AUSTRALIAN INSTITUTE
of COMPANY DIRECTORS

Level 30
20 Bond Street
Sydney NSW 2000
www.companydirectors.com.au
ABN 11 008 484 197

T: +61 2 8248 6600
F: +61 2 8248 6633
E: contact@companydirectors.com.au

17 February 2015

Business Set-Up and Closure in Australia
Productivity Commission
GPO Box 1428
CANBERRA ACT 2600

Email: business.inquiry@pc.gov.au

Dear Commissioners

Business Set-up, Transfer and Closure

The Australian Institute of Company Directors welcomes the opportunity to comment on the issues raised by the Productivity Commission in its discussion paper *Business Set-Up, Transfer and Closure*.

The Australian Institute of Company Directors (AICD) is the nation's leading organisation for directors, dedicated to making a positive impact on society and the economy by promoting professional director education and excellence in corporate governance. We have a significant and diverse membership of more than 35,000 from across a wide range of industries, commerce, government, the professions, private and not-for-profit sectors.

The AICD is of the view that the primary objective of Australia's insolvency regime should be corporate recovery. The insolvency regime should encourage entrepreneurialism and operate to save businesses that can be saved. In turn, the regime would encourage innovation, economic growth and the preservation of employment.

Australia's insolvency regime must also protect relevant corporate stakeholders including employees, suppliers, customers, creditors and shareholders. Unfortunately we are concerned that aspects of the current regime sometimes prevent the best stakeholder outcomes from being achieved.

We confine our comments in this submission to aspects of Australia's insolvency regime.

Summary

In summary, the key comments of the AICD are as follows:

(a) The objective of the insolvency regime should be corporate recovery. The regime should encourage entrepreneurialism and operate to save businesses that can be saved;

(b) While we are of the view that the voluntary administration regime appears to be working well, in order to create a corporate recovery culture there are some key areas where improvements may be beneficial;

(c) The liability of directors for insolvent trading needs to be addressed as it not only encourages, but effectively mandates directors to move to external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage;

(d) The Honest & Reasonable Director Defence should be inserted into the Corporations Act to provide directors with an additional defence for insolvent trading;

(e) The Productivity Commission should consider whether some restrictions on the enforcement of ipso facto clauses during the voluntary administration process may assist to save businesses that can be saved; and

(f) The Productivity Commission should consider whether some restrictions on the rights of substantial secured creditors to immediately enforce their security during the voluntary administration process may assist to save businesses that can be saved.

Objectives of the Insolvency Regime

The AICD encourages the Productivity Commission, when reviewing the responses to the issues set out the Discussion Paper, to first carefully consider the objectives of Australia's insolvency regime. What is our insolvency regime designed to achieve? The recommendations made by the Productivity Commission will depend on the Commission's answer to this fundamental question.

The AICD is of the view, that the primary objective of Australia's insolvency regime should be corporate recovery. The insolvency regime should encourage entrepreneurialism and operate to save businesses that can be saved. In turn, the regime would encourage innovation, economic growth and the preservation of employment.

Australia's insolvency regime must also protect relevant corporate stakeholders including employees, suppliers, customers, creditors and shareholders. Unfortunately we are concerned that aspects of the current regime sometimes prevent the best stakeholder outcomes from being achieved.

Australia's insolvency regime is focussed on creditor outcomes. This approach is exemplified in the Exposure Draft of the Insolvency Law Reform Bill 2014 which increases the rights of creditors during a corporate insolvency event. In addition, much of the commentary around potential improvements to the regime over many years has centred upon identifying the best mechanisms to distribute the assets of distressed businesses rather than helping distressed businesses not to fail in the first place.

Directors are keen to ensure that the value of businesses facing insolvency are preserved as far as possible and turned around where it is possible to do so.

While we are of the view that the voluntary administration regime appears to be working well, in order to create a recovery culture there are some key areas where improvements to the regime may be beneficial. The three areas which require careful consideration by the Productivity Commission are the insolvent trading provisions, ipso facto clauses and the rights of substantial secured creditors in voluntary administration.

A short discussion of each of these areas is included below.

