AUSTRALIAN INSOLVENCY REFORMS - THE HARBOUR APPEARS SAFER THAN IT WAS

Date: 15 June 2017

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On 1 June 2017, the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* (**Bill**) was introduced to the House of Representatives. The Bill introduces amendments to the *Corporations Act 2001* (Cth) (Act) that are aimed at providing a safe harbour for directors from potential insolvent trading liability and also at restrictions on the enforcement of ipso facto clauses. These amendments represent a significant shift in Australian insolvency laws - a shift that is expected to result in both an increase in informal restructuring and workouts and an increase in companies that have had to enter formal administration returning to solvency.

The Bill follows on from draft legislation that was released earlier this year and that was open for consultation with the general public. A number of potential shortcomings were identified by professional organisations in submissions made in respect of the draft legislation and, for the most part, the Bill has sought to address these shortcomings. The result is a workable framework which can be used by prudent directors of struggling companies to steer a path out of troubled waters without risking personal liability. However, whether the aims of the law reforms will be achieved will depend on a shift in prevailing market practices in Australia.

SAFE HARBOUR

Carve out, not a defence

The Bill has clarified the uncertainty that existed in the draft legislation by making it clear that the safe harbour provisions create a "carve out" rather than a "defence". This is a positive outcome for directors and company officers that could be caught by the insolvent trading provisions as it allows them to incur debts on behalf of the company without technically contravening the insolvent trading provisions.

The safe harbour carve out will now be available to directors who take a course of action that is reasonably likely to lead to a better outcome for the company, as opposed to "the company and the company's creditors" as per the draft legislation. This represents a lower threshold and overcomes challenges where action taken to benefit a company is not necessarily in the interests of all creditors.

Debts incurred directly or indirectly

There has also been a change in the scope of debts to which the safe harbour provisions apply. The new drafting in the Bill refers to debts "incurred directly or indirectly" in connection with the course of action taken. The explanatory memorandum provides that the reference to "indirectly" incurred debts extends to debts incurred in the ordinary course of trading, as well as debts related to the restructuring efforts such as paying for professional advice. This change addresses a concern with the original legislation that ordinary course debts may not be captured by the safe harbour.

The explanatory memorandum further provides that in order to have the benefit of the safe harbour, directors will not need to scrutinise every debt incurred, but they will need to make an ongoing assessment of whether there is still a reasonable likelihood of a better outcome if the company continues trading and incurring debt. Significant debts, such as non-ordinary course asset purchases, will require greater scrutiny by directors.

Period of safe harbour

The period during which the safe harbour carve out will apply has been amended so that it commences when a director starts "developing" one or more courses of action that are reasonably likely to lead to a better outcome. The previous draft legislation provided that the safe harbour only commenced when a director "starts taking" such a course of action. This is an important and necessary expansion of the safe harbour protection, particularly when it comes to complex business structures where commencing immediate action may be impractical or impossible and where detailed analysis and advice will be required before a plan can be formulated.

When the safe harbour is unavailable

The Bill has extended the circumstances in which the protection of safe harbour will be unavailable. Safe harbour will be unavailable where the company is failing to pay employee entitlements when they fall due and that failure either amounts to less than substantial compliance by the company with these obligations or is one of two or more failures by the company in the 12 month period ending when the debt is incurred.

In comparison, the draft legislation provided that the company only had to comply with "a standard that would reasonably be expected of a company that is not at risk of being wound up in insolvency". Whether this standard is equivalent to "less than substantial compliance" remains to be seen.

The Bill has also expanded on the sections of the Act under which a director or other relevant person is required to have complied with his or her obligations to provide books of the company or deliver a report as to the affairs of the company in order to rely on the safe harbour provisions.

Continuous disclosure requirements

Several submissions in respect of the draft legislation questioned the interplay between the safe harbour provisions and the continuous disclosure obligations imposed on publicly listed companies. The explanatory memorandum to the Bill has expressly stated that safe harbour will not affect any obligations for publicly listed companies to make continuous disclosures to the market (ie relying on safe harbour does not provide a carve out to continuous disclosure obligations under s674 of the Act or any applicable listing rules). Therefore, as s674 requires publicly listed companies to disclose any information that a reasonable person would expect to have a material effect on price or value of its securities, it would seem that publicly listed companies will have to disclose to the market if they are operating under safe harbour as this is clearly reasonably likely to impact on the price or value of such companies' securities. Market reaction to such safe harbour disclosure may make it more difficult for publicly listed companies to successfully negotiate information restructuring arrangements.

