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Dear Senior Adviser

Financial System Inquiry Final Report: Public Submission
Recommendation 36

This submission comments on the Inquiry's recommendation 36, consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.

This submission:

- provides background comments in paragraph 1;
- comments on the proposal for a safe harbour in paragraph 2; and
- comments on the proposal for an ipso facto moratorium in paragraph 3.

I have shared a draft of this submission with a number of business leaders in the Australian restructuring and insolvency industry to obtain their input. While I have not asked any one of them to endorse my views, this paper incorporates so far as practicable the observations of those people.

1. BACKGROUND COMMENTS

The Inquiry found that submissions indicate that Australia's external administration provisions are generally working well and do not require wholesale revision. Relevantly, stakeholders presented little evidence to suggest that the Australian regime causes otherwise viable businesses to fail.

That is, there does not appear to be any broad demand that the external administration provisions be overhauled.[1]

1.1 A restructuring regime

If Treasury is desirous of considering more comprehensive amendments to the external administration regime aimed at encouraging and facilitating corporate turnarounds, I refer Treasury to our DibbsBarker (Attachment) submission of 18 August 2014 to the Inquiry's interim report. In that submission, I commented:

(a) a regime expressly aimed at corporate turnarounds may take the form of legislation, as is the case, for example in the USA with Chapter 11, and our submission describes a possible regime (and its key elements) for discussion purposes; or

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1 Although I am aware of, and have spoken with, a few advocates who note that the Harmer Report is now decades old, that a substantive review of the external administrations provisions would be beneficial and to that end, regard should be had to overseas regimes including the USA, Canada and the UK.

(b) a regime expressly aimed at corporate turnarounds may take the form of protocol, as is the case, for example in the UK with the London approach or in the global restructuring market with the INSOL principles, and our submission provides a summary of the key aspects of an effective protocol.[2]

Given my experience in the UK, I see benefit in delivering corporate turnarounds pursuant to protocol, whereby parties conduct themselves in a manner consistent with a framework which becomes market standard practice, and as such, provides parties consistency and certainty, coupled with flexibility. In the UK, the London approach has been very successful given the involvement of the Bank of England. The London approach is a domestic protocol (and not to be confused therefore with the INSOL principles, an international protocol for application on cross-jurisdictional transactions) which mandates the conduct expected of financial creditors (whether as a syndicate or individually) operating in the UK and regulated by the relevant UK authorities including the Prudential Regulation Authority and the Financial Conduct Authority. I comment on one of the aspects of such a protocol, standing still, in paragraph 3.1 below.

In Australia, there is no equivalent legislative regime or protocol. As such, at present there is no consistent or certain framework focused on corporate turnarounds for firms and their stakeholders, when facing financial distress[3].

1.2 Culture

In my view, the status quo in Australia can be summarised as follows: it is broadly believed that where restructurings are viable they are pursued effectively including via use of the existing external administration and scheme frameworks. However, not all financially distressed companies can be turned around and an efficient capital system rightly allows companies to fail.[4]

This differs to the status quo for example in the UK, where I experienced an overwhelming and pervasive attitude that while financially distressed companies may well fail, prior to that occurring all relevant stakeholders should act in a supportive, cooperative and coordinated manner, making decisions based on accurate information, to consider the alternatives. Fundamentally, failure is seen as a negative outcome, economically and socially.[5]

This culture difference means that many Australians view the status quo in Australia, differently to those with a different culture persuasion or set of experiences. Based on my experience working in Australia and abroad, I believe that more can and should be done to deliver more turnarounds, more effectively, more of the time in Australia.

Critically however, unless there is a broad cultural change, then Australia will continue to use the laws provided for a purpose consistent with the overarching view that financially distressed companies should be allowed to fail. This is most clearly observed in relation to voluntary administration. While the objective of voluntary administration expressly contemplates an insolvent company continuing in existence (and in a turnaround context, to be read as a going concern as opposed to a corporate shell), in fact that objective is rarely pursued. Rather, voluntary administration more often than not, is used to deliver no more than a quasi-liquidation outcome[6].

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2 An excellent summary of the London approach, some of the reasons for its effectiveness, and a summary of the INSOL principles, can be found at pages 5 to 17 of "Restructuring Law & Practice" by Chris Howard and Bob Hedger, Second Edition published by LexisNexis.

3 In Australia, at present, the consistent and certain frameworks are schemes of arrangement (a useful but limited and very expensive tool), voluntary administration (which has been used principally as a quasi-liquidation tool, see footnote 4 below and comments at paragraph 1.2 of my paper), liquidation and receiverships.

