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Practice Group:

Restructuring and Insolvency

The Harbour is Not Yet Safe – Reform on the Move in Australia

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Following on from the Productivity Commission's Report on *Business Set-up, Transfer and Closure*, the Australian Government has issued a Proposals Paper entitled *Improving bankruptcy and insolvency laws.*

The paper has identified and asked for submissions on three measures to improve Australian bankruptcy and insolvency law, namely:

1. Reducing the bankruptcy period from three years to one year;
2. Introducing a 'safe harbour' for directors to avoid personal liability for insolvent trading; and
3. Making 'ipso facto' clauses unenforceable if a company is undertaking a restructure.

The deadline for submissions is 27 May 2016.

This article will focus on the recommendations regarding safe harbour and ipso facto clauses.

Safe Harbours for Insolvent Trading

The insolvent trading regime in Australia can attract harsh personal liability for directors who incur debts while a Company is insolvent. This is a punishing provision as it is often difficult to identify the point in time that a Company becomes insolvent. Given this uncertainty, the current insolvent trading regime can discourage directors from taking measures to restructure the Company.

The proposal recommends the introduction of Safe Harbours to relax the current insolvent trading regime. The Australian Government has outlined that a "*safe harbour is designed to preserve enterprise value and offer a cost effective and flexible mechanism to work through liquidity issues outside of formal administration."* For this reason, two Safe Harbours have been proposed by the Australian Government:

Safe Harbour A

The first proposed Safe Harbour model provides a defence where a director would have an expectation based on advice received by an appropriately experienced, qualified and informed restructuring advisor that the Company can be returned to solvency within a reasonable period of time and the director is taking reasonable steps to ensure it does so. This defence would only apply to insolvent trading situations, not to all potential breaches of the *Corporations Act* (**Act**) by the Directors.

This proposed amendment would urge directors to address financial issues early and to attempt informal workouts, such as engaging a restructuring professional.

Safe Harbour B

The second proposed Safe Harbour model provides for a "carving out" of the Act. The insolvent trading provisions would not apply:

1. if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and
2. 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
3. incurring the debt does not materially increase the risk of serious loss to creditors.

The proposal notes that this Safe Harbour model aims to address situations where "*it may be in the best interests of both the company and its creditors as a whole to trade out of its difficulties or to undertake a restructure outside formal insolvency to return the company to long term viability."* This model would allow a director to continue trading in situations where it is in the best interests of the Company and its Creditors.

Ipso Facto Clauses

Ipso facto clauses provide for the variation or termination of a contract in specific insolvency circumstances, such as the appointment of an administrator. The operation of ipso facto clauses can significantly devalue a business and provide additional hurdles for a Company to overcome in any attempt to restructure or sell the business. As a result, these clauses can have a significant impact on the payment of creditors in any following liquidation. The Australian Government proposes to amend the Act such that any term of a contract which terminates that contract only by reason of an insolvency event would be void. This will have positive effects on a Company's ability to restructure following an insolvency event.

Comment

Safe Harbour Model B, with its carve out of the insolvent trading regime, seems to be the Model of choice. This Model provides a clearer outcome as the Liquidators will have the onus of proof in any action. Some commentators think that a combination of both Models may also work. The amendments relating to ipso facto clauses should also assist genuine attempts to restructure trading businesses which currently face dire consequences if counterparties relying on these types of clauses terminate contracts. The proposed amendments are, in our view, long overdue. It is expected that legislation will be introduced by the middle of 2017. With the Federal election being recently called, hopefully there is no delay to the timing of implementing these positive and necessary amendments to the Australian insolvency regime.

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