Appropriately Qualified Entity

While the Bill does not prescribe any specific qualification requirements that an "appropriately qualified entity" giving advice to directors should have (other than stating that such entity must be "appropriately qualified"), the explanatory memorandum does provide some limited guidance. "Appropriately qualified", according to the explanatory memorandum, means fit for purpose and must be judged on a case by case basis in light of the particular circumstances of the company and its financial position. Directors are specifically warned against any advisors that target struggling companies and suggest illegal solutions such as phoenixes. However, without set qualification requirements, the concern remains that unqualified and underinsured pre-insolvency advisors may continue to operate in a space best suited to experienced lawyers or insolvency and turnaround professionals who carry appropriate qualifications and professional indemnity insurance.

Holding companies

The Bill now extends the operation of the safe harbour provisions to holding companies. A holding company will not be liable to the subsidiary's creditors in relation to a debt where the holding company has taken reasonable steps to ensure that the subsidiary's directors have the benefit of the safe harbour provisions and those provisions do in fact apply to the subsidiary's directors and the debt in question.

IPSO FACTO

Expansion of stay

The application of the stay on the enforcement of ipso facto clauses has also been expanded in the Bill. A contracting party will not be able to enforce its rights pursuant to an ipso facto clause where the company is a disclosing entity and publicly announces that it will make an application to restructure the business. Similarly, rights under an ipso facto clause will not be exercisable merely due to a company's financial position. These ipso facto grounds in addition to those provided for in the draft legislation which included entering into a scheme of compromise or arrangement, or administration. This expanded application of the stay may assist companies undergoing informal restructuring as, for example, certain provisions in contracts that allowed for termination as a result of commencing restructuring or taking preparatory steps towards a scheme of arrangement, will now not be enforceable - giving such a company more "breathing room" to actually undertake the restructuring.

The Bill now also includes an indefinite prohibition on enforcing rights under an ipso facto clause for circumstances arising before or during the stay period. This will prevent a party from using the circumstances for which its right of enforcement was stayed in the first place as a reason to enforce its rights once the stay period has expired. However, if those same circumstances (or similar circumstances) arise after the end of the stay period, the contracting party will not be prohibited by the new laws from enforcing its rights on the basis of those circumstances.

The Court also now has the power to order an extension of the stay period if it is in the interests of justice to do so.

Rights not subject to the stay

Notably, the draft legislation originally provided that the stay would not apply to a right that managed financial risk associated with a financial product, where it is commercially necessary to have that right for the provision of financial products of that nature. This exclusion has now been removed from the draft Bill. However, there is still scope for certain types of contracts, including contracts that manage financial risk such as swaps and hedges, to be excluded from the application of the stay by regulation.

Appointment of a Managing Controller

The Bill has been amended to also provide a stay on the enforcement of rights which arise merely because of the appointment of a managing controller over the whole or substantially the whole of the company's assets. The Bill therefore allows for a receiver to be appointed to a company's property without risk of a contracting party enforcing its rights pursuant to an ipso facto clause.

In these circumstances, the stay period runs from the appointment of the controller until the controller's control ends, or for an extended period if ordered by the Court. The stay period also continues despite any replacement of the controller.

CONCLUSION

The Bill has addressed a number of potential shortcomings in and criticisms of the previous draft legislation. As a result, the Bill provides greater certainty to directors who may seek to rely on the safe harbour carve out when pursuing restructuring efforts. It also provides for a wider stay on ipso facto enforcement which can now assist companies during informal restructuring efforts, as well as companies undergoing formal enforcement or insolvency proceedings.

However, whether the wider aims of the legislation, being the increase of successful company turnarounds and informal restructuring, will be achieved will depend on how the Australian market adapts to the new changes.