1. Insolvent Trading Provisions

The AICD believes that Australia has a risk-averse corporate regulatory and operating culture. In 2014, the AICD released a paper titled *The Honest & Reasonable Director Defence: A proposal for reform* (Attachment A). The paper identifies some of the domestic pressures that are evident in Australia's corporate operating and regulatory environment.

One of the pressures identified is the impact of Australia's insolvent trading provisions on directors, boards and the economy.

A person, including a company, is solvent for the purposes of the Corporations Act if that person can pay their debts as and when they fall due.[1] A person is insolvent if they are not solvent.[2] Section 588G of the Corporations Act provides that a director of a company will be personally liable if the company incurs a debt when the company is insolvent, or becomes insolvent by incurring a debt. A breach of section 588G exposes a director to civil penalties of up to $340,000,[3] liability to compensate the company or the relevant creditor for the amount of any debt incurred as a result of the breach[4] and, in egregious cases meriting criminal prosecution, the possibility of a fine of up to $340,000, imprisonment for five years or both.[5]

Section 588H of the Corporations Act contains a number of defences that can be relied on by directors alleged to have contravened section 588G. These defences are based on a director being able to prove that the director reasonably believed that the company was solvent when a debt was incurred or was unable, having taken all reasonable steps, to prevent the debt being incurred.

The Chief Justice of the Supreme Court of Western Australia has noted that Australia's insolvent trading laws are "arguably the strictest in the world".[6] In AICD's view, this regime:

- not only encourages, but effectively mandates directors to move to external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage;
- discourages directors from taking sensible risks when considering other kinds of informal corporate reconstructions or "work-outs" to deal with a company's financial problems;
- provides an incentive for creditors, especially secured creditors, to act in their own self-interest and arrange for the disposal of key assets and the termination of continuing contractual arrangements as soon as possible;
- can lead to financially viable companies suffering the consequences of external administration, including ceasing to be a "going concern", suffering the loss of value and goodwill and incurring the expense of engaging administrators or receivers when it may have been possible under a less prescriptive legislative regime for the company to restructure itself and secure its financial standing; and
- can lead to losses by shareholders, creditors, employees and, in many cases, may have downstream impacts on the broader community through the loss of the value of their investments, retirement savings and jobs.

[1] Corporations Act 2001 (Cth), s 95A(1).

[2] Corporations Act 2001 (Cth), s 95A(2).

[3] Corporations Act 2001 (Cth), s 1317E and s 1317G.

[4] Corporations Act 2001 (Cth), s 588M.

[5] Corporations Act 2001 (Cth), s 1311 and Schedule 3, Item 138.

[6] The Hon. Wayne Martin, Chief Justice of Western Australia, 'Official Opening Address' (Speech delivered at Insolvency Practitioners' Association of Australia 16th National Conference, Perth, 28 May 2009).

A review of the insolvent trading legislation in a number of other common law jurisdictions in 2009, including the United Kingdom, New Zealand, Canada and the United States published in the *Australian Journal of Corporate Law* concluded that:

> "Many major economies have some form of reckless trading provision which requires an absence of reasonable prospects for continued trading. Some countries have no insolvent or reckless trading provision whatsoever. The Australian insolvent trading provision encourages directors to put businesses to the sword even where there may be prospects for future prosperity. An effective culture of corporate rescue requires a number of key elements, including cooperation of major stakeholders... It is important that struggling businesses are not put to a premature death because of an unwillingness of company directors to expose themselves to personal liability."[7]

We also note the comments made by the then Chief Justice of the Supreme Court of NSW, the Hon Justice Spigelman AC, who stated:

> "There are thought to be cases where directors have prematurely put their company into external administration, diminishing enterprise wealth and possibly destroying businesses in order to avoid exposing their company and themselves to breaches of insolvent trading or continuous disclosure law. If the Australian law has that effect, then the law is at odds with economic policy goals and needs to be reformed."[8]

It is critical to remember that a company may be placed into external administration for a range of reasons, including external economic or market related pressures. It does not always follow that because a company has been placed into external administration that a director has acted improperly, incompetently or has failed to discharge his or her duties.

