Law Council
OF AUSTRALIA

Via email: insolventtrading@treasury.gov.au

Manager
Governance and Insolvency Unit
Corporations and Financial Services Division
The Treasury
Langton Crescent
Parkes ACT 2600

Dear Sir or Madam,

Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration

I have pleasure in enclosing a submission which has been prepared by the Insolvency and Reconstruction Law Committee of the Business Law Section of the Law Council of Australia.

The submission has been prepared jointly with the Insolvency Practitioners Association of Australia and the Turnaround Management Association Australia.

Please note that the submission has been endorsed by the Business Law Section. Owing to time constraints, the submission has not been reviewed by the Directors of the Law Council of Australia Limited.

Yours sincerely,

Margery Nicoll
Acting Secretary-General

2 March 2010

Enc.

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2 March 2010

Manager
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Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Ms Preston,

Insolvent Trading - Safe Harbour proposals

The IPA is pleased to be party to a joint submission, a copy of which accompanies this letter, in response to the invitation to make submissions on the Insolvent Trading Safe Harbour Paper issued in January 2010.

As indicated in the submission, the IPA may wish itself to provide a supplementary submission addressing other aspects. We understand we may do this in the next week or so.

If you have any questions about the submission, please contact the IPA's Legal Director

Yours sincerely

Mark Robinson
President

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Australia Chapter

Insolvent Trading Safe Harbour Options Paper
Corporations and Financial Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: insolventtrading@treasury.gov.au

2 March 2010

To the Hon. Chris Bowen MP

Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside Of External Administration

The TMA is pleased to be party to a joint submission, a copy of which accompanies this letter, in response to the invitation to make submissions on the Insolvent Trading Safe Harbour Paper Issued in January 2010.

In addition the TMA Is submitting a supplementary submission in which the TMA expands on issues raised in the joint submission and outlines some additional reforms that would be beneficial to improving the turnaround framework in Australia.

If you would like any additional information please let us know,

Yours sincerely

Adrian Loader
TMA President
Turnaround Management Association

JOINT SUBMISSION IN RELATION TO INSOLVENT TRADING SAFE HARBOUR OPTIONS PAPER

SUBMITTED BY:

Law Council of Australia
Insolvency Practitioners Association of Australia
Turnaround Management Association Australia

DATED: 2 March 2010

SUBMISSION IN RESPECT OF SAFE HARBOUR OPTIONS PAPER

1 SECTION 1 – INTRODUCTION

1.1 This submission is made jointly by the Law Council of Australia, the Insolvency Practitioners Association of Australia, and the Turnaround Management Association Australia, representing the legal, accounting and business advisers whose principal area of practice is insolvency. It is intended to provide the Government with the views and experience of those professionals whose day-to-day practice and business over many years has been in addressing and dealing with the very matters canvassed in the Discussion Paper.

1.2 As major participants in insolvency and turnaround matters, the bodies represented in this joint submission wish to confirm their collective view that limited reform to insolvent trading laws to provide a restructuring safe harbour would be beneficial, and that the adoption of a modified business judgement rule defence would be the appropriate means for achieving this reform. Such a change should be seen as an improvement to, rather than a replacement of, the status quo, as it provides a framework for directors and stakeholders to lawfully pursue proper restructuring opportunities, and encourages **early** attention to be given to insolvency concerns.

1.3 The parties to this joint submission are as follows:

(a) Law Council of Australia (**LCA**).The LCA's Insolvency and Reconstruction Law Committee of its Business Law Section, which has participated in the preparation of this submission, is comprised of legal practitioners across Australia who specialise in the insolvency and restructuring field, and includes many of Australia's leading practitioners in this area.

(b) Insolvency Practitioners Association of Australia (**IPA**). The IPA is the peak professional body representing company liquidators, trustees in bankruptcy, other insolvency professionals, financiers and academics. The IPA and its members necessarily have extensive knowledge of and expertise in insolvency law, policy and practice and in the particular issues of insolvent trading which are the subject of this submission; and

(c) The Turnaround Management Association Australia (**TMA**). The TMA is a not-for-profit organisation comprising professionals practising in the field of "Turnaround Management", aimed at restoring value to struggling enterprises and avoiding terminal insolvency. The TMA's membership is made up of professionals practising in turnaround management, law, insolvency, accounting, management consulting, banking, finance and private equity.

1.4 The parties to this joint submission may wish individually to provide a supplementary written submission addressing additional matters of interest.

2 SECTION 2 – PRELIMINARY MATTERS

Importance of restructurings and informal workouts

2.1 Generally speaking, a successful restructuring or informal work-out will resolve the financial position of a company through the private agreement of key stakeholders outside of any formal insolvency process. More common among large enterprises and public companies, a restructuring will involve negotiations between the company and its bankers, bondholders and/or major investors, and can involve the injection of fresh capital from an external source. Alternatively, those negotiations may produce a moratorium on repayment of bank or bond debt pending asset sales, injection of fresh capital, or both. Successful negotiations can produce a restructured balance sheet that returns the company to a state of solvency, or otherwise eliminates the question mark over the company's solvency and may thereby preserve enterprise value, employment and the business as a going concern.

