Law Council of Australia – Business Law Section

Submission on aspects of the Productivity Commission's Issues Paper - Business Set-up, Transfer and Closure December 2014 (Issues Paper)

1 Overview

The Business Law Section of the Law Council (**BLS**) welcomes the Productivity Commission's initiative in considering how best to remove barriers to business set-up and exit in order to drive efficiency and growth in the Australian economy – and appreciates this opportunity to make a submission.

There are two questions on which the BLS wishes to make a submission:

- Question 23 – in relation to foreign investment; and
- Question 29 – regarding a safe harbour in relation to financially distressed companies.

Each of these questions raises issues on which analysis which the BLS has done in the past is relevant. So, as well as making short submissions below on aspects of each of these questions, we have attached the following more detailed papers prepared in the past in case these are of assistance:

- BLS foreign investment working group submission made to Foreign Investment Review Board (**FIRB**) in 2014;
- BLS foreign investment working group submission in relation to the Agricultural Competitiveness Green Paper 2014; and
- Joint submission of the BLS (Insolvency and Restructuring Committee), the Insolvency Practitioners Association of Australia and the Turnaround Management Association Australia – made to Treasury in 2010 regarding a safe harbour for directors of financially distressed companies.

2 Foreign investment – question 23

Question 23 on page 13 of the Productivity Commission's Issues Paper - Business Set-up, Transfer and Closure December 2014 (Issues Paper) asks:

> *To what extent has the foreign investment policy acted as a deterrent to business set-up? Are the existing review processes timely, efficient and transparent?*

Page 18 of the Issues Paper notes:

> *Also, regulation surrounding foreign investment may also impact on the efficient sale and transfer of government owned assets through the different treatment of foreign and domestic investors.*

The BLS formed a working party to consider the regulation of foreign investment in Australia in late 2013. Members of the working party comprise lawyers who have many years' experience dealing with the regulatory regime.

There have been concerns raised in various quarters over the last few years about the transparency and clarity of Australia's foreign investment rules.

The BLS believes that there is much that could be done to improve the perceived transparency of the foreign investment rules, simplifying the language of the legislation and policy, removing inconsistencies and red tape and reducing processes which are currently conducted outside the legislation itself. The BLS considers there are a number of areas which could be improved in the short or medium term, with a broader root and branch modernisation of the foreign investment regulatory regime to be undertaken over the longer term.

For example, the BLS believes that:

- investments by sovereign wealth funds (SWF) and state owned enterprises (SOE) could be regulated more effectively to meet policy objectives. Such investors would become increasingly significant in providing competitive tension for the proposed sale and transfer of government owned assets;

- aspects of the submission and review process can be streamlined to reduce red tape;
- there are too many thresholds for review, which levels are not proportionate to the level of sensitivity associated with the investments. In particular, the broad and simplistic approach taken to what constitutes a "foreign government investor" combined with the A$0 threshold for "direct investments" results in uncertainty and delay for routine investments by entities which have SWFs or SOEs as upstream investors; and
- in an environment where Australia is increasingly competing with other countries for foreign investment, there is a risk that Australia's foreign investment rules are sending inconsistent messages to potential investors. To illustrate, at the same time that a free trade agreement with China was announced with increased review thresholds, the thresholds for scrutiny of investment in agricultural land were lowered. This risks placing Australia at a competitive disadvantage when compared to other countries. It may also lead to confusion or concern about whether potential investments will be scrutinised, delayed or rejected.

These and other issues were canvassed in detail in a proposal prepared by the BLS for a review of Australia's Foreign Investment Regime (**FIRB Proposal**) which was provided to the FIRB and the Parliamentary Secretary to the Treasurer the Honourable Steven Ciobo in 2014. A copy of the FIRB Proposal is attached.

The BLS has also prepared a submission in response to the foreign investment issues raised in the Agricultural Competitiveness Green Paper issued by the Department of the Prime Minister and Cabinet in October 2014. A copy of that submission dated 12 December 2014 is attached.

