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Business Set-Up, Transfer and Closure in Australia
Productivity Commission
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Dear Commissioners

Draft Report on Business Set-up, Transfer and Closure

The Australian Institute of Company Directors (AICD) welcomes the opportunity to comment on the recommendations made by the Productivity Commission in its draft report on *Business Set-Up, Transfer and Closure* (Draft Report).

The 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 36,000 from across a wide range of industries, commerce, government, the professions, private and not-for-profit sectors.

We confine our comments in this submission to the Productivity Commission's recommendations on aspects of Australia's corporate insolvency regime.

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.

Summary

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

(a) The voluntary administration regime should be available to insolvent companies and companies approaching insolvency, therefore, we do not support the Productivity Commission's proposal that only solvent companies be able to appoint an administrator. We are concerned that the Productivity Commission's Draft Recommendation 15.1 is not workable in practical business terms;

(b) While the AICD remains of the view that the introduction of our proposed Honest and Reasonable Director Defence is preferable, an appropriately formulated safe harbour provision for insolvent trading would be an improvement to the current position at law and may improve the ability of directors to attempt a restructure;

(c) The AICD supports the proposal that ipso facto clauses allowing contracts to be terminated due to an insolvency event be unenforceable on the appointment of an administrator or a receiver or when the company is in the safe harbour. However, some limited exceptions to this restriction could be considered;

(d) The changes proposed by the Productivity Commission to the powers and duties of receivers and managers require further consideration; and

(e) The AICD supports effective efforts to reduce fraudulent phoenix activity. However, we query whether the resources necessary to introduce and supervise the Director Identification Number regime could be better utilised by ASIC to enforce existing laws targeted at phoenix activity.

1. Draft Recommendation 15.1 – The voluntary administration regime be restricted to solvent companies

The AICD does not support the proposal that section 436A of the Corporations Act 2001 (Cth) be amended to remove the option to appoint an administrator when the company is insolvent.[1]

The distinction between solvent and insolvent companies

The AICD considers that the threshold problem with this proposal is that determining whether a company is insolvent, or solvent but approaching insolvency, is a difficult task that must be made by directors in real time, rather than by a court with the benefit of hindsight.[2] This issue was canvassed in the AICD's previous submission to this inquiry dated 17 February 2015. The lack of clarity in this area was also acknowledged by the Productivity Commission in its Draft Report.[3]

The courts have recognised that "there is sometimes no clear dividing line between solvency and insolvency from the perspective of the directors of a trading company which is in difficulties."[4] As events unfold in real time, a director may have imperfect or partial information on which he or she must make this assessment.[5] The information available to directors may, at a particular point in time, indicate that a company is solvent or insolvent, even if, in retrospect, a court with its "inestimable benefit of the wisdom of hindsight"[6], determines this was not the case.

The proposal under Draft Recommendation 15.1 would require an administrator to convert the administration into a liquidation if he or she determines that the company is insolvent. Aside from clear instances of insolvency, an administrator will experience the same difficulties as the directors when making a real-time solvency determination. An administrator may even be in a less advantageous position to make the assessment because he or she does not have the directors' same familiarity with and understanding of the company's circumstances.

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1 See Draft Recommendation 15.1

2 For some practical examples of the complexity that arises in real time considerations of solvency, see the list of examples in paragraph 2.8 of the *Joint submission in relation to insolvent trading safe harbour options paper* dated 2 March 2010 by the Law Council of Australia, Insolvency Practitioners Association of Australia and Turnaround Management Association Australia, which was annexed to the Law Council of Australia's submission to the Productivity Commission dated 18 March 2015 and available at: http://www.pc.gov.au/inquiries/current/business/submissions

3 At page 326

4 *Hall v Poolman* 65 ACSR 123, Palmer J at [266]

5 *Martech International Pty Limited v Energy World Corporation Limited* [2006] FCA 1004, French J at [351]

6 *Lewis v Doran* 50 ACSR 175, Palmer J at [108]

Accordingly, the AICD submits that Draft Recommendation 15.1 is problematic because it requires directors (or an administrator) to make an assessment of solvency in circumstances where that assessment may be difficult to accurately determine. The AICD acknowledges that there may, of course, be instances where a company is obviously insolvent.

The difficulty in determining solvency when a company is in financial distress is significant because, if the proposal in Draft Recommendation 15.1 is enacted, the directors' assessment will determine whether the company enters liquidation or administration.