2.2 The significance of this for addressing doubtful solvency is twofold:

(a) by avoiding a formal insolvency appointment, the risks of enterprise value destruction are largely avoided or diminished. These risks are identified in paragraphs 2.3 - 2.7, and the importance of them cannot be underestimated;

(b) it is usually the case that the only losses that are experienced are at the banker/bondholder/investor level - ordinary trade creditors will generally get paid in full.[1] This outcome directly contrasts the position in a formal insolvency process where ordinary unsecured creditors rank behind secured and priority creditors and share the deficit equally (and where that deficit may be enlarged should the formal appointment result in a diminution in enterprise value).

Significance of preserving enterprise value

2.3 In a circumstance of financial distress, "enterprise value" may be defined as the value of the company's assets and businesses. Preservation of enterprise value is important for at least two reasons:

(a) it maximises the prospect that a reorganisation, whether in or outside of a formal insolvency process, will be achievable. For example, to the extent that fresh capital might be a solution (either from existing investors or from an external source), the smaller the differential between the enterprise value and company's total liabilities, the lesser the amount of additional capital that would be required to remedy the position;

[1] By way of amplification, in an informal work-out of a major corporation, it is usually the case that the claims of its financiers are so significant as a percentage of its total liabilities, that it is in their commercial interests to permit the company to continue to trade under agreed funding arrangements while a restructuring is pursued. In such cases, the business continues to operate and trade creditors are paid in the ordinary course of business during the period of restructuring.

(b) in the event that the company cannot be saved and its assets need to be sold, the higher the enterprise value, the higher the return to unsecured creditors.

2.4 Similarly, where the financial difficulties of the company can be addressed by a reconstruction of the entity's banking facilities or bondholder debt (or by a combination of that and fresh capital), preservation of enterprise value is critical. Again, the smaller the differential between assets and liabilities, the smaller the gap that the reconstruction needs to address.

2.5 For the above reasons, preservation of enterprise value must be an important public policy goal in dealing with financial distress.

2.6 It is the experience of the practitioners and industry participants represented by this joint submission that formal insolvency appointments can, and often do, cause a destruction of, or diminution in, enterprise value. This can occur (as noted in the Discussion Paper) in a number of ways, including:

(a) asset sales by an administrator, receiver or liquidator can have connotations of a "fire sale", and this can produce a lower price for those assets;

(b) the ability to hold assets for sale at a later time, perhaps when the market has improved, is more difficult in a formal insolvency administration[2];

(c) the operation of "ipso facto" clauses in commercial agreements can destroy businesses overnight, consequent upon entry into a formal insolvency process, particularly where a business has few if any hard assets, but is dependent on its contractual arrangements. One.Tel is but one example of a company that completely lost its business as a retailer of telecommunications services when its wholesale suppliers of those services relied upon ipso facto clauses to cease providing those services upon the appointment of an administrator. In our experience, the prevalence of such clauses is widespread. Where businesses are, for example, reliant upon leased premises, those leases invariably contain an ipso facto clause permitting the landlord (subject to the temporary moratorium which permits continuing occupancy during the voluntary administration period) to terminate the leases even though rent is up-to-date and there is no default under the lease;

(d) customers may shun a product or brand affected by a formal insolvency when concerned about future servicing or warranty issues. Some recent examples of funds management business have evidenced this adverse impact on 'goodwill' from such formal appointments;

(e) the costs of the insolvency process, including the costs of the appointed insolvency practitioner, and his or her lawyers, can be substantial and need to be met before creditors are paid; and

[2] The *Corporations Act* imposes certain time restrictions on the conduct of an external administration. The voluntary administration regime in Part 5.3A of the *Corporations Act* provides short timeframes for the transition of the company out of administration. Section 477(1)(a) empowers a liquidator to carry on the business of the company, but only insofar as it is necessary for the beneficial disposal or winding up of that business. Also, section 478(1) requires a liquidator to cause the company's property to be applied against its liabilities as soon as practicable after the Court order that it be wound up.

(f) the crystallisation of contingent liabilities will further reduce the return to creditors.

2.7 In circumstances where it is feasible to overcome a company's solvency difficulties by an informal work-out or a restructuring of its balance sheet, it will in most cases be important for this to occur outside of a formal insolvency process.

Solvency is often a complex issue

2.8 The Discussion Paper contains the suggestion in a number of places that a company is either "solvent" or "insolvent". It is acknowledged that chronic or "obvious" insolvency can be readily identified in some companies that have continued to trade. However, in the experience of the practitioners and participants in the insolvency process represented by this submission, the company's state of solvency is frequently not black and white. The following illustrations provide a few examples of complexities that occur in practice:

(a) when, to use the phraseology used in the Discussion Paper, a "mere temporary lack of liquidity" is weighed against the ability to sell assets in the short term, what assumptions may reasonably be made by the directors as to how quickly the assets can be sold (ie what is meant by "temporary"), and the amount that can be realised for these assets. Moreover, how ought directors address them in, say, the circumstances of the recent global financial crisis when there was a question mark over the value of assets, and real concerns about whether the assets could be sold at all;

(b) where the company has a letter of comfort from its parent that is not legally binding but which has always been supported in the past, is it reasonable for directors to assume that they are solvent if they can only meet their debts by reason of their ability to call on that letter of comfort?