4 See the Inquiry's interim report, Funding, External Administration.

5 This cultural persuasion does not go so far as to suggest that a non-viable company should be preserved. The London approach does not aim to preserve businesses unless there is a commercial case to do so. Viability is addressed in paragraph 1.4 of my submission.

6 As evidenced by the paper titled "A sample review of deeds of company arrangement", by Mark Wellard 19 May 2014. In 72% of cases, a deed of company arrangement delivers a quasi-liquidation outcome.

The question arises: can law reform assist in shaping culture? Law reform is driven by policy. If the policy objective is consistent with a moving culture, then yes, law reform can assist. I address culture in the context of the proposed reform in paragraphs 2 and 3 below.

1.3 Fundamental tenets of turnaround

Law reform will only encourage and facilitate corporate turnarounds, and provide additional flexibility for businesses in financial difficulty with the objective of seeing more companies continue in existence as going concerns, more of the time, if the reform promotes a number of fundamental tenets of a successful turnaround.

In turn, to understand the fundamental tenets, it is helpful to consider the existing issues. Key issues that threaten a successful turnaround are that directors leave matters too late, stakeholders do not access the right advice (but instead are provided insolvency advice or combative advice) and creditors are not always supportive. Additionally (and related to the second point), in my experience, restructurings fail if they are a band aid solution. An effective restructuring must be conditional on a plan underpinned by accurate and realistic information, which identifies the changes that the financially distressed firm will make to deliver a lasting turnaround.

My paper published titled “Encouraging and facilitating corporate turnarounds: effective debt restructuring”[7] provides some further colour to the issue of why restructurings fail, based on my experience overseas and on-deal experience in Australia since my return in May 2014. See also chapter 2 of our DibbsBarker (Attachment) submission of 18 August 2014 to the Inquiry’s interim report.

Two fundamental tenets of a successful turnaround are:

(a) **the firm must own its issues and take positive action to address them**. The firm must realistically assess its current position and **have a plan** based on realistic forecasts to return to profitability, which it agrees with its creditors and implements in a timely fashion.

If a firm does not take positive action to turn itself around, there is almost certainly, no prospect of a turnaround being achieved. Accordingly, any reform must address this issue to be effective.

(b) **a stable platform from which to deliver a turnaround**. A stable platform is achieved by stakeholders adopting a reasonable and **supportive attitude** towards the firm experiencing financial difficulties, to which they have been willing stakeholders in the first place, as evidenced by the manner in which they elect to stand still and negotiate the terms of any restructuring with the firm.

The broader the stakeholder support, the more stable the platform. Crisis management and juggling competing stakeholder demands, is inefficient and time consuming for a firm, it increases the costs of the turnaround efforts (diverting funds and resources from structuring and deleveraging, to fire fighting) and it increases the risk of the turnaround failing (when parties take individual stances and fight individual battles, it is very difficult to structure an overall solution and, meanwhile, the firm’s financial position continues in decline).

Key stakeholder groups include financial creditors including those with security, government creditors including the ATO and unsecured creditors including lessors, trade creditors and employees. Other key stakeholders include regulators, shareholders and in large complex restructurings, can include others such as the press.

In a successful restructuring, it is not uncommon for supportive financial creditors to provide working capital solutions to enable the continuing payment of unsecured creditors, which in turn gains the support of those parties. Treasury might consult

7 Published by LexisNexis in the Australian Banking & Finance Law Bulletin, 2015 Vol 31 No 1 at page 9.

with government creditors on their approaches to supporting firms in their turnaround endeavours and whether existing protocols adequately enable them to do so.

A stable platform is of course about a supportive attitude, not just an imposed stand still. Laws which promote a supportive attitude will encourage and facilitate a turnaround culture. Laws which mandate a stand still will not necessarily encourage and facilitate a turnaround culture, although will do, if applied for that purpose.

1.4 Viability

Viability is not without complexity in the context of a financially troubled firm. In my view, viability depends on a key question: is the firm able to attract sufficient capital to continue as a going concern both in the short term and the medium to longer term?

This in turn depends on whether:

(a) there is a core business that generates positive cash flow or is able to generate positive cash flow at some future point in time; and

(b) the firm's stakeholders[8], existing or new, are willing to support the firm on terms that enable the business to generate that cash either now or in the future.

That is, a firm might be able to generate sufficient cash in the future and be viable in the meantime, because of the support of certain stakeholders on certain terms. In that regard, a financially troubled firm is not dissimilar to a start-up.