The BLS requests that the Productivity Commission takes the views of the BLS as expressed in the FIRB Proposal and the agricultural submission into account in the its inquiry into the barriers to business entries and exits in the Australian economy.

3 Safe harbour to facilitate the restructuring rather than liquidation of companies with viable businesses – question 29

Question 29 of the Issues Paper asks:

> *Is the underlying incentive structure within the corporate and personal insolvency arrangements able to effectively and efficiently facilitate business closure without discouraging new business start-ups? Where should the balance lie between creditors and debtors in the arrangements? Are there feasible alternatives to the existing corporate insolvency arrangements? Is the use of safe harbour provisions for firms seeking to restructure a feasible alternative to existing corporate insolvency arrangements?*

The Issues Paper notes (at page 16) that:

> *The Financial System Inquiry noted proposals to use 'safe harbour' provisions for directors to seek expert assistance and permit restructuring efforts for firms in financial difficulties without invoking external administration processes. Such protections could also be extended to the expert advisors to avoid them being considered de facto directors. However, the Inquiry noted that more work was required to assess the potential value of these proposals (Australian Government The Treasury 2014).*

The particular aspect on which the BLS wishes to comment is the need for a safe harbour for directors of distressed companies, in order to facilitate the restructuring and continued existence of companies which have viable businesses but have typically run into trouble through taking on too much debt or having liquidity issues, which threatens their survival when circumstances change (e.g. when the global financial crisis struck).

The Issues Paper notes (at page 15) that where an insolvency regime is pitched impacts on the broader business environment, giving the following example:

> *[A] regime that is more "debtor-orientated" may impact on the availability and cost of finance while the severity and length of any sanctions against an insolvent proprietor or directors facing solvency issues will likely influence the level of entrepreneurial activity (Bickerdyke, Lattimore and Madge 2000).*

That paragraph may suggest that the interests of creditors and debtor company directors will inevitably be at odds in an insolvency context. However, as major restructurings in Australia like Alinta, Centro and Nine have shown, in large scale corporate distress situations, the interests of creditors and debtor companies' directors are aligned, in saving the company or its business through a restructuring which compromises the company's debt to a level at which its business is viable. This results in the continued existence of the company or its business in some corporate form, continuation of jobs that would otherwise have been lost, and lesser losses for creditors than they would have suffered in a liquidation of the distressed company.

However, the successful major restructurings in Australia have been fraught with risk, greenmail attempts and court challenges, and they are not for faint-hearted directors. They were difficult and time-consuming to implement. Other companies which may have been saved have not been able to overcome those risks and difficulties and have instead gone into liquidation.

In that context, a tension arises between the creditors' wish for the company to trade on while the restructuring proposal is attempted, and the debtor company's directors' fear that, if they attempt the restructuring but it fails, the directors will be held personally liable for the debts the company incurred during the period in which the restructuring was attempted. Australia's insolvency law is considered the toughest on directors of all the major Western economies. If the company trades while it is insolvent, the directors are personally liable for any debts the company incurred while directors had reasonable grounds to suspect that it was insolvent (section 588G of the Corporations Act).

To overcome that in relation to a corporate restructuring of a distressed company, the directors need reasonable grounds to believe that the company will ultimately be able to pay its debts as and when they fall due – i.e. that the restructuring will be successful (see section 588H of the Corporations Act). At the very time that the directors need to have that belief, the company is likely to be negotiating with hedge and distressed debt funds (which often buy up the debt of a distressed company). Those funds may be extremely aggressive in negotiations for the compromise of their debt. Although the funds actually want the company to survive so that they avoid the greater loss of liquidation, they may well threaten to walk away from the negotiations as part of a negotiation strategy. The directors face the prospect that, if those negotiations do fail and they have to appoint an administrator, the directors will have their actions in allowing the company to continue trading in that window judged in hindsight – as to whether they had reasonable grounds to believe that the negotiations would result in a successful restructuring. And if that judgement (with hindsight) is that they should have realised the negotiations would fail, those directors will be personally liable for the company's debts incurred during that negotiation window.