(c) where a company has been trading unprofitably and has only been meeting the claims of its creditors through the financial support of its major shareholder, and where that support has always been forthcoming when called upon in the past, can the directors rely on the shareholder continuing to support the business? What is the position where the directors ask for a legally binding commitment, and the shareholder declines to provide it, but indicates that it is its present intention to continue to support the company?

(d) the Australian subsidiary of an overseas company that is in a formal insolvency process overseas is trading solvently, but its balance sheet identifies a very substantial debt owed by it to its insolvent parent which is payable on demand and which it could not meet if called upon. The parent company's liquidator refuses to give a commitment that it will not call upon the intercompany debt, but has to date not done so;

(e) a large property company's facilities with its foreign banker expire on 1 December 2010, and the bank, which is withdrawing from the Australian market, will not roll the facilities. Other banks so far approached to refinance the facilities have similarly refused even though the company can clearly demonstrate it can service the facilities. It is perhaps clear that:

(i) the company is not insolvent today (i.e. March 2010); and

(ii) the company will be insolvent on 30 November 2010 if not in receipt of a commitment to refinance.

However, when, between today's date and 30 November 2010, does this company change from being solvent to insolvent?

2.9 The above represent a few examples in practice of circumstances facing honest, diligent directors. If the directors appoint administrators they risk destroying or substantially diminishing the value of the business. If they do not call in administrators, they risk incurring personal liability for the company's debts incurred in the future, which would usually mean personal bankruptcy for the directors, if found to be liable.

Comparative analysis

2.10 The laws of other countries do not impede proper restructuring attempts by directors in the way that our insolvent trading laws do. A full comparative analysis of laws is contained in the INSOL publication "Directors in the Twilight Zone", but generally speaking, in a circumstance of doubtful solvency the laws of other countries impose an obligation on the directors to have primary regard to the interests of creditors in actions they take in consequence of the financial distress. This contrasts with Australian law where the overriding insolvent trading prohibition compels directors to place the company into administration where they cannot form the requisite view as to an expectation of solvency, even in circumstances where the interests of creditors might be better served by an informal work-out. There is no flexibility at all in the law as it presently exists.

3 SECTION 3 - INSOLVENT TRADING LAW - MAINTAIN THE STATUS QUO OR INTRODUCE A RESTRUCTURING SAFE HARBOUR?

Historical and Policy Context

3.1 The issues of principle raised in the discussion paper can be seen to engage a number of different public policy considerations, including:

(a) protecting prospective creditors from the risk of loss through extending credit to an insolvent company;

(b) protecting existing creditors and other stakeholders from the risk of loss through destruction of enterprise value that is often associated with formal insolvency appointments;

(c) protecting creditors and other stakeholders from the risk of loss through the actions of unscrupulous directors; and

(d) protecting creditors and other stakeholders from the risk of loss by circumscribing the options available to honest, capable directors in dealing with the company's financial challenges.

3.2 Questions surrounding the balance to be struck between preventing abuse and curtailing honest behaviour, and between enhancing or diminishing enterprise value, are not new. As far back as the introduction of the first modern insolvency

statute, the *Bankruptcy Act 1883* in the UK, the following was said by the President of the Board of Trade on moving the second reading of the Bankruptcy Bill in the Westminster parliament:[3]

> *Every good bankruptcy law must have in view two main, and at the same time, distinct objects. First, the honest administration of bankrupt estates, with a view to the fair and speedy distribution of the assets among the creditors whose property they were; secondly, following the idea that prevention was better than cure, to do something to improve the general tone of commercial morality, to promote honest trading, and to lessen the number of failures. In other words, Parliament had to endeavour, as far as possible, to protect the salvage and also to diminish the number of wrecks.*

3.3 Other policy issues were identified in the UK Greene Committee Report in 1926, where the following observations were made:[4]

> *Many of the suggestions made to us show that the idea that fraud and lesser malpractices can be stopped by the simple expedient of a prohibition in an Act of Parliament, dies hard. Other witnesses with a view to making such malpractices impossible have advocated the imposition of statutory regulations and prohibitions calculated, not merely to put a stop to the activities of the wrongdoer, but to place quite intolerable fetters upon honest business. It is often forgotten that in dealing with a matter such as company law, which affects so closely the whole business life of the nation, a certain amount of elasticity is essential if the system is to work in practice.*
>
> *Impressed by these considerations, we have refrained from recommending any important change which was not, in our view, quite clearly demanded and justified by the evidence before us. We realise that the system of limited liability leaves opportunities for abuse. Some of these we consider to be part of the price which the community has to pay for the adoption of a system so beneficial to its trade and industry. It appears to us, as a matter of general principle, most undesirable, in order to defeat an occasional wrongdoer, to impose restrictions which would seriously hamper the activities of honest men and would inevitably react upon the commerce and prosperity of the country.*

3.4 The two above passages go to the heart of the policy issues raised in the discussion paper. As observed in 1883, Parliament must endeavour "*to diminish the number of wrecks*". And as observed in 1925, the policy objective of deterring some instances of wrongdoing must be balanced with the fetters it places on "*honest business*" and the damage it can do in consequence.