As such, the question about viability depends very much on stakeholder support and the terms required to obtain that support. If a stakeholder is not willing to support a firm on certain terms, but the firm is able to garner such support on terms acceptable to other persons, then the firm is viable, so long as the firm is also able to agree the terms on which the existing stakeholder remains or exits.

It is when understood in this way, that the significance of the role of stakeholder coordination, communication and the sharing of accurate information, becomes clear. A firm can fall into external administration if just one stakeholder takes an individualistic stance that, from the perspective of the other stakeholders, is unreasonable. Hence the objective of the London approach: "The ultimate objective is to avoid corporate collapse as a result of inter-creditor disputes or ill-informed decisions, when collective support by lenders during the initial period of uncertainty is generally thought likely to yield a higher rate of recovery than would be achieved by receivership, administration or related insolvency in other jurisdictions."[9]

It also highlights the fact that any firm with the ability to generate cash in the future can be viable, even a firm which is on the brink of collapse, if that firm is also able to garner requisite stakeholder support.[10] Key to obtaining that support, is a plan that makes commercial sense. Hence, the two fundamental tenets of a successful turnaround.

2. SAFE HARBOUR

Recommendation 36 contemplates safe harbour provisions that permit restructuring efforts for firms in financial difficulty without invoking external administration processes. These protections would only apply where directors seek expert assistance.

The suggestion that a director must seek expert assistance to benefit from a safe harbour, is a response to the concern that directors often lack the requisite expertise to respond to financial difficulties (as is to be expected, unless they themselves have experienced financial difficulties before) and directors are to be actively encouraged to engage experts to assist them in such circumstances.

8 Key stakeholders include directors, management, employees, shareholders and creditors.

9 "Restructuring Law & Practice" by Chris Howard and Bob Hedger, Second Edition published by LexisNexis at page 6

10 In my paper "Encouraging and facilitating corporate turnarounds: effective debt restructuring" (see footnote 7) I comment that early intervention is key to a successful turnaround. I do not suggest that a turnaround is not possible if intervention is very late, rather turnaround at a very late point in time is more difficult to implement and therefore, a less effective way of pursuing turnaround. Late intervention means that stakeholder support can be more difficult to obtain, more complex to negotiate and more expensive, all threatening the viability of the turnaround.

I support the implementation of safe harbour provisions that permit restructuring efforts for firms in financial difficulty without invoking external administration processes[11]. My understanding is that the key concerns in the context of financial difficulties are section 588G of the *Corporations Act* (insolvent trading), coupled with regulator and other potential suits.

Historically, it has been proposed that a business judgment rule be introduced by way of defence to section 588G of the *Corporations Act*[12]. Although the business judgement rule has been the subject of some criticism[13], past proposals do contain a number of helpful concepts which I revisit below. Additionally, the AICD has proposed a broad safe harbour giving directors protection where they act honestly and reasonably[14].

In relation to section 588G, and focusing on the objective of providing additional flexibility for businesses in financial difficulty, and the Senate Economic References Committee recommendation 61 of 26 June 2014 that law reform be considered to encourage and facilitate corporate turnarounds:

(a) What we expect of directors ought to be clear from the text of the safe harbour provisions. Specifically, in a turnaround context, we expect directors to come up with a plan.

The plan needs to identify the specific steps that the firm will take to turn itself around over a defined period. The plan is devised from a review of existing and forecast information about the firm: namely, a review to determine the current financial position, the current issues, what changes will be made, what consents are required to effect those changes, and if implemented, what impact will those changes have on the financial forecast over what period? A turnaround plan needs to address both the operational and financial changes that need to be made, to deliver sustainable improvement over the medium to longer term. While immediate changes might be a part of the plan to deliver short term improvement (and in the context of a safe harbour defence, a return to solvency), experience shows that such short term improvement is unsustainable unless complemented by additional changes to deliver longer term improvement.

(b) Preparation and implementation of a turnaround plan involves a specific area of expertise. As such, we expect directors to engage an expert to assist them.

However, in my view, a safe harbour which seeks to prescribe by definition, and therefore confine, the person equipped to give such expert advice to the directors is likely to be unhelpful. In my experience, companies may draw on internal resources including existing directors or management with turnaround experience, or companies may engage new or interim directors or management to assist with the turnaround strategy and implementation. Alternatively or as well, a firm might engage turnaround advisors, investment banking professionals, persons connected with alternative sources of working capital, accountants, lawyers to name a few. The right person/s will depend on the particular turnaround needs of the firm and the size and complexity of the firm.

