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24 April 2017

Mr James Mason
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

via email: insolvency@treasury.gov.au

Dear Mr Mason

National Innovation and Science Agenda – Improving corporate insolvency law

Thank you for the opportunity to provide a submission on the Australian Government's Exposure Draft titled *Treasury Laws Amendment (2017 Enterprise Inventive No. 2) Bill 2017*, and the accompanying draft Explanatory Memorandum and draft Explanatory Document (together, the **Proposed Reforms**).

The Australian Institute of Company Directors (**AICD**) is committed to excellence in governance. We make a positive impact on society and the economy through governance education, director development and advocacy. Our membership of more than 40,000 includes directors and senior leaders from business, government and the not-for-profit sectors.

We welcome the significant step taken by the government in releasing the Proposed Reforms, which include a safe harbour for insolvent trading (**ED Safe Harbour**) and a stay on *ipso facto* clauses triggered by a formal insolvency process (**ED Stay**).

1. SUMMARY

The AICD is strongly supportive of reform to Australia's insolvency laws, particularly the insolvent trading prohibitions in s 588G of the *Corporations Act 2001* (Cth) (**Corporations Act**), which are considered to be among the 'strictest' in the world.[1] These laws can lead to a premature invocation of insolvency, resulting in job losses, contract terminations, destruction of goodwill and overall value diminution.

The Proposed Reforms, if designed effectively, should facilitate innovation and entrepreneurship by encouraging responsible risk-taking by companies and directors. The potential of these changes – subject to getting the legislation right – cannot be underestimated. They will save rather than destroy billions in wealth and tens of thousands of jobs. Directors of an ailing company should be given a fair opportunity to take reasonable steps to turn around viable businesses for the benefit of all.

The AICD supports an insolvent trading safe harbour that facilitates reasonable efforts to rehabilitate distressed businesses, while appropriately protecting corporate stakeholders such as employees, suppliers, customers, creditors and shareholders from reckless and unscrupulous actions. However, after significant consultation with members and stakeholders,

[1] The Hon. Wayne Martin, 'Official Opening Address', Insolvency Practitioners' Association of Australia 16th National Conference, Perth, 28 May 2009.

we are concerned that the ED Safe Harbour may not provide directors with sufficient certainty to encourage good faith restructuring. Accordingly, in Section 2 of this submission we make recommendations to enhance the effectiveness and operation of the ED Safe Harbour.

In addition, the AICD supports the government's initiative to introduce a stay on certain *ipso facto* clauses. While we broadly endorse the approach taken in the ED Stay, we have again made some suggestions to improve the draft legislation. These suggestions are set out below in Section 3.

2. SAFE HARBOUR FOR INSOLVENT TRADING

2.1 Overview of the AICD's position

The AICD is of the view that a workable safe harbour requires the following features:

- certainty, to provide directors with sufficient comfort that reasonable restructuring efforts taken in good faith will be protected;
- flexibility, so that the laws apply irrespective of a company's size, industry and legal structure; and
- functional, so that the laws work in practice, bearing in mind the complexity and time constraints under which decisions must be made when a company is financially distressed.

In assessing whether the ED Safe Harbour is sufficiently certain, flexible and functional, we have consulted broadly with our members, other stakeholders and counsel. Based on this feedback, and our own analysis, we are concerned that certain features of the ED Safe Harbour undermine its effectiveness. Indeed, feedback we have received from some of our members is that they simply would not use the ED Safe Harbour in its current form.

Our specific concerns with the ED Safe Harbour are detailed below, together with our recommendations for addressing them.

2.2 Determining the 'better outcome'

Section 588GA(5) of the ED Safe Harbour defines 'better outcome' as an 'outcome that is better for both: (a) the company; and (b) the company's creditors as a whole; than the outcome of the company becoming a Chapter 5 body corporate.'

The ED Safe Harbour therefore requires a director to undertake a counterfactual evaluation of the various outcomes which may flow from a course of action, and compare them to the various outcomes which may result from the company becoming a Chapter 5 body corporate.