3.5 In this submission, five principal policy reasons are advanced as to why there should be a safe harbour defence to insolvent trading liability. They are:

(a) the existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts;

(b) the effect of the existing laws on honest, capable directors, particularly non-executive directors;

[3] Westminster Hansard, 19 March 1883, col. 817.

[4] Report of the Company Law Amendment Committee appointed by the Board of Trade on 19 February 1925.

(c) the focus of directors of a financially troubled company should primarily be (as it is everywhere else in the world) on the interests of creditors;

(d) the existing insolvent trading law limits the options available to deal with financial distress; and

(e) a safe harbour defence would promote the critically important policy objective of obliging directors to obtain **early** restructuring advice.

3.6 It is also important to bear in mind that to the extent that a refinement to the law in this area will enable some companies to be saved through a restructuring or informal workout, this will result in the protection of employment and reduce job losses.

First policy reason - The existing law, without any safe harbour, can impede or prevent proper attempts at informal workouts

3.7 No other major Western economy has laws that operate in the same manner, and with the same severity, as Australia's insolvent trading laws.[5] If there are grounds for suspecting that the company is insolvent and the director is unable to form an expectation that it is in fact solvent, the director faces personal liability for all of the company's debts incurred after that date. In almost all cases, this would mean personal bankruptcy for the director. A dishonest breach of the provision renders the directors liable to imprisonment for up to 5 years.

3.8 Faced with these consequences, honest, diligent directors will ensure that they do not breach the law. For the reasons explained earlier in this submission at paragraphs 2.8 - 2.9, the question of a company's solvency frequently is not black and white, particularly with regard to large enterprises. If the solvency of a financially distressed company is uncertain or incapable of precise determination, it follows that it may be difficult for the director to form the necessary positive expectation that the company actually is able to pay all its debts as and when they fall due. Thus, not only will honest, diligent directors of companies that are actually insolvent place them into administration, but also there will be directors who feel compelled to do the same thing where the solvency is simply brought into question, because of the absence of their ability to form their positive expectation of solvency.

3.9 Moreover, there is a lack of flexibility with the current insolvent trading law. Once the operation of the law is triggered and a director is unable to form a positive expectation that the company is solvent, the director must cease incurring debts, with the likely result that administrators are appointed. This is so even though professional advice suggests it may be in the best interests of creditors that the company explore an informal workout or restructuring. The adverse implications arising from this inflexibility can be illustrated in several ways.

3.10 There are many examples of directors citing the insolvent trading laws as a reason for the appointment of administrators where a restructuring or informal workout was available to be pursued.

3.11 One example is the Henry Walker Eltin group, where the directors, citing concerns regarding insolvent trading liability, placed the company into administration.

[5] See paragraph 2.10 of this submission and the INSOL publication, "Directors in the Twilight Zone".

Ultimately, all creditors were paid 100¢ in the dollar, and the destruction of enterprise value was experienced at the shareholder level.

3.12 In many of the recent spate of corporate failures associated with the GFC, insolvent trading concerns have been cited by directors as a significant or determining factor in their decision to appoint administrators.[6]

3.13 This is not to say that a restructuring would have been feasible in all or, for that matter, most of the matters. That is not to the point. Of significance is the fact that the option of a restructuring or informal work-out is simply not available to be pursued when directors form the view that the insolvent trading law obliges them to make a formal appointment. There are many cases like Henry Walker Eltin where the formal appointment has been considered premature. No doubt in other cases, no attention was given to the issue of a restructuring as this was simply not an option given insolvent trading concerns.

3.14 It is the experience of practitioners and participants represented by this submission that the relevance of the above observations extends to companies of a smaller size as well as large enterprises and public companies.

Second policy reason – the effect of the existing laws on honest, capable directors, particularly non-executive directors

3.15 As indicated above, insolvency is often not black and white. Faced with the severe consequences of insolvent trading, there is a high burden placed on directors when the company enters the "zone" of questionable solvency. In these circumstances, directors, particularly non-executive directors for whom their personal reputation is of paramount concern, may not wish to continue their appointment. Non-executive directors in particular have been observed to resign from a company when its solvency is brought into question. This is to the detriment of the company and its creditors as this is the very time when their skilled, objective input would be highly valuable.

Third policy reason - the focus of directors of a financially troubled company should primarily be (as it is everywhere else in the world) on the interests of creditors

3.16 As indicated in paragraph 2.10, the laws of other major Western countries universally oblige a company's directors to have primary regard to the interests of creditors where the company is of doubtful solvency. As it is the company's creditors that are the stakeholders whose interests are paramount at this point, this is an appropriate policy choice. To the extent that Australian law differs, it is suggested that our laws reflect an inappropriate policy choice.