As such, in my view, the emphasis is better placed on the output that is sought from the expert adviser(s).

(c) Specifically, the advice must have solvency focused outcomes for the purposes any defence to section 588G. However, to be an effective turnaround plan, the advice needs to have outcomes focused on sustainability, which arguably falls outside the purview of the defence.

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11 As submitted in our DibbsBarker (Attachment) submission to the Inquiry's interim report, section 6 page 30.

12 The paper titled "Insolvent trading: A safe harbour for reorganisation attempts outside of external administration" (19 January 2010) released by Minister Chris Bowen MP.

13 See "The Honest and Reasonable Director Defence: A proposal for reform" at page 6, para 1.2 of the detailed proposal, link at: http://www.companydirectors.com.au/Director-Resource-Centre/Policy-on-director-issues/Policy-Papers/2014/The-Honest-and-Reasonable-Director-Defence

14 http://www.companydirectors.com.au/Director-Resource-Centre/Policy-on-director-issues/Policy-Papers/2014/The-Honest-and-Reasonable-Director-Defence

The contravention under section 588G is concerned only with insolvency. A firm may return to solvency, not because its core is improved but because, for example, the terms of the debt have been softened with the agreement of financial creditors, or employees have been made redundant. While both may be necessary short term stabilisation measures, neither (of itself) is likely to deliver a viable turnaround. To be viable, a turnaround will require additional improvements over a period of time to build a sustainable operation and a fully funded capital structure on normalised terms.

Nonetheless, a solvency focused defence which requires expert assistance will still be helpful in encouraging and facilitating corporate turnarounds, as follows:

(i) currently, directors are advised that if they have solvency concerns they must appoint a voluntary administrator to protect themselves from personal liability;

(ii) with a safe harbour defence, directors will be advised that they must appoint a voluntary administrator to protect themselves from personal liability or alternatively, appoint a person who can give advice about the steps to take to return the firm to solvency. That in itself is significant – once a turnaround expert is engaged, then those who are good at what they do, will assist the firm not just with their short term solvency requirements, but with their medium to longer term operational and financial sustainability.

The safe harbour ought to remove fear from the equation and get directors to focus on the steps that need to be taken to turn the firm around.

2.2 A possible defence to section 588G of the *Corporations Act*

A possible defence to insolvent trading is suggested below for discussion purposes. The defence is craft around the above principles and, acknowledging the Inquiry's comment that the defence is to apply where directors seek expert assistance, draws on existing legislation where a director relies on a competent and reliable person.

Proposed amendment to section 588H:

(7) (**Defence of expectation of future solvency – competent and reliable person**) It is a defence if it is proved that, at the time when the debt was incurred, the person:

(a) had reasonable grounds to believe and did believe:

(i) that a competent and reliable person or persons (the **other person**) was responsible for providing to the first-mentioned person advice supported by information, about the steps to be taken which, if taken, were reasonably likely to result in the company becoming solvent by a future point in time as evidenced by the information; and

(ii) that other person was fulfilling that responsibility; and

(b) expected, on the basis of the advice and information provided to the first-mentioned person by the other person, that the company was reasonably likely to become solvent by that future point in time; and

(c) took all reasonable steps to implement or facilitate the implementation of the advice provided to the first-mentioned person by the other person.

For the purposes of subsection (a)(i), information must include but is not limited to historical and current financial information which is accurate and financial forecasts which are objectively realistic.

(8) (**Defence – competent and reliable person**) It is a defence if it is proved that, at that the time when the debt was incurred, the person is the other person mentioned in subsection (7), the person was fulfilling the responsibility mentioned in subsection (7)(i), the person expected, on the basis of that person's advice and information, that the company was

reasonably likely to become solvent by the future point in time, and the person took all reasonable steps to implement or facilitate the implementation of the advice.

2.3 Explanatory comments

Explanatory comments on the draft defence to section 588G of the *Corporations Act* are as follows:

(a) The other person is engaged to provide advice about the steps to be taken by the company, to become solvent by a future point in time.

(b) The other person might be a director or construed to be a shadow director (and in that regard, would benefit from the defence in sub-section (8)). Alternatively, the other person might be management, an employee, a consultant, an external adviser or a team of external advisers (or any combination of them) engaged by the company.

(c) That advice must be supported by information, which evidences the return to solvency.