There is perhaps a stereotypical image of a company and its directors desperate to ward off insolvency and to continue trading at the risk of the creditors where the company is close to insolvency. However, in the major restructuring context, this situation is turned around. It is not uncommon to see worried directors wanting to appoint an administrator because of their fear of personal liability for debts – while the bondholders in the company threaten to sue the directors if they *do* appoint an administrator, because the bondholders prefer a solvent reconstruction to be attempted which would deliver them a better outcome than an insolvency process.

When Treasury consulted on the prospect of a safe harbour for directors in 2010, a joint submission was made by the Law Council (through the Business Law Section of the Law Council, co-ordinated by the Insolvency and Restructuring Committee), the Insolvency Practitioners Association of Australia and the Turnaround Management Association Australia (**Joint Submission**).

The Law Council adopts the reasoning in that paper for the benefit of a "safe harbour" for directors of distressed companies.

Without such a "safe harbour":

- businesses fail which were viable if their debt was compromised, and could have been saved;
- jobs are therefore lost which could have been saved;
- trade creditors (which often include small businesses) miss out on the full repayment of their debts which is typical in major restructurings, and instead (as unsecured creditors in a liquidation) frequently recover only a fraction of what they are owed;
- lenders including banks and bondholders miss out on opportunities to mitigate and, in some cases, eliminate, the losses which they would otherwise suffer as against the face value of their debt;
- loss of enterprise value of businesses is caused by the insolvency itself;
- the system of voluntary administration, though designed to facilitate corporate workouts, itself accelerates the loss of enterprise value; and
- unproductive insolvency costs are incurred which could have been avoided.

The 2010 Joint Submission:

- points to actual businesses and companies for which there could conceivably have been a more positive outcome had there been such a safe harbour for directors, including OneTel, Henry Walker Eltin;
- explains the several different ways enterprise value is lost through formal insolvency processes;
- details the tough Australian insolvent trading regime relative to all other major Western economies and the impediment which it imposes to restructuring financially distressed companies; and
- contrasts the Australian regime with the United States of America regime – where General Motors was successfully restructured – and the United Kingdom regime where Whittard of Chelea, Mosaic and USC were each able to be successfully restructured – in circumstances where that would have been a more challenging outcome to achieve in equivalent circumstances under the Australian regime.[1]

Since the 2010 Joint Submission, the position for directors of Australian companies has got worse again. The Western Australian Court of Appeal handed down its decision in the "*Bell Case" - Westpac Banking Corp v Bell Group Ltd (in liq) No 3 (2012) 89 ACSR1; [2012] WASCA 157.* In that case, two of the judgements in the Western Australian Court of Appeal contain passages suggesting that it may be a breach of the duties of directors of a distressed company to undertake restructuring efforts without the agreement of all creditors or legally binding mechanisms to ensure that no category of creditor would be disadvantaged by the restructuring attempt, irrespective of any honest belief the directors may have that the restructuring proposal was in the interests of the company and its creditors (Drummond AJA at [2095] and Lee AJA at [1092-1093]).

In complex restructurings, it is simply not practical or feasible to obtain the agreement of all creditors within an acceptably tight time frame to give comfort to nervous directors who, if that consent is not ultimately forthcoming, risk personal liability for debts incurred in the meantime.

The Joint Submission commented on two potential forms of safe harbour which had been floated by Treasury. In view of the breadth of the Issues Paper and question 29, we do not comment here on the optimal form and scope that a safe harbour might take. The BLS requests that the Productivity Commission support the development of a safe harbour for directors of financially distressed companies. The BLS would be happy to work with the Productivity Commission to develop a proposal or alternatives regarding the optimal form that a safe harbour might take, or to comment on any potential alternatives which the Productivity Commission might consider.

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[1] Further, see Dr RP Austin, 'Introductory Essay', in *Restructuring Companies in Troubled Times: Director and Creditor Perspectives* (Ross Parsons Centre of Commercial, Corporate and Taxation Law, Publication 12, 2012, University of Sydney).