3.17 Australian law does differ in this respect as our insolvent trading law, in practical effect, requires the directors to place a trading company that is insolvent into administration (or liquidation), even though this may immeasurably harm the company and its business, and that they are in receipt of professional advice that a restructuring was feasible and to the advantage of creditors. In such a situation, the

[6] While it is not appropriate for parties to this submission to identify those companies in this public submission, some of the parties would be pleased to provide further detail in a private meeting with Treasury officials, should this be considered helpful.

directors ought to be permitted to take proper steps to pursue a restructuring, as is the case in all other major Western economies.

3.18 This is not to say that a formal insolvency appointment is inappropriate as a general proposition. This is not the case, and an early appointment of an insolvency practitioner to the company will often, perhaps in most cases, be the appropriate course. The problem with the current law is the lack of flexibility for directors to choose the appropriate course in the particular circumstances of the company.

3.19 A safe harbour is needed to provide the necessary degree of flexibility for directors to make that choice.

Fourth policy reason - The existing insolvent trading law limits the options available to deal with financial distress

3.20 Options available to deal with financial distress and which are commonly employed in overseas jurisdictions, are limited by Australia's insolvent trading laws in at least three important respects.

3.21 First, as explained in paragraphs 3.7 - 3.14 above, the achievement of a work-out or restructuring, by private agreement between key stakeholders, is impeded.

3.22 Secondly, a common feature in overseas jurisdictions is the appointment of a Chief Restructuring Officer (**CRO**) by the company, who is a skilled professional in the field. It will be the task of the CRO to perform the following executive tasks so as to advise the company's board of directors on all aspects of the restructuring:

(a) assess the financial condition of the company;

(b) examine restructuring options;

(c) engage with key stakeholders;

(d) negotiate, on behalf of the company, the restructuring with relevant stakeholders;

(e) implement the restructuring.

3.23 In contrast to the position overseas, the appointment of CROs is a very rare occurrence in Australia. This can be seen largely as a product of our insolvent trading laws in two respects.

3.24 The first is that restructurings are less frequently attempted in Australia for the reasons set out above in paragraphs 3.7 - 3.14.

3.25 Secondly, given the professional skills and expertise brought to bear by the CRO, it is anticipated that the board of directors would largely be guided by, and proceed to implement the recommendations of, the CRO. This would likely make the CRO a "shadow director" in accordance with the *Corporations Act* definition of a "director", and would therefore render the CRO personally liable for insolvent trading liability. It is unlikely that many sensible professionals would be prepared to assume that risk.

3.26 Thus, providing a safe harbour defence to insolvent trading liability for proper restructuring attempts would, subject to one qualification, enable Australian

companies to enjoy the benefits associated with the appointment of CROs. The one qualification is that a further amendment would need to be made to modify or eliminate, in a restructuring context, the extended definition of a "shadow director". It is therefore very important that legislative attention is given to the definition of "director" so that a CRO, or any other stakeholder, participating in the restructuring process is not taken to be a "shadow director" of the company.

3.27 Finally, a safe harbour to enable proper attempts at a restructuring would enable another commonly used tool overseas to be available in appropriate circumstances in Australia. This is where a formal insolvency appointment will be necessary in order to restructure a company, but it is considered desirable to resolve by negotiation with key stakeholders the material aspects of the restructure prior to the formal appointment. This can enable the formal appointment to be accompanied by the assertion that the appointment has been made in order to implement the reconstruction. This can be a critical element in preserving enterprise value. A recent example is the General Motors restructuring in the United States. The "pre-pack" approach adopted with GM enabled the bankruptcy filing to be accompanied by press reports of "GM saved" rather than "GM goes bust".

3.28 General Motors traded for many months whilst insolvent in order to enable the detailed and complex negotiations with unions, bondholders and the Government to be consummated. A fully negotiated restructure plan was then presented to the Bankruptcy Court at the commencement of the formal process and adopted. Damage to the brand was minimised. In contrast, had this occurred in Australia, Australia's insolvent trading laws would most likely have compelled the directors of General Motors to appoint administrators many months earlier, at a time when there was no agreement with the Government to recapitalise the company, and no agreement with bondholders and unions to convert substantial entitlements into equity. In short, at the time of any hypothetical formal appointment in Australia, there would have been no guarantee as to the company's future and no security to anyone buying a General Motors branded car that there would be service or warranty support in the future. The damage that would have resulted to enterprise value would have increased the amount of equity required from Government and the quantum of concessions required to be made by the unions and bondholders. It would very quickly have rendered any restructuring of the nature entered into in the US increasingly unviable. In short, a restructure of this type almost certainly could not have occurred in Australia.

3.29 The contrast between what was achieved in the US, and what would have occurred in Australia, could not be starker. It is important to record that the difference has nothing to do with the availability of "Chapter 11" procedures in the US; it is a product of Australia's insolvent trading regime.

3.30 While the General Motors example is at one end of the extreme in terms of the size and complexity of businesses, the dynamics in play are no different in principle to companies smaller in size and less complex in structure. There are many examples of pre-negotiated restructure plans of a smaller, more modest size that are being successfully effected in the UK and US. Examples in the UK are Whittard of Chelsea, Mosaic and USC.[7]

[7] It must be acknowledged that some difficult policy issues exist in this area.. The fact that some regulation may be necessary in the area should pre-negotiated restructure plans become common practice in Australia does not mean that this tool for addressing insolvency should not be available.

