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# I GET KNOCKED DOWN, BUT I GET UP AGAIN

## Restructuring Law Reform in Australia - paving the way for a 'rescue culture'

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Australia has long been known for its "have a go" attitude and it appears that this sentiment has been behind major reform in Australia's restructuring and insolvency laws over the past year. New laws aim to expel the stigma of failure and focus on successfully restructuring financially distressed businesses to promote entrepreneurialism and, hopefully, strengthen Australia's economy. However, while the changes are a welcome addition to what was a traditionally strict insolvency regime, Australia's law makers have missed some opportunities to introduce further reforms that may have assisted companies in distress.

## What's changed?

The *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (**Enterprise Act**) was passed this year. The Enterprise Act contains two key reforms; the first is the introduction of a safe harbour for directors of struggling corporations which came into effect on 1 September 2017. The second component is a stay on the enforcement of *ipso facto* clauses, which is set to take effect from 30 June 2018.

The Enterprise Act reflects a shift in the focus of the financial and debt industries away from insolvency towards restructuring. It remains to be seen whether this is really a paradigm shift in ideology or whether it is being driven by the political landscape and concern about the now confirmed Banking Royal Commission.

The Enterprise Act's provisions have been introduced to facilitate and encourage informal restructuring efforts where potentially viable companies would have otherwise prematurely entered into voluntary administration under the previous insolvent trading regime. The Enterprise Act also focuses on preserving value and increasing the chances of a successful turnaround if a company does enter into voluntary administration or a scheme of arrangement. The term "rescue culture" has been coined to describe the underlying push behind the changes.

*Safe Harbour*

There has been a lot written and spoken about the fact that Australia has one of the strictest insolvent trading regimes in the world with directors of insolvent companies facing potential personal liability and even criminal sanctions for continuing to trade an insolvent company. This state of law created an environment of over-caution and provided incentive for directors, where there was a whiff of insolvency, to place the company straight into administration to avoid the risk of personal liability.

The new safe harbour laws provide a carve out to the insolvent trading provisions whereby a director will not be liable for a debt incurred by the company as part of a course of action, developed by the director when he or she suspects the company may become or be insolvent, that is reasonably likely to lead to a better outcome for the company.

The carve out will only be available where a company has complied with its employee entitlements and tax reporting obligations. What is reasonably likely to lead to a better outcome will vary depending on the circumstances of the company and will be judged against the likely outcome of an immediate appointment of an administrator or liquidator. The Enterprise Act has provided some guidelines on what steps a director may take, however, it is clear that the listed considerations are not a conclusive checklist of what must be shown to come under the safe harbour regime.

There may be examples where a director complies with all five of the guidelines and still cannot rely on the safe harbour regime. By the same token, a director may do none of these and the Court could find he or she has the protection of the safe harbour.

*How safe is the harbour?*

Given the novelty of the safe harbour regime, it is yet to be seen just how much protection will be afforded to directors of failing companies. Despite the factors referred to in the Enterprise Act, it may be difficult for a director to determine whether a course of action will lead to a better outcome than the immediate appointment of an administrator or liquidator. This is especially so having regard to the high stress and high stake decision making that is likely going on at the time.

There are concerns that the definition of “better outcome” means that directors will be required to undertake a counterfactual evaluation of the various outcomes which may result from a course of action against an external administrator appointment. The appointment of an administrator in particular, can have very broad and differing outcomes for a company.

This therefore heightens the need to recruit the assistance of an advisor to guide the director to safer waters. However, exactly who constitutes an “appropriately qualified entity” is also clouded in uncertainty and risk. There is concern that the new provisions could see a proliferation of illegal phoenix activity through the engagement of unregulated pre-insolvency advisors.

Some have advocated that an appropriate advisor would be a registered liquidator, however, the issue of potential fees may make such an appointment unworkable for small companies. It is clear to me that the appropriate advisor will vary depending on the characteristics of the business, however, regardless of the size of the company the advisor should have some form of qualification, appropriate experience and have an adequate level of professional indemnity insurance cover.

Many professional bodies, including the Australian Restructuring Insolvency and Turnaround Association (**ARITA**), have taken the steps of preparing material not only for its members but also for companies that are in a distressed situation. In addition, many accounting firms have developed literature about safe harbour and their expertise - some firms have even starting referring to themselves as "Harbour Masters". Having said that not all insolvency and advisory firms have embraced the safe harbour regime as a source of work, with some opting not to be involved in the market.

In my view, it is the education piece by organisations like ARITA, the Turnaround Management Association and the Australian Institute of Company Directors that will assist in the success of the safe harbour regime.

*Stay on enforcement of Ipso facto clauses*

Ipso facto clauses typically allow a counterparty to a contract to terminate or exercise another right (such as accelerate the due date for payments) under a contract on the occurrence of an insolvency event. For some companies, the most significant assets they have will be their contracts with customers. The loss of these contracts can have catastrophic consequences on a company's business and the prevalence of ipso facto clauses in Australia has been cited as a reason for why many companies struggle to trade out of voluntary administration. The new stay will help companies trade out of a financial distressed situation by retaining its core business.

Under the new laws, a contracting party will not be able to terminate a contract merely because:

(a) if the company is a disclosing entity, it publicly announces that it will make an application to restructure its business;

(b) the company is under administration;

(c) a managing controller has been appointed;

(d) the company is subject to an application to enter a compromise or arrangement or enters into a compromise or arrangement as a result of that application; or

(e) of the company's financial position.

