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Business Set-up, Transfer and Closure
Productivity Commission
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By email: business.inquiry@pc.gov.au

Dear Productivity Commission

Productivity Commission Business Set-up, Transfer and Closure Draft Report: Public Submission due 3 July 2015

This submission comments on the Commission's draft report released on 21 May 2015, and in particular those aspects concerned with corporate restructuring processes and the recommendations concerned with business restructuring.

This submission:

- attaches, by way of submission, a copy of DibbsBarker's submission to Treasury on the Financial System Inquiry's Final Report recommendation 36 (made 26 March 2015) ("**FSI Submission**") – specifically addressing the topics of culture, safe harbour and ipso facto reform;
- attaches, by way of background, a copy of DibbsBarker's submission to the Senate Economic References Committee's recommendation 61 in its report on the performance of ASIC dated 26 June 2014 – specifically addressing potential legislative reform to deliver a restructuring framework, albeit in so doing, recognising that a 'tweak' will tend to result in far more substantive reform than is publicly aired to be desirable;
- attaches, by way of background, a copy of an article by me which proposes, in the alternative to substantive legislative reform, a restructuring framework delivered pursuant to informal protocol;
- by way of supplement to the FSI Submission, provides specific comments on the draft report.

The observations in this submission are based on my experience in the restructuring and insolvency industry since 1995. I have worked in Australia, the UK and the Middle East. In my dealings in the UK and the Middle East, I worked on restructurings alongside persons recognised globally as preeminent practitioners, and involving parties from the UK, the Middle East, USA, Europe and Asia.

1. General

Page 21 "*In international comparisons, the use of restructuring processes in Australia and the United Kingdom compares poorly to countries such as the United States and Canada*."

In my experience working in the restructuring and insolvency industries in Australia and the UK, the use of informal restructuring protocols in the UK (known as the London Approach and the INSOL principles) form the basis of a very mature and sophisticated restructuring market when compared to Australia. These protocols routinely deliver the successful restructure and turnaround of companies. Schemes of arrangement are also commonly used as a restructuring tool in the UK in relation to large, complex companies. While pre-packs have been the subject of criticism, particularly those involving small to medium sized companies and the sale of assets to a related party, pre-packs are a commonly used restructuring tool in the UK in relation to large, complex companies. That is, there is a robust and very successful restructuring culture in the UK, which routinely delivers the restructure and turnaround of companies via informal protocols, schemes of arrangement and pre-packs.

Rec 15.1 In my view, the proposed amendment to section 436A of the Corporations Act potentially goes too far. I am of the view that insolvent companies should be able to access voluntary administration.

I note that the proposed amendment arises as a result of the numerous instances where administration fails to deliver more than a liquidation or quasi-liquidation outcome. However, as the Commission notes, insolvency can be incredibly difficult to assess without the benefit of hindsight. Moreover, if a company which is technically insolvent requires the benefit of the moratorium granted by administration to deliver a deed of company arrangement proposal, there are funds available to enable the company to continue as a going concern during the administration, and that deed has the potential to turn the company around or deliver a better outcome for creditors than otherwise would have been the case in liquidation, then the company should be able to avail itself of the regime. Alternatively, a deed may be desirable to achieve a share transfer under section 444GA of the Corporations Act as a part of a broader financial restructuring of an insolvent company.

Noting the discussion by the Commission of pre-positioned sales (addressed below), it is possible that a pre-positioned sale will result in the company being insolvent but that a component of that sale or the overall restructure of the company involves a deed of company arrangement being approved by creditors (via a subsequent administration). It would be unfortunate if the existing flexibility in delivering restructurings via voluntary administrations (irrespective of actual use) was diminished. I am supportive of adding restructuring tools that encourage and facilitate a restructuring culture and more turnarounds. I am not supportive, at this stage, or taking existing tools away.

If the Commission remains of the view that an amendment is desirable, perhaps an insolvent company which proposes at the time of appointment (whether by its directors, its members or other third party) a deed of company arrangement which has the potential to deliver a restructuring or a better return to creditors than liquidation, ought to be able to appoint an administrator. I accept there is no benefit in enabling a director of an insolvent company without any plan to appoint an administrator; that process tends to result in no more than a delayed liquidation and increased costs of administration.

2. Safe harbour

Page 355 The Commission's recommendation warrants clarification as to the scope of the proposed safe harbour and when it operates. In particular, at page 355 the Commission notes that "*where the independent adviser sees that insolvency has occurred (or is about to), they should be under a duty to inform both directors and creditors of this, so that a liquidation process can be initiated. From this point, the safe harbour protections would cease and should directors incur any debts after this time they would expose themselves to potential liability*."