The AICD is concerned that this feature of the ED Safe Harbour is unduly onerous, and likely to discourage reasonable restructuring efforts.

The causes of our concern – uncertainty and complexity, and hindsight review on a purely objective basis – are discussed in turn. Our recommendations for addressing these issues then follow.

(a) <u>Uncertainty and complexity</u>

The counterfactual analysis required under the ED Safe Harbour is inherently uncertain as it involves predictions about possible future events. These predications may need to be made under time pressure and with imperfect information. Further, it may be necessary to make predictions in relation to several potential alternative courses of action (which may be modified over time), each with a number of possible outcomes.

The counterfactual analysis to be undertaken by directors is made even more complex because the comparator is the company becoming a 'Chapter 5 body corporate'. As

there are a number of ways in which a company may become a Chapter 5 body corporate, the ED Safe Harbour requires that directors assess each particular course of action (as modified from time to time) against each possibility entailed by the company becoming a Chapter 5 body corporate. This is, in our view, a burdensome counterfactual exercise.

A similar point has been made by Herbert Smith Freehills (**HSF**) in a recent article:[2]

> *The better outcome test requires that the course of action adopted be reasonably likely to lead to an outcome better than the outcome of the company becoming a Chapter 5 body corporate. This term is broadly defined (see above), and includes steps that may actually be required as part of implementing the restructuring (e.g. a scheme of arrangement or deed of company arrangement (DOCA)). The test therefore sets the bar too high (it appears to require pursuit of a restructuring without using any of the Chapter 5 tools) and is difficult to evaluate (does a director need to consider all of the possible outcomes under any of the Chapter 5 processes?). We think it would be simpler and clearer to simply require that the course of action is reasonably likely to lead to a better outcome than the immediate (or prompt) appointment of an administrator or liquidator.*

While the guidance provided in the Explanatory Memorandum ([1.38]) provides some assistance to directors, due to its subordinate nature, we believe it inadequately deals with this issue. In our view, there is merit in making the ED Safe Harbour more specific in the manner suggested by HSF (see Recommendation 1 below).

(b) Hindsight review on a purely objective basis

In conducting the counterfactual analysis required by the ED Safe Harbour, directors will be making decisions in real time, under deadlines and often with incomplete information. Yet, whether directors have met the requirements of the ED Safe Harbour and so enlivened its protection will be judged by a court retrospectively. As acknowledged by Justice Palmer in *Lewis v Doran*, the court's vantage point brings with it the 'inestimable benefit of the wisdom of hindsight.'[3] Unlike directors, the court will be able to see 'the whole picture, both before, as at and after'[4] a failed restructure.

Hindsight review of directors' decisions is particularly problematic under the ED Safe Harbour as they are to be judged on a purely objective basis. Consequently, rational restructuring decisions by directors may be found wanting on an objective basis due to issues, events or information, with the benefit of hindsight, emerging as more significant than they appeared to the directors who were otherwise acting with due care and diligence.

In any event, as the AICD has previously observed, there is empirical evidence which shows that persons who know the outcome of a decision or a series of events 'tend to exaggerate the extent to which that outcome could have been correctly predicted beforehand.'[5] This tendency is known as 'hindsight bias'.

[2] Paul Apathy, Sarah Spencer, Lisa Filippin, 'Australian Government Releases Draft Insolvent Trading and Ipso Facto Legislation', 5 April 2017, Herbert Smith Freehills, < https://www.herbertsmithfreehills.com/latest-thinking/australian-government-releases-draft-insolvent-trading-and-ipso-facto-legislation>
[3] *Lewis v Doran* (2004) 50 ACSR 175, Palmer J at 198-199.
[4] *Ibid*,198-199.
[5] See Jacobs, Allen & Strine, 'Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem' (2000) 96 Nw. U.L.Rev. 449, 451– 52 (2002) cited in Hal R. Arkes & Cindy A. Schipani, 'Medical Malpractice v The Business Judgment Rule: Differences in Hindsight Bias' (1994) 73 Or. L. Rev. 587, 588.