The insertion of a broad based defence that extends to the insolvent trading provisions is particularly important because the question of whether a company is solvent is extremely complex and time-dependant. The complexity of the question was acknowledged in *Metropolitan Fire Systems Pty Ltd v Miller & Ewins* where Einfeld J said:

> "I do not doubt that many companies are or would be found to be insolvent on particular days or even for longer periods if a balance sheet were taken at a particularly difficult trading time. It is also easy in hindsight and in the remoteness of a courtroom many years later to be too artificial about the day to day running of the business in what I imagine was a highly competitive and 'rough and tumble' entrepreneurial field."[9]

Irrespective of any further insolvency reform approaches that may have merit, we consider that a critical element to addressing the problems created by the insolvent trading regime is for directors to have access to a broad based defence such as the Honest and Reasonable Director Defence.

The AICD proposes that the Honest and Reasonable Director Defence be inserted into Chapter 9 of the Corporations Act and that it apply in addition to the other specific defences which already exist in the Act. The Defence would apply not only to insolvent trading but to all contraventions set out in the Corporations Act and the ASIC Act (and any equivalent grounds at common law or in equity) pursuant to which a director may be liable.

---

[7] Jason Harris, "Director liability for insolvent trading: Is the cure worse than the disease?" (2009) 23 *Australian Journal of Corporate Law* 266, 286.

[8] Supreme Court Annual Corporate Law Conference '*Restructuring Companies in Trouble: Director and Creditor perspectives*' Conference Papers: Welcome by the Chief Justice dated 15 August 2010.

[9] (1997) 23 ACSR 699, 710–711.

The AICD's proposed Honest and Reasonable Director Defence is as follows:

> "Notwithstanding any other provision of this Act or the ASIC Act, if a director acts (or does not act) and does so honestly, for a proper purpose and with the degree of care and diligence that the director rationally believes to be reasonable in all the circumstances, then the director will not be liable under or in connection with any provision (including any strict liability offence) of the Corporations Act or the ASIC Act (or any equivalent grounds of liability in common law or in equity) applying to the director in his or her capacity as a director."[10]

The purpose of the Honest and Reasonable Director Defence is to create an environment that is conducive to strong yet responsible corporate performance and which supports directors who act honestly. The defence would not alter the primary duties and obligations imposed on directors by the law.

Further information about the Honest & Reasonable Director Defence is available in Attachment A.

2. Ipso Facto Clauses

Clauses in commercial contracts often provide that a party will be in default if a specified event occurs. If the directors of a company in financial distress place the company into voluntary administration, even with a view to rescuing it, ipso facto (by the act itself) the company may trigger contractual defaults.

The combination of personal director liability for insolvent trading and the existence of ipso facto clauses place directors of financially distressed entities into a dilemma. As set out above, Australia's insolvent trading provisions render directors personally liable if they allow their company to trade while insolvent. Yet determining the exact point at which a company is insolvent is complex and time dependent. As set out in submissions to CAMAC's inquiry *Rehabilitating large and complex enterprises in financial difficulties*: "it is difficult to judge whether a company is insolvent or just approaching insolvency."[11]

Despite this difficulty directors, whether they are directors of small businesses or large corporations, are required to make decisions at the time events are unfolding and do not have the benefit of hindsight. As explained by Steven Cole in *Mind the Expectation Gap:*

> "...the performance of corporations and their boards, and the decisions and judgments taken by NEDs [non-executive directors] in the course of their role and responsibilities, are usually assessed and judged by regulators, the courts, the media and the public with the benefit of hindsight, without time constraints and with access to all information possible that may be relevant to the decision or judgment made and its probable consequences. Hindsight truly is 20:20 vision but 20:20 vision is not available to the board when the decision needs to be made."[12]

In *Lewis v Doran* (2004) 50 ACSR 175 Palmer J at 198-199 recognised this commercial reality in an insolvency context and referred to the Court's "inestimable benefit of the wisdom of hindsight." Justice Palmer stated:

---

[10] See further "Honest & Reasonable Director Defence: A Proposal for Reform"

[11] CAMAC Report *Rehabilitating large and complex enterprises in financial difficulties*, 2004 at 23

[12] Cole S *Mind the Expectation Gap The Role of A Company Director*, Australian Institute of Company Directors 2012 at 24

> "Where the question is retrospective insolvency, the court has the inestimable benefit of the wisdom of hindsight. One can see the whole picture, both before, as at and after the alleged date of insolvency. The court will be able to see whether as at the alleged date of insolvency the company was, or was not, actually paying all of its debts as they fell due and whether it did, or did not, actually pay all those debts which, although not due as at the alleged date of insolvency, nevertheless became due at a time which, as a matter of commercial reality and common sense, had to be considered as at the date of insolvency."