A voluntary administration can benefit an insolvent company

The AICD's view is that the primary objective of the insolvency regime should be corporate recovery. While the voluntary administration regime appears to be working well, there are some areas where targeted changes may be beneficial to improving the regime and achieving this objective.

The Productivity Commission has pointed to the high rates of subsequent deregistration of companies that have entered into voluntary administration as an indicator that the current insolvency regime does not promote effective restructuring.[7] Similarly, directors have raised concerns that the strict insolvent trading provisions can lead to financially viable companies being placed into voluntary administration and, as a result: cease to be a "going concern"; suffer loss of value and goodwill; and incur the expense of engaging administrators and receivers. Under a less prescriptive legislative regime it may be possible for such companies to restructure themselves and secure their financial standing. However, the AICD does acknowledge that the figures referred to by the Productivity Commission may not account for the survival of the underlying business where it has been restructured and sold by the administrator.

In some circumstances, whether a company is insolvent or solvent, having the voluntary administration regime available as an option may produce a desirable outcome. An insolvent company may have a viable business that can be restructured and/or sold. A voluntary administrator may be able to achieve this outcome in circumstances where directors have not been able to do so (even with the benefit of the proposed safe harbour provision in Draft Recommendation 15.2) and where liquidators could not do so.

For example, an administrator appointed to a chain of stores might determine that some of the stores are unprofitable and that, without these, there is otherwise the potential for a profitable business. The voluntary administration regime provides a temporary moratorium on legal proceedings,[8] winding up proceedings,[9] execution against company property[10] and restrictions on third party property rights.[11] These elements of the regime allow an administrator the time to make an assessment of the viability of the business and to either restructure, or progress and complete a sale. The administrator can cause the company to repudiate the leases of the unprofitable stores and terminate employees. The administrator can then sell the business comprising the profitable stores (including a novation of leases and a transfer of employees). While the company may then go into liquidation, the business (either in part or in whole) has survived. The potential for the success of this process would be enhanced if the proposed reform to restrict reliance on ipso facto insolvency clauses in Draft Recommendation 15.4. was adopted.

[7] At page 340
[8] Section 440D of the Corporations Act 2001 (Cth)
[9] Section 440A of the Corporations Act 2001 (Cth)
[10] Section 440F of the Corporations Act 2001 (Cth)
[11] Section 440B of the Corporations Act 2001 (Cth)

While the directors may be able to achieve a similar restructure (with the benefit of the proposed safe harbour provision in Draft Recommendation 15.2), the company will not have the benefit of the moratorium during this period and the directors personally will not have the benefit of the moratorium on enforcement of personal guarantees given by the directors, their spouses and relatives.[12] The company may also be burdened by the costs of the restructure (for example, a claim by the landlord for damages associated with repudiation of a lease) and may need to enter into liquidation in any event. As such, it is plausible that there would be scenarios where directors would still like to have the voluntary administration regime available to them even with the availability of a safe harbour.

Further, it is far more difficult for a liquidator to achieve the same results as an administrator. When an asset is sold by a liquidator, it is essentially a "fire sale" because potential buyers for that asset know the liquidator is winding up the company, has no use for the asset and is not able to hold assets for sale at a later time.[13] An administrator is not limited in the same way and is able to have the company enter into a Deed of Company Arrangement with its creditors[14] rather than to sell its assets. Also, a liquidator may only carry on the business of the company to the extent necessary for the beneficial disposal or winding up of that business.[15] As the proposed ipso facto clause restrictions in Draft Recommendation 15.4 would not extend to liquidations, the suppliers of a company are far more likely to abandon the company when it is in liquidation than if it is in administration.

Accordingly, it appears inconsistent with the objective of facilitating a continuation of existing valuable business activity that the voluntary administration regime would be unavailable to an insolvent company. Even an insolvent company may have an underlying business that may be restructured, transferred and/or be subject to a Deed of Company Arrangement. By removing a possible means to perform a restructure and transfer of business, this reduces the options available to directors to maximise outcomes for all stakeholders.

2. Draft Recommendation 15.2 - A safe harbour be introduced to allow companies and directors to restructure without liability for insolvent trading

The AICD is pleased that the Productivity Commission has recognised the concerns that directors have about personal liability in an insolvency context. While the AICD's preferred position is for our proposed Honest and Reasonable Director Defence to be included in the Corporations Act,[16] we are of the view that the insertion of a safe harbour mechanism would still be an improvement on the current position at law for directors.

The AICD is willing to consider the concept of a safe harbour but notes that the safe harbour proposed by ARITA and referred to by the Productivity Commission[17] is essentially a modified business judgment rule to be applied in circumstances where a company is seeking to restructure.

