Law Council OF AUSTRALIA
Business Law Section

Mr Mark Fitt
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600
Via email: economics.sen@aph.gov.au

12 July 2017

Dear Mr Fitt,

Inquiry into the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017

This is a joint submission by the Insolvency and Reconstruction Committee and the Corporations Committee of the Business Law Section of the Law Council of Australia ('the Committees') in response to the *Inquiry into the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017* ('the Bill').

Summary

The Committees believe the reforms in the Bill are long overdue and should be passed by the Parliament. Australia's legal framework needs to better support companies in financial distress to restructure by reducing or removing unnecessary impediments to effective restructuring that currently exist in the law. Based on the considerable experience of members of the Committee, aspects of the current law, namely the threat of personal liability for insolvent trading and the lack of protection against ipso facto clauses in contracts, make effective restructuring more difficult, and in some cases impossible. This harms the economy and the broader community through unnecessary business closures and more expensive and complex restructuring efforts. We strongly support the passage of the Bill through Parliament, although we suggest a number of amendments to ensure that the Bill achieves its purpose and minimises adverse consequences:

- Clarifying what an appropriately qualified entity is for the safe harbour;
- Providing a transitional period so that the stay against ipso facto clauses can apply to existing contracts; and
- Clarifying the application of the stay when transitioning to liquidation from a scheme or voluntary administration.

General Comments on the Safe Harbour

We agree with the Minister's second reading speech introducing the Bill that 'Australia's current insolvent trading laws put too much focus on stigmatising and penalising failure' and that a 'cultural shift' in approaches to corporate failure and restructuring is needed. The law should encourage and support directors of companies to seek out appropriate professional advice and assistance to address potential financial difficulties before the company becomes insolvent. This provides the best chance to deal with the company's problems and return to profitable trading. Taking early action is more likely where the company maintains proper books and records and the Bill supports this by requiring that books and records be given to liquidators or the safe harbour will be unavailable and by requiring that tax office lodgements and employee entitlements are being met.

We note that there are valid concerns about the harm that improper phoenix activity has on the economy and we share those concerns. However, the Committees believe that phoenix problems are better addressed by specific legislation, which is likely to be more effective than including provisions in the Bill. We support ARITA's submission that the Director Identification Number (DIN), as recommended by the Productivity Commission in 2015, would assist with addressing improper phoenix activity. The safe harbour provisions should discourage phoenix activity because directors will have an incentive to seek and rely on competent professional advice in order to gain the benefit of the safe harbour. We also note that the current law does provide measures to address improper phoenix activity through breaches of directors' duties and the potential for accessorial liability against advisors. Concerns have also been raised about the position of creditors who deal with the company during the safe harbour period, at a time when those creditors will likely be unaware that the company is involved in restructuring under a safe harbour for directors. While it could be argued that these creditors will be at a disadvantage because they will not be able to take action against the directors for insolvent trading, it must be borne in mind that the purpose of the safe harbour is to encourage and support directors while they try to successfully restructure the company. If this succeeds then the company may return to profitability and the company's stakeholders will be better off because the company will continue to trade. The chance to save the business should not be limited by the opportunity for a creditor to take legal action if the restructure fails and the company ends up in liquidation years later.

Restructuring companies in financial distress involves multiple complex and difficult problems. The safe harbour provision is not a panacea but it is an important step in the right direction that provides appropriate incentives to encourage directors to undertake restructuring efforts.

The Committees support the introduction of the safe harbour for directors. We also support the extension of this to wholly owned corporate groups.

Specific Comment

The Committees suggest that the concept of an 'appropriately qualified entity' in s588GA(2)(c) should be clarified in legislation and by regulatory guidance. As presently drafted the provision allows directors to select whoever they may believe appropriate. Although it is likely that the courts will deny the safe harbour if an inappropriate person is selected as an advisor, we believe that leaving this up to the directors also leaves directors susceptible to largely unregulated pre-insolvency advisors who may give inappropriate advice and facilitate improper phoenix activities. Imposing tougher standards on who is an 'appropriately qualified entity' will send a strong message to the business community that turnaround and restructuring advice requires minimum standards of knowledge and skills and give creditors greater confidence in the bona fides of those undertaking the restructuring effort.