Section 588G of the Corporations Act is only triggered in the event that the company is insolvent. Directors of a solvent company are not exposed to liability under section 588G. Conversely, the Commission's safe harbour appears to operate outside of insolvency, with an obligation to appoint a liquidator in the event of insolvency. In my view, the benefit of a safe harbour arises during "the twilight zone" when a company is probably or is insolvent but nonetheless, restructuring efforts warrant pursuit.

Rec 15.2 The recommendation proposes that a safe harbour would only be available where a company appoints a registered adviser. The recommendation appears to be focused on the appointment of a person rather than what is proposed to be achieved or done during the safe harbour period. The recommendation does not appear to consider the impacts of requiring a registered adviser to be appointed, including the suitability of such a person, the cost of such a person, the oversight of such a person, the scope of the person's role and any duties and liabilities. In my experience in the UK, a turnaround practitioner might be a company executive and not an adviser (although in large, complex restructurings, advisers will be involved in addition to, for example, a chief restructuring officer). The parties who can assist with a restructuring vary greatly, from turnaround executives, accountants, investment bankers, shadow banking participants and lawyers. The suitability and mix of such persons will depend on the size and complexity of the company and nature of the restructuring. See page 5 of our FSI Submission for further comment on this point.

The business judgment rule has been criticized (see footnote 13 of our FSI Submission) and accordingly, is unlikely to be the appropriate measure for future legislation.

3. Ipso facto clauses

Page 21 "*Ipso facto clauses allow a contract to be terminated solely due to the fact that the business has experienced an 'insolvency event*."

This statement is not, strictly, correct. Ipso facto is a Latin phrase which means "by the fact itself". An ipso facto clause is a clause which stipulates the consequences of a fact or event. The consequence will not always be termination. In the US, a provision in a contract which terminates *or modifies* that contract upon insolvency is unenforceable under 365(e)(1) of Bankruptcy Code (subject to certain exceptions). A subtle but important distinction in the context of recommendation 15.4 (see comments below).

"*Many countries have heavily restricted the use of such clauses*."

I am unaware of the source of this comment. The Commission should note (1) Australia is a common law jurisdiction, (2) common law jurisdictions tend to hold paramount the freedom to contract in good faith, and Courts will give effect to contractual terms which parties have agreed, subject to there being no deliberate intention to evade insolvency laws, (3) to my knowledge, most major trading nations, including the UK, Germany, China, Hong Kong, Japan and Australia, permit the enforcement of ipso facto clauses upon the opening of insolvency proceedings. The notable exceptions, in addition to the US, are France and Canada. The US and France are civil jurisdictions, Quebec is a civil jurisdiction and Canada's legal system combines civil and common law.

See the competing UK and US judgments of *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc* [2011] UKSC 38 where a "flip clause" was held to be valid and enforceable in insolvency by the UK Supreme Court and *In re: Lehman Brothers Special Financing Inc v BNY Corporate Trustee Services Limited* (Case No: 09-01242) (2010) where, on the same facts involving the same parties, the US Bankruptcy Court held that the "flip clause" constituted an ipso facto clause and was thus unenforceable under the Bankruptcy Code. See also the Australian case, *International Air Transport Association v Ansett Australia Holdings Ltd* (2008) 234 CLR 151.

In my experience in the UK, the fact that ipso facto clauses are enforceable in insolvency is an enticement to deliver an effective restructuring and turnaround of a company outside of formal insolvency regimes, that is, to avoid the value destruction that occurs once a company enters into administration or liquidation.

Rec 15.4 In recommending that ipso facto clauses be unenforceable, it not apparent on the face of the draft report that the Commission has considered the breadth of the proposed amendment. For example, does the Commission intend to recommend that such clauses should only be unenforceable where they terminate the contract, but not where they otherwise modify the arrangement? Does the Commission intend to recommend that all such clauses be unenforceable, or for example, are financing arrangements excluded and if so, what of contracts containing PPSA interests that are otherwise supply contracts? Does the Commission intend that such clauses would be unenforceable, potentially to the detriment of the relevant supplier, where a receiver is appointed for example only over certain property and not with respect to the business as a whole of a company? As I understand the draft report, such clauses would become enforceable in liquidation; although this perhaps warrants clarification given that the position in the US is different. Perhaps the Commission can consider such issues or make it plain that the breadth will warrant further submission and consideration.

International evidence: see my comments regarding my UK experience above.

Schemes of arrangement: I was involved in a scheme of arrangement in the UK, where there was a real concern that certain contracts could be terminated by virtue of the scheme of arrangement. However, the view was taken (which view proved to be correct) that such parties would be unlikely to terminate by reason that commercially, those parties were better off if the scheme was approved. Where there is a positive business rescue culture, in my experience in the UK, parties tend to operate commercially taking into account the medium term benefits of a successful restructuring and tend to be less reactive. Stakeholder management is a key aspect of any successful restructuring. In the context of a mature and sophisticated restructuring culture, a need to overly regulate to stipulate the conduct expected of parties in supporting a company in its restructure is less necessary. This is particularly so in the context of schemes of arrangement which tend only to be utilised in large, complex situations where parties are well advised. That said, in Australia, it might be considered desirable that a court be given a broad power to effect, suspend or modify the rights of certain parties connected with a company where their conduct is likely to impede the success of a scheme to the detriment of the company and its stakeholders taken as a whole.