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[12] Section 440J of the Corporations Act 2001 (Cth)

[13] Section 478(1) of the Corporations Act 2001 (Cth) requires a liquidator to cause the company's property be applied against its liabilities "as soon as practicable" after the Court orders that it be wound up.

[14] A company in voluntary administration may, on resolution of its creditors, enter into a Deed of Company Arrangement (DOCA) pursuant to section 439C(a) of the Corporations Act 2001 (Cth). The Corporations Act 2001 (Cth) does not mandate the exact form a DOCA is required to take – it is an inherently flexible arrangement – and dissenting creditors are bound to its terms. A DOCA may rescue an otherwise insolvent company and result in a better return to creditors than would be available if the company was liquidated.

[15] Section 477(1)(a) of the Corporations Act 2001 (Cth)

[16] The AICD's basis for that position is set out in the AICD's earlier submission to the Productivity Commission dated 17 February 2015.

[17] Box 15.1 of the Draft Report at page 354

The AICD remains of the view that the introduction of the Honest and Reasonable Director Defence addresses a range of issues in the Corporations Act and overcomes many of the limitations that arise from the insertion of a modified business judgment rule. However, to assist the Productivity Commission, we provide some comments below as to the issues which would need to be considered in the drafting of any such safe harbour.

1. As a threshold question it needs to be determined where the safe harbour provision would sit in the Corporations Act. For example, is the intention that the provision would comprise an amendment to the existing business judgment rule in section 180(2) of the Act or that it be an entirely new provision in Part 5.7B of the Act (where the insolvent trading provisions sit)?

2. The Productivity Commission refers to ARITA's proposed formulation of the safe harbour provision in Box 15.1 of the Draft Report which requires that directors make a 'business judgment' in order to attract protection.

   The existing business judgment rule in section 180(2) of the Act has narrow application because, among other reasons, it applies only to decisions.[18] In other words, a director must positively turn their mind to an issue in order to rely on the defence. Foreseeably, not all debts incurred during a safe harbour period will result from a 'business judgment'. For example, certain tax liabilities or the superannuation guarantee charge liability will accrue as an incidence of continued trading rather than any particular decision to incur those liabilities. Further, courts have confined the definition of business judgment.[19] The definition and interpretation of 'business judgment' will therefore be critical to the success of the safe harbour provision.

3. The safe harbour may also need to extend beyond consequences of insolvent trading (which the AICD's proposed Honest and Reasonable Director Defence does).[20] Section 588M of the Corporations Act (which gives a liquidator and a creditor standing to commence a proceeding against a director in respect of a breach of section 588G) is not the only way that a director may find him or herself personally pursued for the obligations of the company. Other than navigating all of the requirements of the Corporations Act and the Australian Securities and Investments Commission Act 2001 (Cth) while the company is in distress, a director may be personally liable to the Commissioner of Taxation either by the Director Penalty Notice regime[21] or in respect of unfair preference payments subsequently recovered from the Commissioner by a liquidator.[22] In order to be effective, the safe harbour provisions will likely need to provide directors with protection from these sources of liability.

4. Directors may not use the safe harbour provision if it is unduly complicated or onerous because of the risk that, if the requirements of the provision are not discharged, the directors may be personally liable for debts incurred by the company. This is particularly important in circumstances where the company seeks new directors with different skills to join the board to assist the company's turnaround in a

[18] Section 180(3) of the Corporations Act 2001 (Cth) defines a "business judgment" to be "any decision to take or not take action in respect of a matter relevant to the business operations of the corporation".
[19] For example, decisions taken on planning, budgeting and accounting have been found to be business judgments but not oversight duties like monitoring the company's affairs and maintaining familiarity with the company's financial position.
[20] The Honest and Reasonable Director Defence would be a defence to all contraventions under the Corporations Act and the ASIC Act.
[21] Set out in Division 269 of the Taxation Administration Act 1953 (Cth)
[22] Pursuant to section 588FGA of the Corporations Act 2001 (Cth)

period of financial distress. The proposed formulation of the safe harbour provision in Box 15.1 of the Draft Report has a number of limbs to it. While the AICD appreciates this is a result of seeking to find an appropriate compromise between stakeholder interests, a complex safe harbour will not render it accessible to directors, particularly if a director must satisfy him or herself that the requirements have been met before making each and every 'business judgment'.