General Comments Regarding Ipso Facto Clauses

The Committees strongly support the proposals in the Bill to give limited protection against ipso facto clauses in limited circumstances during formal restructuring efforts using voluntary administration, receivership or a creditors' scheme of arrangement. We believe that the wording of the Bill appropriately balances the needs of the company's stakeholders and will provide protection for companies seeking to restructure using formal appointments.

The Committees support the Bill's extension to creditors' schemes of arrangement, voluntary administration and managing controllership (such as a receiver and manager appointment).

The Committees also support the extension of the stay to reasons solely based on the company's financial condition, with the exception of where the company is not in a creditors' scheme, voluntary administration or managing controllership.

The Committees also support appropriate exceptions as stated in the Bill and the Explanatory Memorandum, and support the powers given to the court to lift the stay against ipso facto clauses and to limit the rights of contractual parties relating to ipso facto clauses in limited circumstances.

Specific Comments

1. It is critical that the current clause 17 in the Bill be amended so that there is a way for long standing contracts to be brought into the new regime, otherwise the protections offered by the Bill will be minimal and in some matters wholly ineffective. Clause 17 of the Bill proposes that the new protections will only apply to contracts entered into after the commencement date of the Bill. While the Committees, and the Law Council, are generally opposed to retrospective legislation, the current drafting means that existing contracts can be amended and added to in the future without ever coming under the protection against ipso facto clauses. This is likely to significantly limit the effectiveness of the stay.

Where a contract is changed in the future this will not generally result in a new contract coming into effect unless that is expressly stated as creating a new and distinct contract. For many commercial dealings, a standard contractual framework will allow for numerous individual amendments over many years (even decades) without entering into a new contract. This means that all existing contracts will never come within the scope of the protections and the law will effectively create two classes of contracts, those that started before commencement in 2018 (even where there have been multiple changes over time) and those new greenfields contracts that only started from 2018. This will create a competitive imbalance in the economy and will make it harder, not easier, to restructure as different contracting parties (who might even have virtually identical contracts) will have radically different rights in restructuring simply because one contract is pre-2018 and the other is post-2018.

We strongly recommend introducing a transitional period (perhaps of 12 months or 2 years) during which time contracts can be reviewed and amended by the parties to accommodate the ipso facto changes. After this time, the protection against ipso facto clauses should apply, subject to any general policy exceptions against the ipso facto provisions that may be set out in regulations.

2. We note the proposed wording of s451E(2)(c) may encourage more companies to use voluntary administration because if they transition into a liquidation then the protection against ipso facto clauses will continue until the affairs of the company are 'fully wound up'. This offers protection in liquidation, despite there being no protection offered in a stand-alone liquidation. We support this on the basis that a liquidation arising from a voluntary administration may still be for the purpose of providing a better return to creditors than a stand-alone liquidation.

3. The Committees support ARITA's submission that liquidators should be permitted to consent to the rights being exercised despite the stay when a company moves from voluntary administration or a creditors' scheme of arrangement into liquidation.

Further General Comments

While we are supportive of the law reform proposals in the Bill, we wish to make it clear that in our view there is still more work to be done on the insolvency and restructuring law reform agenda. We note that there are a range of measures that have been recommended by the Productivity Commission's Set-up, Transfer and Closure Report from 2015 which are either still subject to review or have been rejected by the Government. In particular, the need to ensure that the legal framework for insolvency and restructuring is effective and efficient for the full range of business structures that are used in the Australian economy. We have concerns that the current model of one-size-fits-all for business restructuring may be difficult and expensive for micro, small and medium sized enterprises and highlight the need for further review and reform to ensure that businesses have access to efficient and effective tools for restructuring and insolvency that appropriately balance the needs of the business' stakeholders and the community. However, these issues should not delay the progress of the Bill.

If you have any questions regarding this submission, in the first instance please contact the Chair of the Insolvency and Reconstruction Law Committee, Victoria Butler, via email: [redacted] or via phone [redacted]

Yours sincerely,

[redacted]

Teresa Dyson, Chair
Business Law Section