The time at which the moratorium period will expire will vary depending on the insolvency event that has occurred, however, it will generally expire when the external administrator's control ends, when the relevant application is withdrawn or dismissed or when the compromise or arrangement ends. A contracting party will be indefinitely precluded from enforcing its rights under an ipso facto clause for circumstances arising before or during the stay period.

It should be noted that contracting parties will still be able to terminate for other reasons, such as because the company has failed to perform an obligation, including a payment obligation. This will restrict the effect of the protection to companies that are able to meet their payment and other contractual obligations.

*Possible Issues*

Like the safe harbour provisions, the stay on *ipso facto* rights has not gone as far as some people had hoped. The big issue is that the stay will only apply to contracts entered into on or after the enactment date (30 June 2018) so it will be some time before financially distressed companies feel the relief. There is also concern that suppliers with *ipso facto* clauses in their contracts may attempt to circumvent the new law by "rolling over" or varying existing contracts to argue that no new contract has been entered into or entering into new long terms contracts prior to the 30 June 2018 commencement date. Law makers missed a good opportunity to overcome these issues by making the law retrospective to give struggling companies the best chance of survival.

Regardless, some clever drafters down the track may be able to draft clauses so that the contract terminates immediately prior to the insolvency event, thereby circumventing the *ipso facto* provisions.

*What about the creditors?*

The safe harbour and *ipso facto* reforms have been introduced for the benefit of financially distressed companies and their directors. However, this has, to an extent, come at the expense of the creditors. In regards to the safe harbour provisions, creditors will lose out where the company takes a course of action which, although reasonably likely to lead to a better outcome, ultimately fails. Moreover, the stay on *ipso facto* clauses until the end of the winding up seems somewhat unfair to the contracting party if it is precluded from exercising its rights until the company is wound up. When the decision is made to place a company into liquidation, this would seem to be the final "nail in the coffin" and it is unlikely that the company will recover from that point. However, these factors may be weighed up against the benefits to the same creditors if the restructuring does in fact succeed.

## What's to come?

Given the safe harbour provisions have just come into play and in light of the concerns about how effective the reforms will be the regime will be subject to an independent review in two years to examine its impact and whether it is meeting its objective. Pending the outcome of that review, more reform could be on the horizon.

Furthermore, the "rescue culture" has not been limited to the corporations' arena. In October this year, the *Bankruptcy Amendment (Enterprise Incentives) Bill 2017* (Cth) (**Bankruptcy Bill**) was introduced into the Senate. Arguably the most notable change under the Bankruptcy Bill is the reduction of the period of bankruptcy from three years down to one year from the date on which the bankrupt files his or her statement of affairs. A similar reduction is proposed to the period in which one is obliged to disclose his or her status as a bankrupt, the requirement to seek permission to travel overseas and the ability to work in certain professions or hold certain positions. To protect creditors, the Bankruptcy Bill provides for the income contribution obligations for discharged bankrupts to extend for at least two years following discharge. As with the Enterprise Act, the Bankruptcy Bill has at its heart, the objective of promoting risk taking and overcoming the fear and stigma of failure.

## Could we have done better?

The reforms discussed above have roots back to the Productivity Commission's Business Set-Up, Transfer and Closure Report dated 30 September 2015 (**Productivity Report**) which identified a range of reforms to improve the effectiveness of Australia's restructuring and insolvency regime. In addition to the safe harbour and *ipso facto* reforms, the Productivity Report also proposed a number of other recommendations which, to date, have not been implemented.

'*Pre-positioned' sales*

One recommendation in the Productivity Report not adopted was an amendment to the *Corporations Act 2001 (Cth) (***Corporations Act***)* allowing for sales of the business to proceed even where they are entered into prior to, and due to settle during, a formal insolvency appointment.

It should be noted that the concept of 'pre-positioned' sales, while similar, is contrasted with 'pre-packaged' sales in the United Kingdom which are not always transparent and do not always lead to the most beneficial outcome for the company and its creditors. The proposed 'pre-positioned' sales regime would have operated such that where the sale is to an unrelated party, an administrator could overturn a sale only if he or she could prove it was not for market value or would have an unduly detrimental impact on the performance of his

or her duties. Where the sale is to a related party, the administrator or liquidator's review of the sale process would continue as normal.

For some people, the failure to implement the 'pre-positioned' sales recommendation represents a missed opportunity to further strengthen the restructuring environment. In Australia, there has been a consistent level of skepticism of "pre-packs' although some parties say that a proper "pre-positioned sale" would be beneficial for insolvencies of smaller enterprises. The challenge, as always, is trying to make a reform like this universal for all distressed companies. This may have been one of the reasons why the recommendation about 'pre-positioned' sales was not acted upon.

## Conclusion

2017 has seen some significant reform in Australia's restructuring laws that reflect a current trend that focuses on reinvigorating struggling companies. The 'rescue culture' attempts to expel the stigma of failure so that companies, their directors and their creditors will "have a go" with less risk and set them up for a softer fall if things do not go as hoped. While the introduction of the safe harbour provisions and a stay on the enforcement of *ipso facto* clauses are likely to be embraced by financially distressed companies, further reform would help strengthen Australia's restructuring environment.

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