5. Draft Recommendation 15.2 also appears to propose that a specific duty be imposed on directors to act in the interests of creditors and members. Currently, directors owe fiduciary and statutory duties to the company (meaning members as a whole) and the courts have recognised that directors should consider the interests of creditors when a company is in financial difficulties.[23] However, the directors do not owe a specific duty to creditors.[24] We are concerned that the proposed safe harbour extends the current position at law and in this regard will hinder decision-making. This is because conflicts between the interests of the company's creditors and the company's members as a whole will inevitably arise, particularly when a company is in financial difficulty. If directors owe a specific, enforceable duty to creditors and members at the same time, this may complicate and encumber decision making. It may also render the safe harbour unusable at a time when the company is in a precarious position and in need of timely and effective decisions. The result may be that the prospects of a successful restructure are reduced.

6. We also note that even though many restructuring attempts relate to companies in a group, where a company forms part of a group the directors' duties are owed to the specific company, not to the group. This would also need to be kept in mind by directors when utilising a safe harbour for any restructuring attempt.[25]

7. The AICD queries whether public notification of the operation of the safe harbour provision will impede the objectives it is designed to achieve. Public notification to ASIC and the ASX that directors are invoking the safe harbour may lead to the same stigma currently applied when a company appoints an administrator (but without the statutory moratorium that a company in administration benefits from). As the proposed safe harbour is intended to protect against insolvent trading liability, third party suppliers may incorrectly infer from the public notification that the company is in fact insolvent. As a result, creditors may increase pressure to receive payment for existing debts (including by issuing statutory demands or commencing legal proceedings) or reject otherwise reasonable requests for a further extension of credit, which may distract directors, divert resources and otherwise impair the company's ability to effect the restructure.

   Further, if a company enters a safe harbour publicly, suppliers will be on notice of the company's potential insolvency. If the restructure fails and the company is liquidated, suppliers may be pursued by the liquidator for amounts received during the safe harbour period on the basis that they received an unfair preference.[26] This may be a disincentive for suppliers to trade with a company in safe harbour and may impact the prospects of a successful restructure.

8. The AICD notes that it appears essential to the success of the safe harbour mechanism that the proposed restriction on enforcing ipso facto clauses be extended

[23] *Walker v Wimborne* (1976) 3 ACLR 529
[24] *Spies v R* [2000] HCA 43
[25] *Walker v Wimborne* (1976) 3 ACLR 529
[26] Unfair preference is defined in section 588FA of the Corporations Act 2001 (Cth).

to the period when the safe harbour has been invoked (which, if enacted, will no doubt be added to the standard list of events of default in contracts that permit a contract to be terminated). Our comments on ipso facto clauses are set out in more detail below.

9. The AICD considers that an effective safe harbour mechanism would also need to provide protection to the advisers consulted by the directors. Without such protection, advisers may be deemed 'shadow directors',[27] rendering advisers liable for breaches of the Corporations Act, including insolvent trading liability. The risk for an adviser appears particularly acute here because, as the directors are seeking that the company benefit from the safe harbour provisions, they may be reluctant to act other than in accordance with the recommendations of the adviser.

The AICD's view is that the threshold issues discussed above are critical to the formulation of a safe harbour provision that gives directors the requisite comfort to implement a restructure. A safe harbour provision that addresses these issues would improve the probability of directors being able to execute a successful corporate recovery to the benefit of all stakeholders.

3. Draft Recommendation 15.4 – Restrictions be imposed to prevent reliance on ipso facto clauses upon an insolvency event

The AICD supports the proposal in Draft Recommendation 15.4 that ipso facto clauses, which allow contracts to be terminated due to an insolvency event, be unenforceable on the appointment of an administrator or a receiver or when the company is in safe harbour. However, the AICD believes that this proposal may be improved by inserting some exceptions to the unenforceability of ipso facto clauses.

We note that the proposed restriction to ipso facto clauses would apply during the safe harbour period proposed in Draft Recommendation 15.2. Currently, an administrator or a receiver who continues to trade a business after his or her appointment, is personally liable for that trading[28] so that a supplier who continues to trade with a company in receivership or administration will be protected. However, there would be no similar protection for a supplier who would be obliged to continue to trade with a company utilising safe harbour. It is a foreseeable outcome of the combined effect of Draft Recommendations 15.2 and 15.4 that a supplier may be obliged to continue to provide goods or services on credit to a company during the safe harbour and that the company may then enter into liquidation. The supplier would then be an unsecured creditor in the liquidation in respect of the goods and services provided during the safe harbour period.