4. Pre-packs and pre-positioning

Page 358 In the UK, pre-packs have developed as a restructuring tool for delivering the best return to creditors where a restructuring outside of formal insolvency cannot be achieved. Best practice dictates that an administrator ought to satisfy the following criteria in entering into a pre-pack (see also Statement of Insolvency Practice 16 (“**SIP16**”) published by the Joint Insolvency Committee for England, Wales and Northern Ireland):

- there must be transparency around the terms of the pre-pack and reasons given to creditors why it was necessary to dispose of the assets in this way;
- creditors must be advised whether appropriate marketing efforts were undertaken (or reasons given for not doing so);
- there must be a valuation to support the price that is paid (at least two independent valuations ought to be obtained); and
- while independence is cited as a concern in the UK, there are express duties in place which impose on administrators an obligation to secure the best price reasonably obtainable and to act in a manner which is not prejudicial to creditors (with avenues for complaint, the unwinding of transactions and disciplinary measures available to administrators who fail to comply with their duties).

While at the top of town, pre-packs operate effectively and administrators tend to adhere strictly to the above criteria/SIP16, in the case of small to medium sized companies, there is a real concern that pre-packs are subject to significant abuse to the prejudice of creditors. There is a balancing act being undertaken in the UK to ensure that pre-packs remain available for use, but that abuse is minimised. For example, while SIP16 provides a set of guidelines, they do not comprise law and as such, the sanctions for abuse are not available as they would be if those guidelines were set out in legislation. This is one of the matters being contemplated in the UK currently, as a means to respond to the abuse of pre-packs.

Rec 15.3 In general, I support legislation which provides a framework for pre-positioned sales whether entered into immediately prior to administration or by an administrator on or soon after their appointment. I believe a framework based on the criteria outlined above in relation to the UK is desirable.

However, beyond stipulating criteria which guides and regulates parties when seeking to sell assets prior to administration, I do not support legislation which alters an administrator's ability to repudiate pre-appointment contracts (or a liquidator's ability to disclaim certain contracts). I discuss why, below.

In the UK, where an administrator determines to enter into the sale on or soon after their appointment, *in addition to* meeting the criteria above (summarised for the UK), the administrator will be concerned to ensure that the terms are suitable in light of the administrator's obligations in connection with the administration itself. For example, deferred consideration will be considered in the context of the company's circumstances overall and the risk to creditors in accepting deferred consideration.

In Australia, where the company pre-positions a sale and subsequently appoints an administrator, the administrator might have to terminate the sales contract even if the sale is for reasonable market value.

Actual case example (Australia, 2015): a seller entered into a sales contract with a buyer and several days later, appointed an administrator. The sales contract involved a reasonable market value price for the company's business and certain assets however, there was an extended post signing due diligence period and purchase price adjustment provision in favour of the buyer, with completion and payment of the purchase price anticipated some 4 months after signing. Additionally, part of the purchase price was payable in listed shares issued by a third party, conditional on a successful capital raising by that third party. During the due diligence period, the sales contract presupposed that the seller would continue as a going concern (to preserve the value of the business and assets sold). The administrator had insufficient funds to continue the company as a going concern beyond the first week(s). The administrator was unable to complete the contract, the conditions in the contract meant that the overall arrangement was not obviously in the best interest of creditors and so the administrator needed to terminate the contract, and put the business and assets back on the market for sale to a purchaser able to move quickly and provide upfront consideration by way of cash.

In light of the above, the reality is, that for a pre-positioned sale to work, the administrator of the company will need to be consulted or the views of an administrator obtained, to ensure that it is likely to be commercially acceptable to the administrator (or liquidator) taking into account their duties and personal liabilities.

If the Commission is desirous of effectively mandating that an administrator (or liquidator) be bound by a pre-positioned sale, then the topic of deferred consideration, the type of consideration and conditions to completion (at least), in the context of the administrator's (or liquidator's) duties and personal liabilities, will need to be considered. While in some cases, deferred consideration or non-cash consideration may well be in the best interests of creditors (such consideration may secure the highest price), in other cases it will not be (deferred consideration might pose an unacceptable credit risk).

Alternatively, the Commission might accept that a pre-pack sale allows the administrator (or liquidator) to consider such matters on a case by case basis, and it is better placed therefore to consider legislative guidelines to guide and regulate insolvency practitioners in those considerations.

I am happy to discuss any aspect of this submission with you.

Yours sincerely

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