Information must include accurate historical and current financial information. An external adviser will not wish itself to sign off on the accuracy of such information, rather the adviser will require that the company do this, although a competent and reliable person should identify anomalies, inconsistencies and any issues in the financial information which the company provides, and require more thorough information if not satisfied of its accuracy. If the information proves to be inaccurate, the director will be unable to avail itself of the defence. Minor inaccuracies however, ought not to be an impediment to frustrate a defence. Query whether some flexibility ought to be framed around the term “accurate”, for example “accurate in all material respects”. Alternatively, the text “which presents a true and fair picture of the company’s financial circumstances at the time” could be adopted.[15]

Information must include objectively realistic financial forecasts. Again, an external adviser will not wish itself to confirm that such forecasts are realistic, rather the adviser will require that the company do this, although a competent and reliable adviser will assist the company to prepare its forecasts, including to sensitise any blue sky, and will require more thorough analysis, for example of forecast revenues, if not satisfied that they are realistic. “Realistic” can be subjective and indeed in a turnaround context, it is common for people to genuinely believe that the issues are short term, that the market will turn, and that accordingly, their revenue forecasts are realistic. One of the skills of a good turnaround executive or practitioner is to remove the subjective element of a forecast and sensor check it to create a more realistic, that is an objectively realistic, forecast. If the forecasts prove to be objectively unrealistic, the director will be unable to avail itself of the defence.[16]

A financial forecast may make certain assumptions, including assumptions which require the agreement of a third party. If it is objectively reasonable to assume that the agreement is reasonably likely to be forthcoming, then a financial forecast will be objectively realistic.[17]

15 Feedback on the draft submission suggests that there may be a preference, particularly from those who will be engaged as the competent and reliable person, for greater flexibility around the quality of the information. In practice, early information is often inaccurate and it is only with time, that a turnaround practitioner is able to become confident with the quality of information they are working with. To that end, flexibility around the term “accurate” warrants further consultation.

16 Feedback on the draft submission notes as a concern, that forecasts will be low balled so that the competent and reliable person avoids risk of suit. I acknowledge that in attempting to deal with the existing issue, where forecasts are unrealistically high, this is a potential issue. The issue in not legislating on the quality of the forecasts is that the legislation is open to abuse where unrealistic forecasts support a return to solvency. The matter warrants further consultation.

17 What is reasonable will depend on the particular circumstances of the case. The assumption may be reasonable, for example in the initial period, if there are no factors to suggest that the third party would not negotiate towards an agreed position in good faith.

(d) It is expected that the director will implement the advice, or take such steps as the director is able to, to facilitate the implementation of the advice. It is appreciated that a director is not obligated to take an external adviser's advice and may wish only to adopt part of such advice. So long as the director is able to show that the director took such steps as he/she was able to, towards implementing such advice as he/she expected would lead to solvency, as evidenced by the information, then the defence should be available. Alternatively, text along the lines "diligently pursued" might be preferred.

(e) The advice is likely to be moving daily. For example, early advice may be about daily cash management and the availability of working capital, the steps that need to be taken to secure sufficient cash to pay debts as and when due, supported by rolling cash flows current and forecast. The information relied upon to support such advice will necessarily be limited, although it remains important that it be accurate[18].

Subsequent advice, once the financial information has been gathered and reviewed and financial forecasts prepared, will be about the turnaround plan, which sets out the steps that need to be taken, for presentation to the various stakeholders whose agreement is required.

There will be continuing advice during the process of negotiating the turnaround plan, with each variation that has a financial impact being supported by a corresponding variation to the financial forecast.

For so long as advice is being given about steps to take, supported by information including current financial information and financial forecasts, which will reasonably likely deliver solvency at a future point in time, and the person is implementing those steps (or facilitating their implementation) as and when appropriate, it is intended that the defence be available.

If the advice is that agreement on a key factor is unlikely to be forthcoming and no alternative step is available, so that the future solvency of the company is unclear, then the defence ceases to be available[19]. This highlights the need for contingency planning in the context of a turnaround plan, to ensure that there are a number of alternatives being canvassed, any of which would likely result in the solvency of the company at a future point in time.

(f) There may be nervousness about the term 'a future point in time'.[20] Depending of course on the particular circumstances of a company, the time when a company returns to solvency, may be:

(i) within days or weeks, with careful cash management and working capital support;

(ii) at the point in time when all creditors with debts due and unpaid have agreed to defer payment of their debts[21];

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18 Or materially accurate, noting earlier comments relating to information.