While we agree that there should be room for suppliers and others to make an application to a court to enforce ipso facto clauses in some circumstances, an application to a court may not be feasible for smaller businesses because of the costs of such an application.[29] This will

[27] Section 9 of the Corporations Act 2001 (Cth) defines a "director" to include circumstances where the directors of a company are accustomed to act in accordance with the person's instructions or wishes, even though the person is not validly appointed as a director.

[28] An administrator is personally liable for debts incurred during the administration in respect of services rendered, goods bought or property hired, leased, used or occupied pursuant to section 443A of the Corporations Act 2001 (Cth). Similarly, a receiver is personally liable for debts incurred during the receivership in respect of services rendered, goods purchased or property hired, leased, used or occupied pursuant to section 419 of the Corporations Act 2001 (Cth).

[29] As at 1 July 2015, the filing fee for an application by a corporation to a state or territory Supreme Court varies between $600 and approximately $3,300 and to the Federal Court of Australia is $3,320. The applicant would also be required to pay professional fees to a lawyer to prepare the application and supporting evidence.

particularly be the case where that business is already experiencing the undue hardship required for such an application to be made.

Some limited exceptions to the ipso facto restriction may therefore assist. As noted in the AICD's previous submission to this inquiry, it may be useful to consider some of the limited exceptions that apply to the unenforceability of ipso facto clauses in Chapter 11 cases in the United States. These include:

- where the trustee/assignee of the company is not able to fulfil the bargain originally offered by the company to the party;[30] and
- where 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).[31]

4. Draft Recommendation 15.6 – Amendments to the powers and duties of receivers and managers

The AICD is pleased that the Productivity Commission has considered the issue of the rights of substantial secured creditors when a company is in financial difficulty.

Draft Recommendation 15.6 proposes that a receiver and manager appointed by a secured creditor be subject to a duty to not cause harm to the interests of creditors as a whole and that a sale of an asset by the receiver and manager be subject to a vote by creditors in certain circumstances.

The AICD is of the view that the recommendations put forward may not be workable in practice. We anticipate that further analysis is required to assess the costs and benefits of Draft Recommendation 15.6.

5. Draft Recommendation 15.8 – Directors be allocated a Director Identification Number

The vast majority of Australia's directors govern their companies with integrity. Accordingly, the AICD supports effective efforts to reduce fraudulent phoenix activity that do not unnecessarily increase the compliance burden for directors acting appropriately. The AICD also supports efforts to assist new directors to improve their understanding of their duties and responsibilities.

Draft Recommendation 15.8 suggests that directors be allocated a unique director identification number. Before any director identification number proposal is progressed, careful consideration, through a cost-benefits analysis, should be given as to whether fraudulent phoenix activity would be better curtailed by allocating funds to ASIC's enforcement of suspected phoenix activity via the existing laws rather than allocating funds to the proposed introduction of the Director Identification Number.[32] If ASIC is required to implement and monitor the regime proposed in Draft Recommendation 15.8, the Government should ensure that ASIC is adequately funded to conduct that work.

[30] See 11 U.S.C §365(e)(2)(A).
[31] See 11 U.S.C §365(e)(2)(B)
[32] In 2011, the ATO estimated that there were "approximately 6,000 phoenix companies in Australia" involving "approximately 7,500 – 9,000 company directors." (See Media Release, *Protecting Employee Super and Strengthening the Obligations of Company Directors,* the Hon Bill Shorten MP, 13 October 2011). If these figures are accurate, in 2011, less than 0.5% of Australia's company directors were involved in this type of misconduct.

The AICD took the opportunity to obtain the views of its members on Draft Recommendation 15.8.[33]

In a recent survey, approximately 67% of AICD members who responded to our survey[34] supported the proposal that directors be allocated a unique Director Identification Number.

The main reasons provided by the approximately 33% of members who responded to the survey and objected to the proposal were that:

- it would increase the administrative burden on directors;
- there was insufficient information about the potential costs and benefits; or
- rogue directors would inevitably find ways to work around the system.

Some AICD members who objected to the proposal stated that they would be supportive, if directors' personal identifying information (such as residential addresses and dates of birth) were no longer made publicly available on the ASIC register as a result of the Director Identification Number.

We hope our comments will be of assistance to you. If you would like to discuss any aspect of our views, please contact us .

Yours sincerely

JOHN BROGDEN
Managing Director & Chief Executive Officer

[33] We caution that the number of respondents to our survey was small (225 members) and may, therefore, not be conclusive of the views of the director community.
[34] The AICD survey received responses from 225 members.