3.31 Denying the availability of these restructuring tools in Australia is manifestly to the disadvantage of Australian business and the Australian economy.

Fifth policy reason - A safe harbour defence would promote the policy objective of obliging directors to obtain early restructuring advice

3.32 In circumstances where the law provides relief conditioned on the director obtaining professional restructuring advice, the important policy objective of ensuring that financial distress issues are addressed early and with the benefit of professional advice would be served. This is important as early intervention would maximise the prospect of a solution being found. Equally importantly, should a restructuring not be feasible, early action by directors in seeking professional advice would nonetheless identify the need for an appropriate formal appointment at an early stage.

4 SECTION D – WHICH SAFE HARBOUR OPTION SHOULD BE ADOPTED?

4.1 There are a number of legal and practical problems and disadvantages associated with the proposed moratorium that is option three in the Discussion Paper. These include:

(a) upon the issue of the notice to creditors, all creditors who then receive a payment from the company will be obliged to disgorge that payment to a liquidator should the company enter into liquidation within a six month period, as the notification would destroy any defence to an action against them for receipt of an unfair preference. This legal impairment would also no doubt have a substantial practical impact on the preparedness of those creditors to extend further credit given that repayment of that credit would also constitute preferential payments;

(b) the issuing of the notice to creditors would likely trigger the operation of many "ipso facto" clauses, permitting commercial contracts to be terminated by reason of the issue of such notification. Even where ipso facto clauses as presently drafted would not be triggered, upon the introduction of legislation providing for such a moratorium, the ipso facto clauses of many contracts would be redrafted (as was the case when the voluntary administration regime was introduced) to incorporate such an event within the definition; and

(c) the issue of such a notification to creditors and prospective future creditors would likely substantially damage the business of the company. Existing creditors would be very keen to be paid their debt as soon as possible, exacerbating any cashflow difficulties being encountered by the company. Future creditors (or existing creditors asked to rollover their debt, or those operating on a running account basis) will likely be reluctant to extend fresh credit. Suppliers may be reluctant to supply goods except on a COD basis, placing further strains on cashflow. Moreover, customers may be reluctant to buy goods manufactured by that entity, no doubt concerned about future service or warranty issues.

4.2 These additional strains placed on the business will likely make any informal restructure more difficult, and may diminish enterprise value.

4.3 It might be argued that notification or disclosure and the transparency associated with the process is the "price" of being accorded time to trade whilst insolvent in order to effect a successful restructuring. We do not in this submission take issue with that proposition. The point made in the above paragraphs is that the "price" might be such that it simply renders the restructuring incapable of being achieved, due to the impact of the process on the company's business.

4.4 It is, however, suggested that there is a further dimension to the issue. Directors are under general law duties to the company, and will be held accountable for damage caused to the company if they act negligently. If one accepts that the following two propositions are correct, then it is considered that the moratorium proposal will not work in practice in many of the circumstances in which it is designed to operate. These two propositions are:

(a) the issue of a notification to creditors, prospective creditors and all other stakeholders will place substantial additional burdens on the cashflow of the business and carry a substantial risk of damage to its business (for the reasons set out above); and

(b) it is often the case, particularly with large enterprises and public companies in financial distress, that the question of whether they are "solvent" or "insolvent" is not black and white (as to which see paragraphs 2.8 - 2.9 above).

4.5 Any "premature" issue of an insolvency notification would leave the directors exposed to an action for any consequent damage to the business. Conversely, if they do not issue a notification, they would remain at risk, as they are today, that a court would, in the future, hold them liable for insolvent trading.

4.6 This dilemma presented by the proposed moratorium would leave honest, diligent directors in the invidious position they are in today, and arguably they would be in a worse position as availing themselves of the moratorium would potentially expose them to liability as well.

4.7 Other problems and deficiencies with the moratorium option include:

(a) the process is not properly protected against abuse, as it is unrealistic to expect that the proposed "creditor oversight" will prevent abuse. Creditors will often lack the financial resources (or the preparedness to expend further financial resources) to monitor or review the appropriateness of the moratorium. Moreover, as the directors remain in control of the business, the creditors will only receive the information that the directors are prepared to provide; and

(b) the ability to approach a court to conclude the moratorium would be illusory in many, if not most, cases. A court would, quite properly, require notification of any court proceedings to be given to all interested parties and would enable them to have sufficient time within which to consider their position and present their case. The competing arguments would largely centre on financial accounting, and this would likely involve the engagement of expert accountants to review the company's accounts and prepare reports. By the time the process was undertaken and the matter was ready for hearing, it is likely that a period of weeks, if not months, would have passed. By then considerable damage could have been done to the

company, with no liability attaching to the directors as they have been trading within the safe harbour.

4.8 The practitioners and participants represented by this submission are firmly of the view that option two, with some modifications, is a far superior option to option three. The principal virtues of the modified business judgment rule are as follows:

(a) it addresses the policy concerns identified in submissions sent to Minister Bowen last year that the insolvent trading laws impede proper restructuring attempts;

(b) it directly addresses the identified policy issue and does not create wider issues and implications or employ an untried and untested structure that may produce unintended or unforeseen consequences;

(c) the risk of abuse by dishonest or negligent directors is carefully addressed by the imposition of a number of objective criteria that need to be established in order to make out the defence; and

(d) it is more closely aligned with the legal position in other comparable legal systems.