19 To avoid doubt, the defence ceases to be available, not while directors are diligently pursuing and expecting solvency, but at the point when it is no longer reasonable to expect that those pursuits will result in solvency. That is, interim measures can be taken and the defence will apply, even if subsequently, new information or a material change means that solvency can no longer be expected. The one qualification, is where information is subsequently found to be inaccurate and as a result, solvency can no longer and could not previously, be reasonably expected. As mentioned above, it may be viewed that the text of any defence needs to be softened to accommodate genuine errors. Alternatively, it may be viewed that directors need to recognise the continuing and critical importance of accurate information and that if they cannot meet that fundamental obligation, then they should be not be entitled to the defence (although they would still have the benefit of other defences such as the discretionary defences under s1317S(2) and 1318(1) and perhaps section 588H(3) of the *Corporations Act*.)

20 There will naturally be a real concern that some directors will look to abuse any safe harbour defence by obtaining self-fulfilling advice, which they rely on to delay matters. A defence which was able to apply pressure to ensure that real progress is made with the necessary degree of diligence and urgency given the precarious financial position of the company would be desirable. That said, in practice, the defence is unlikely to be made out before a Court in such circumstances. For example, in *Hall v Poolman* [2007] NSWSC 1330, we saw the Court allow the directors an objectively reasonable period of time beyond which their conduct was no longer considered reasonable and so they were no longer exonerated from liability.

(iii) at the point in time when all parties connected with the company whose position impacts the solvency of the company, and whose agreement to the turnaround plan is required for it to be implemented, provide their agreement. This tends to include financial creditors and new money providers. Aspects of a turnaround plan such as cost cutting and the divestment of assets might also require the agreement of third parties, although query whether solvency can be achieved irrespective of such agreement, bearing in mind solvency under the *Corporations Act* is a cash flow test not a balance sheet test.

Such parties become less likely to provide their agreement if negotiations are protracted or delayed - if their agreement is required and it becomes less likely (and there is no contingency plan), then the adviser is unable to advise that solvency is reasonably likely and the defence is no longer available. This means that the company should be motivated to return to solvency as soon as possible.

Alternatively, language "within a reasonable period of time" might be preferred. It would also be possible to include a specific timeframe, for example "within three months" although I am personally not in favour of that approach, which lacks flexibility. In my view, the efforts are either reasonable and ought to attract the defence or they are not reasonable, and the defence is not available.

The proposed defence, for discussion purposes, does impose a relatively high standard on a director before a director is able to avail itself of the defence. This is in part to respond to some stakeholder views that directors who permit their companies to trade while insolvent should not escape personal liability and should be held to account. It is in part to prescribe very clearly, the behaviours that are expected of directors of financially troubled companies. Fundamentally, it is intended to encourage directors to focus on the key elements of solvency and accurate information, with the obvious implication that if directors take steps early and ensure that these elements remain high on the board agenda, they avoid the risk of section 588G being triggered altogether.

The fact that technically, a director is unable to avail itself of the defence does not mean that the director would not, nonetheless, have available the discretionary defences under sections 1317S(2) and 1318(1) of the *Corporations Act*. Those sections may benefit a director who acted honestly and bona fide in the interests of the company, including its unsecured creditors. This may be relevant, for example, in the initial stages when the competent and reliable person is first engaged or where information previously relied upon, proves to be inaccurate. Additionally, where information previously relied upon indicated solvency at a point in time and is subsequently found to be inaccurate, depending on all of the circumstances, the defence in section 588H(3) of the *Corporations Act* may also be available.

2.4 Alternative safe harbour

The above, intentionally, focuses on a possible defence aimed at changing behaviours. That is, the defence is only triggered if a director is focused on solvency outcomes supported by accurate information.

This is narrower, for example, than the position in the UK[22] which provides that a director is not personally liable for debts incurred if they reasonably concluded that there was a reasonable prospect that the company would avoid going into insolvent liquidation, or assuming that the director knew that there was no reasonable prospect that the company would avoid going into insolvent liquidation, the director took every step with a view to minimising the potential loss to the company's creditors as that person ought to have taken.

A defence which permits a director to pursue a turnaround or where that is not possible, take steps to deliver greater value for creditors in insolvency could follow the UK example,

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21 As the test of solvency has a degree of look-forward, depending on the circumstances, sub-paragraphs (i) and (ii) may need to be accompanied by a reasonable expectation that a turnaround is possible, that is while time may be required to devise a plan, there is nothing to suggest that such a plan, given time, could not be agreed.

