracts entered into on or after the enactment date (currently 1 January 2018). Rights arising under existing contracts will not be affected meaning that companies undergoing voluntary administration or a scheme of arrangement may not immediately benefit from the new provisions if the bulk of their contracts were entered into prior to the enactment date.

Further, while the proposed laws prevent the exercise of rights that arise solely as a result of the company entering into administration or a scheme of arrangement, other triggers that may give rise to the right to terminate or accelerate payments under a contract are not expressly subject to the stay. For example, termination and acceleration rights can be triggered by material adverse change clauses. The proposed new laws also do not prevent termination by choice if such a right exists under the contract. Given that the aim of the ipso facto provisions are to preserve value and give breathing space while a company goes through the administration or scheme process, the stay may need to be widened so as to prevent counterparties contracting around the ipso facto triggers.

The proposed changes will bring Australia more in line with the United States, which has had similar laws preventing the enforcement of ipso facto clauses for some time. In the U.S. the bankruptcy courts have strictly enforced a statutory stay to prevent contracting parties from terminating their contracts based on ipso facto clauses, in order to give insolvent companies a “breathing spell” to attempt court-sponsored reorganisations with their creditors. That includes allowing an insolvent company time to determine which contracts it wants to keep or scuttle (“assume or reject,” in U.S. bankruptcy terms) as part of its restructured business model, which may include renegotiated contract terms. The stay also applies in court-supervised liquidations, to allow orderly liquidations by bankruptcy trustees.

However, the US statutory stay has various "safe harbours" for financial contracts (eg swaps, repos, securities contracts, commodity and forward contracts, and related netting agreements) that enable counterparties to enforce ipso facto clauses and terminate the contracts immediately on a bankruptcy filing. These are designed to prevent a bankruptcy filing from having a ripple effect on the financial markets if counterparties were forced to freeze these contracts in place and await a restructuring. This has led many lenders and suppliers to attempt to structure their contracts to fit within the bankruptcy safe harbours - something that may similarly occur under the proposed Australian provisions.

Conclusion

While there is scope to clarify the drafting, the reforms are a welcome addition to the insolvency legislative framework. We will provide further updates as submissions are made and the legislation is finalised.

The draft bill and explanatory memorandum can be found at: http://www.treasury.gov.au/ConsultationsandReviews/Consultations

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