4.9 Set out in section 5 below are submissions in relation to the various elements of the business judgment rule that are identified in paragraph 5.3.4 of the Discussion Paper, and the modifications to that rule that are proposed in paragraph 5.3.6 of the Discussion Paper.

5 SECTION 5 – HOW SHOULD THE BUSINESS JUDGEMENT RULE BE FORMULATED?

"Make a business judgement in good faith for a proper purpose"

5.1 This aspect of the test is considered appropriate and not in need of modification.

"In respect of a matter in which they do not have a material personal interest"

5.2 This element is perhaps problematic and in need of revision.

5.3 What is a "material personal interest"? Executive directors will be employees of the company. Many will be shareholders. They may also be creditors on director loan accounts. If the restructuring proposal involves an injection of fresh capital, the source of that additional capital may be one of the directors or interests associated with that director.

5.4 It is considered that none of the above circumstances should disentitle the relevant director from relying upon the defence. Some of the circumstances may well have implications for the participation of the relevant director in the decision of the company whether to agree to a restructuring proposal that involves the director or interests associated with him or her as a counterparty. However, the director should not be precluded from relying upon the defence to resist an insolvent trading action.

5.5 Accordingly, this requirement should either be deleted, or should be subject to the proviso that none of the above circumstances constitutes a "material personal

interest" for the purposes of the application of the rule to this defence to insolvent trading.

"After informing themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate"

5.6 This aspect of the test is considered appropriate and not in need of modification.

"Rationally believe that the judgement was in the best interests of the corporation"

5.7 This aspect of the test is considered appropriate and not in need of modification.

"The financial accounts and records of the company presented a true and fair picture of the company's financial circumstances at the time that the rule was invoked"

5.8 The essence of this element, read together with the next element of the proposed rule, is (or should be) aimed at ensuring that directors and their restructuring advisers rely on accurate and relevant information, so that the directors will be in a position to form a view, with appropriate advice, on whether it is feasible that the company will remain solvent or be returned to solvency in a reasonable period of time.

5.9 The element as currently worded is considered problematic and in need of revision for a number of reasons, including:

(a) the test is essentially an audit test which has more of an historical or "backward looking" focus. In a restructuring, it is the position of the company moving forward that is most critical. While there is no doubt that accurate financial information will assist directors and professional advisers to assess the company's restructuring prospects, forward looking financial information such as cashflow forecasts (including detail as to assumptions) will be just as important, and often more important, than the balance sheet position of the company. In this regard, we note that the test of solvency for a company has been described in case law as a forward looking cashflow test (ability to pay debts as and when they fall due for payment), rather than a mere balance sheet test (assets less liabilities);

(b) if the financial accounts and records do not present a true and fair picture, the defence will not be available. This will mean that non-executive directors (and executive directors not directly involved in the financial management of the company) will not be able to avail themselves of the defence if the accounts presented to them by management turn out to be inaccurate. They have no effective control over this. Indeed, non-executive directors would simply have to take on trust that the detailed financial accounts provided to them on a regular basis are accurate, being a matter they are not in a position to ascertain, particularly with large enterprises and complex corporate groups. This is a substantial deficiency with the proposed test, as one of the policy objectives of option two is to ensure that non-executive directors, and other honest, diligent directors, do not feel unable to continue their directorships simply because of the risk posed by the insolvent trading laws. To achieve this objective it is critical to ensure that the "safe harbour" is sufficiently safe. If directors are concerned about the quality of their

financial accounts or are concerned about having to establish the fact that the statements are in fact accurate (when this may not reasonably be within the directors' knowledge or control), they may not be prepared to risk relying on the rule;

(c) as the National Safety Council case demonstrates, the directors may ascertain that there has been a fraud, or that the accounts are, through no fault of some (or all) of them, inaccurate. Just because the accounts are inaccurate does not mean that a restructuring or informal work-out may not be the appropriate course, so as to serve the best interests of creditors and other stakeholders. This element of the test, however, would prevent directors relying on the business judgement defence simply because of the inaccuracy in the accounts;

(d) as the test presently stands, an inaccuracy in the accounting treatment of goodwill would mean that the restructuring defence would not be available, even though this item in the accounts would have no material impact on any restructuring;

(e) should the business judgement of the director be litigated, depending on the final form of the rule, the onus may be on the director to prove that the accounts met the requisite standard and were accurate. Establishing this point will likely involve considerable time and expense if the issue were ever litigated, and is inherently problematic given that most accounts contain some subjective analysis; and

(f) Part 2M *Corporations Act 2001* already imposes sufficient requirements on a company and its directors with regard to financial reporting.