As set out above, directors can avoid personal liability for insolvent trading by placing their company into voluntary administration. However, the very act of doing so is likely to trigger ipso facto clauses in the company's contractual arrangements potentially destroying the value of the business. As set out in CAMAC's 2004 report:

> "directors may be reluctant to put their companies into VA [voluntary administration] out of concern that this may result in creditors enforcing ipso facto clauses that in effect terminate the company's business."[13]

If the primary objective of the insolvency regime is corporate recovery and saving businesses that can be saved, we anticipate that the position of ipso facto clauses during administration will require further examination.

In Australia, there is currently no restriction on the ability of parties to enforce ipso facto clauses during a voluntary administration. This is a different position to that taken in the United States where ipso facto clauses have limited operation in Chapter 11 cases. Generally ipso facto clauses in the United States cannot be relied on until the bankruptcy case has been closed. There are some exceptions to this general rule, for example:

- A party will not be bound to accept or render the performance of a contract where the trustee/assignee of the company is not able to fulfil the bargain originally offered by the company to the party;[14] or
- the contract is to provide debt financing or financial accommodation to the company (i.e. a lender is not required to provide further funds to the company).[15]

We are aware that there are number of key objections to restricting the enforceability of ipso facto clauses during voluntary administrations in Australia. The key objections are that legislative restrictions would interfere with the rights of private parties to contract and secondly, that it is likely to increase the cost of financing for financially healthy businesses.

We are of the view that consideration of this issue requires further analysis and data. For example, will any restriction on ipso facto clauses increase the cost of financing for business? If so, how much will any increase cost business and the economy? Will any increased costs be offset by the benefits which may accrue if businesses are restored back to good health in circumstances where it is possible to do so?

---

[13] CAMAC Report *Rehabilitating large and complex enterprises in financial difficulties*, 2004 at 70

[14] See 11 U.S.C §365(e)(2)(A)

[15] See 11 U.S.C §365(e)(2)(B)

We recommend that the Productivity Commission consider and consult with stakeholders as to whether some restrictions on the enforcement of ipso facto clauses during the voluntary administration process may assist to save businesses that can be saved.

3. Rights of substantial secured creditors in voluntary administration

The Corporations Act currently allows secured creditors with a charge over the whole, or substantially the whole, of a company's property to appoint a receiver or enter into possession of that property to enforce that security once a voluntary administration has commenced.

In circumstances where the substantial secured creditor has not already enforced its security prior to a distressed company entering into voluntary administration, the substantial secured creditor has 13 business days from receiving notification of the appointment of an administrator to enforce its security.[16] If the substantial secured creditor does not appoint a receiver or enter into possession of the property during the 13 day decision period, the substantial secured creditor will not be able to enforce its security during the voluntary administration period without the written agreement of the administrator or the leave of the court.

While the rights of other secured creditors in a voluntary administration are subject to a moratorium, the right of a substantial secured creditor to enforce their security in the decision period remains. If a substantial secured creditor appoints a receiver or takes possession of a large component of the company's property, little prospect remains of rescuing the company or preserving the value of the business as a going concern. In this way, the regime provides an incentive for substantial secured creditors, to act in their own self-interest and arrange for the disposal of key assets.

We are still considering the extent to which the rights of substantial secured creditors may impede the ability of financially distressed companies to be rescued. We are aware that any changes to the right of substantial secured creditors to enforce their security may increase the cost of financing for all companies. Again, analysis would need to be undertaken as to whether any changes resulting in increased costs to business would be offset by the benefits which may accrue by restoring businesses back to good health.

We recommend that the Productivity Commission consider and consult with stakeholders as to whether some restrictions on the rights of substantial secured creditors to immediately enforce their security during the voluntary administration process may assist to save businesses that can be saved.

We hope our comments will be of assistance to you. If you would like to discuss any aspect of our views, please contact us on (02) 8248 6600.

Yours sincerely

JOHN BROGDEN
Managing Director & Chief Executive Officer

[16] See Corporations Act 2001 (C'th) s441A