22 Section 214 of the *Insolvency Act, 1986* (UK), wrongful trading

although in the Australian context (based on the Inquiry's recommendation 36) varied to include appropriate expert guidance.

The benefit of such a defence is that where it is not possible to avoid a liquidation outcome, a director may take steps to effect, for example, a sale of certain of the company's assets or business ahead of liquidation for greater value than was likely to have been achieved in liquidation. The creditors would benefit from those steps and the director would be free to take them, without threat of personal liability.

The concern with such a defence, is that in the current landscape in Australia, it is possible that only the second objective would be applied (namely, to take steps to improve creditor value) and, as we have observed is the case with voluntary administration, the primary objective of encouraging a return to solvency would be overlooked. That is, there is a real risk that in practice, such a defence would not result in encouraging and facilitating corporate turnarounds although it would create additional flexibility to businesses in financial difficulty to the benefit of creditors where liquidation is inevitable.

There is also a question as to whether such a defence is expressly necessary, in circumstances where sections 137S(2) and 1318(1) of the *Corporations Act* confer a wide discretion on the Courts to excuse the honest and bona fide director who acts in the best interests of the company's creditors from liability (although the issues in relying on a defence which is discretionary are also acknowledged).

Putting aside those matters, such a broad defence might provide as follows:

Alternative proposed amendment to section 588H:

(7) (**Defence of expectation of avoiding liquidation or minimising loss to creditors – competent and reliable person**) It is a defence if it is proved that, at the time when the debt was incurred, the person:

(a) had reasonable grounds to believe and did believe:

(i) that a competent and reliable person or persons (the **other person**) was responsible for providing to the first-mentioned person advice supported by information:

(A) about the steps to be taken which, if taken, were reasonably likely to result in the company avoiding insolvent liquidation as evidenced by the information; or

(B) that there were no steps that could be taken which, if taken, were reasonably likely to result in the company avoiding insolvent liquidation as evidenced by the information and about the steps to be taken which, if taken, were reasonably likely to minimise the potential loss to the company's creditors as evidenced by the information; and

(ii) that other person was fulfilling that responsibility; and

(b) expected, on the basis of the advice and information provided to the first-mentioned person by the other person, that:

(i) if subsection (a)(i)(A) applies, it was reasonably likely that the company would avoid insolvent liquidation; or

(ii) if subsection (a)(i)(B) applies, it was not reasonably likely that the company would avoid insolvent liquidation but it was reasonably likely that the potential loss to the company's creditors would be minimised; and

(c) took all reasonable steps to implement or facilitate the implementation of the advice provided to the first-mentioned person by the other person.

For the purposes of subsection (a)(i), information must include but is not limited to historical and current financial information which is accurate and financial forecasts which are objectively realistic.

(8) (**Defence – competent and reliable person**) It is a defence if it is proved that, at that the time when the debt was incurred, the person is the other person mentioned in subsection (7), the person was fulfilling the responsibility mentioned in subsection (7)(i), the person expected, on the basis of that person's advice and information, that:

(a) if subsection (7)(a)(i)(A) applies, it was reasonably likely that the company would avoid insolvent liquidation; or

(b) if subsection (7)(a)(i)(B) applies, it was not reasonably likely that the company would avoid insolvent liquidation but it was reasonably likely that the potential loss to the company's creditors would be minimised; and

the person took all reasonable steps to implement or facilitate the implementation of the advice.

Alternatively, the text relating to "avoiding liquidation" could be replaced by the text in paragraph 2.2 relating to "becoming solvent".

2.5 Voidable preferences

Treasury should consider whether, if a safe harbour is enacted, section 588FA of the *Corporations Act* ought to be inoperative for such time. Successful turnarounds involve honest discussions with stakeholders and paying creditors in a manner which ensures the most likely success of the turnaround plan, without the disruption of insistence, for example, on cash on delivery or trust payments, to protect the creditor in the event the turnaround fails. It is such disruption that de-stabilises the platform. I do not address the text of such a defence in this paper although am happy to discuss.

3. IPSO FACTO MORATORIUM

It is suggested that ipso facto clauses be suspended from operating during the restructuring efforts. The objective of this proposed reform is to provide a more stable platform.

I note that, according to recommendation 36, the restructuring efforts that would benefit from a safe harbour, are restructuring efforts that take place without invoking external administration processes. That is, the safe harbour presumes that the restructuring efforts occur within an informal process.