5.10 It is suggested that this element of the test be recast in the following respects:

(a) The focus on the objective accuracy of the accounts should be replaced with a focus on the director having taken all appropriate steps to ensure their material accuracy;

(b) The focus on "true and fair picture of the company's financial circumstances" should be recast to focus on the financial information of the company necessary for the provision of restructuring advice. (This revised test should not be expressed in more specific language because different financial reports may well be relevant to different restructurings. A focus on cashflow issues may be relevant in one set of circumstances; conversely where the focus is on restructuring a company's balance sheet liabilities, the accuracy of tangible balance sheet items will be more relevant.); and

(c) Should relevant accounts be inaccurate, this should not prevent a restructuring per se, and directors should be permitted to proceed, where otherwise appropriate, with a restructuring provided they diligently remedy the deficiencies in the accounts. (Existing *Corporations Act* provisions require accounts to be accurate, and it is not being suggested that these provisions be changed.)

5.11 Raised for consideration is a replacement test along the following lines:

The director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed.

"The director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time"

5.12 Six observations are offered in relation to this requirement.

5.13 The first is that this aspect of the test must accommodate the appointment by the company of appropriate personnel with specialist skills, such as a chief restructuring officer (**CRO**). The CRO would be an employee of or contractor with the company, whose role would be to investigate, advise, negotiate and oversee the implementation of the restructuring. The CRO would report to the board. As presently drafted, the provision would not appear to preclude the company from retaining such a professional, nor the directors from being able to rely upon that engagement, and to take account of the advice provided by him or her, in order to satisfy this aspect of the defence. These observations are therefore being made so that if any refinement or amendment to the provision is proposed, the approach should not alter the ability of the directors to perform their duties in this manner, as is commonly the case in overseas jurisdictions.

5.14 Secondly, if the restructuring advice is obtained from an external source (as, it may be apprehended, will more commonly be the case), it is considered important that the external professional be engaged by, and owe his or her duties to, the company, and not the directors. One safeguard against abuse of the safe harbour is that the directors not be able to rely on practitioners who may be sought out and engaged not for their professional skills, but for their preparedness to provide unrealistic or inappropriate advice tailored exclusively to enable the directors to continue to trade with the benefit of this defence. (It is not being suggested that this is currently occurring, only that it would be prudent to ensure that any legislative amendment does not create the opportunity for such conduct to occur in the future). By ensuring that the engagement is by the company, the professional advisers will owe their duty of care and diligence to the company, and be accountable should they fail to properly discharge their duty.

5.15 Thirdly, attention is again drawn to the shadow director concerns raised in paragraphs 3.25 - 3.26 and the need for additional legislative reform to deal with them. The legislative amendments should not have the unintended consequence of making any such adviser to the company a shadow director.

5.16 Fourthly, consideration should be given to some guidance being issued as to the required level of experience, independence and qualifications so as to assist directors in choosing a professional who will satisfy the requirement so that they may avail themselves of the protection of the rule. For example, some guidance could be provided by ASIC as to what constitutes "an appropriately experienced and qualified professional" across a range of circumstances (for example, in small businesses, SME, listed and unlisted entities).

5.17 Fifthly, it is noted that the Discussion Paper raises a concern that this element does not impose any requirement that the advice received be reasonable. We suggest that this concern poses no threat in practice as the advice must be from an appropriately experienced and qualified professional.

5.18 Sixthly, if the reference in the preceding section changes from "financial accounts and records" to "financial information", a corresponding change needs to be made to this provision.

5.19 It is therefore suggested that:

(a) the words "engaged or employed by company" be inserted between "professional" and "with access to"; and

(b) the words "those accounts and records" be replaced with "that financial information".

"It was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring"

5.20 It is understood that this element is intended to direct the attention of the directors to taking account of the interests of the company's body of creditors as a whole, given that the company is of questionable solvency (in addition to ordinary duties of directors to have regard to the interests of members of the company). If so, then this element is supported, but it will need to be carefully drafted so that it is not interpreted as suggesting that the interests of creditors are to be weighed against the interests of members.

5.21 It should also be made clear that the introduction of a modified business judgement rule defence in the context of insolvent trading will not in any way affect the existing statutory and general law duties imposed on directors.

5.22 One consideration raised in the Discussion Paper is the often divergent interests of secured versus unsecured creditors and current versus future creditors, and whether specific considerations need to be made for each of these groups. The interests of creditors may be different, but this is the case at all times. Accordingly, as is the position generally, directors will need to give all creditors due consideration. Accordingly, the reference to "creditors as a whole" is considered appropriate.

"The restructuring was diligently pursued by the director"

5.23 It is suggested that this aspect of the test requires minor attention. This is because it will not necessarily be the role of a director (in particular, a non-executive director of a large public company or group of companies) to be undertaking the day-to-day processes of the restructuring. It is for the director to ensure that the company is diligently pursuing the restructuring.

5.24 It is therefore suggested that this proposed element of the defence should be recast, and the following wording is suggested:

> "The director took all reasonable steps to ensure that the company diligently pursued the restructuring."

5.25 It is also suggested that diligence would almost certainly require early engagement between the company and its key stakeholders, such as its financiers, in the restructuring process. While this observation may not require legislative attention, it would nonetheless be prudent for this point to be made in the Explanatory Memorandum accompanying the amendments, should the government adopt option 2.