3.1 Outside of external administration

In the context of an informal process, a stable platform is achieved by creditors agreeing to stand still, that is, not take adverse action against the firm to terminate contracts, demand payment of debt, commence proceedings, repossess property, benefit from security, exercise any right of set-off or enforce any other right in insolvency. This stand still is one of the key elements of the London approach and the INSOL principles. It could be achieved by a similar protocol introduced in Australia.

Where there is an effective protocol (ie. in my experience in the UK), creditors are motivated to agree to stand still together with other creditors (whether as members of a syndicate or not), as reputationally, it is bad to be seen to be the creditor who refused to stand still and resulted in the firm entering into insolvency proceedings. Where there is an effective protocol (ie. in my experience in the UK), creditors tend to view a turnaround as being more likely to be economically and socially more beneficial than insolvency, so that insolvency becomes the stick to encourage creditors to agree to stand still. For example, if a creditor does not agree to stand still to support an informal turnaround (with the potential for a better outcome than in insolvency), the firm will fall into insolvency where ipso facto clauses are enforceable and value is destroyed (with a certain worse outcome).

3.2 Within voluntary administration

As I understand the position, notwithstanding the above, there is demand to extend the moratorium that is effective during a voluntary administration. That demand arises from a desire to improve the existing voluntary administration regime, particularly in the context of a sale of business.

That is, to better preserve the value of a business during voluntary administration, ipso facto clauses should be unenforceable.

(a) Potential benefits include:

(i) to provide a more stable platform from which to negotiate a sale of business; and

(ii) to increase the return to creditors as a result of the sale of business; or

(iii) to provide a more stable platform from which to negotiate a turnaround, subject to voluntary administration being used in the future more often for maximising the chances of the company continuing in existence as a going concern.[23]

(b) The question that arises, relates to the proposed breadth of the ipso facto moratorium. That is, to what extent should ipso facto clauses be unenforceable and in particular, which creditors in what circumstances would be impacted and how are those parties to be adequately protected during the moratorium? Additionally, what happens during the moratorium, recognising that creditor support is not obtained by imposing a moratorium on creditors?

The broader the range of creditors and circumstances, the more stable the platform, however the greater the adequate protection measures need to be. Such a broad moratorium is only of benefit to the company however, if during the moratorium, the company negotiates a turnaround plan with its creditors and the requisite majority of creditors are supportive of that plan. Otherwise, at the end of the moratorium, the company will face a liquidation or quasi-liquidation outcome. That is, the broad moratorium buys the company time, but does not secure a favourable outcome.[24] Again, the fundamental tenets of a successful turnaround are having a plan and the support of creditors.

The narrower the range of creditors and circumstances, the less stable the platform is for the company. For the company to benefit in such circumstances, it will need to negotiate the terms of any stand still with those creditors not impacted by the moratorium as well as obtain the support of the requisite majority of creditors to a turnaround plan.

Additionally, the narrower the range of creditors and circumstances, the stronger the position is of the creditors who are not impacted by the moratorium. That is, where some creditors are able to act and others are not, that law reform will create or enhance the divergence between classes of creditors, preferring some over others. It is important to note that while this may not be a policy reason for introducing such a law, to strengthen the position of some creditors over others, it will inevitably be one of the outcomes of a moratorium which does not extend equally to all creditors.

(c) It should be expected that those stakeholders who benefit from the enhanced moratorium (this might be the company or any group of creditors who benefit from but are not restricted by the moratorium), will be motivated to use voluntary administration more often.

23 See my comment at paragraph 1.2, culture. There is some encouraging recent use, albeit limited, of voluntary administration as a tool to facilitate a turnaround, for example the financial restructuring effected in *In the matter of Mirabela Nickel Ltd (subject to deed of company arrangement)* [2014] NSWSC 836.

24 This is to be compared with a consensual standstill which is agreed informally with creditors, whereby agreeing to stand still they are effectively also agreeing to be supportive of the restructuring efforts. That is not to say that a standstill which is imposed cannot be of benefit, for example, where the requisite majority creditors agree but certain creditors do not, and time is required to finalise the plan.

Based on existing use of the voluntary administration regime (to deliver a quasi-liquidation outcome) and without more, the reform is unlikely to encourage corporate turnarounds although it may enhance the return to creditors from a sale of business.

That said, with a developing focus on turnaround, it is possible that in the future, voluntary administration will be invoked more often to achieve the objective of maximising the chance of the company continuing in existence on a going concern basis. In that context, the reform may provide an enhanced framework from which to deliver a turnaround.

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

Yours sincerely

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