Having consulted with our members, the AICD is concerned that the complexity and uncertainty inherent in the required counterfactual analysis, together with the risk of having their rational decisions reviewed objectively with the benefit of hindsight, sets the bar too high for directors. Accordingly, we question the degree to which the ED Safe Harbour could achieve the aims of the Proposed Reforms.

To address our concerns, we urge the government to incorporate the concept of 'rational belief' into s 588GA. This term is already employed in the context of directors' duties as an aspect of the statutory business judgment rule in s 180(2).

In regards to s 180(2), 'rational belief' has been interpreted to mean 'based on reason or reasoning': ASIC v Rich.[6] Definitions of 'rational' used in other contexts have included 'not foolish, absurd or extreme' (The Concise Oxford Dictionary), and 'not egregious, patently frivolous, or capricious' (Stanziale v Nachtomi).[7]

Importantly, the use of an orthodox and well-established normative hinge such as 'rationality' would give greater certainty to a director seeking to rely on the ED Safe Harbour when engaging on a course of action.

Recasting the purely objective test in terms of a 'rational belief' could be easily achieved through the amendment set out in Recommendation 2 (below).

If, contrary to our strong view of its merits, Recommendation 2 is not adopted, we urge the government to explicitly frame the ED Safe Harbour's objective test through the lens of a 'reasonable person in a like position' to the relevant director (see Recommendation 3).

The importation of the concept of 'a reasonable person in a like position' into the ED Safe Harbour would require the court to give greater consideration to the specific circumstances of the individual director and the relevant company. This approach directly mirrors the test in s 588G(2)(b) of the Corporations Act, and is analogous to the approach to be taken under s 180(1).

In addition to these recommendations, and irrespective of whether or not they are adopted, sufficient guidance needs to be provided in the Explanatory Memorandum about the evaluative exercise required of directors by the ED Safe Harbour (see Recommendation 4). We would be happy to work with the government in developing any guidance.

Recommendation 1: Consider HSF's suggestion of replacing references to 'Chapter 5 body corporate' in the ED Safe Harbour with references to the 'immediate (or prompt) appointment of an administrator or liquidator'.

Recommendation 2: Amend s 588GA(1) as follows:

'(a) … the person starts taking a course of action that the person rationally believes is reasonably likely to lead to a better outcome …; and

(b) …

(ii) when that course of action ceases to be one that the person rationally believes is reasonably likely to lead to a better outcome …'

Alternatively

Recommendation 3: Amend s 588GA(1) as follows:

[6] *ASIC v Rich* (2009) 75 ACSR 1 at [7289] – [7290].
[7] 330 BR 56 D. Del, 2004.

> '(a) … the person starts taking a course of action that a reasonable person in a like position in a company in the company's circumstances would believe is reasonably likely to lead to a better outcome …; and
>
> (b) …
>
> (ii) when that course of action ceases to be one that a reasonable person in a like position in the company's circumstances would believe is reasonably likely to lead to a better outcome …'

Recommendation 4: Provide guidance in the Explanatory Memorandum of the mechanics of the counterfactual analysis required by the ED Safe Harbour.

2.3 Having regard to both the company and the company's creditors as a whole

To invoke the ED Safe Harbour, a director must be able to demonstrate, to the satisfaction of the evidentiary burden, that restructuring efforts are 'reasonably likely to lead to a better outcome for the *company and the company's creditors*' [emphasis added]. As previously mentioned, s 588GA(5) defines 'better outcome' as an outcome 'that is better for both: (a) the company; and (b) the company's creditors as a whole; than the outcome of the company becoming a Chapter 5 body corporate.' Several important issues arise from the draft legislation's use of the phrases 'the company and its creditors' and the 'the company and its creditors as a whole'.

First, the conjunctive phrase 'the company and its creditors' is ambiguous. The phrase implies the possibility of cleavage between the interests of the company and its creditors, but leaves uncertainty as to what this might comprise.

Secondly, the requirement that a course of action be for the betterment of the company and its creditors may cause confusion as this construction departs from the current law on directors' duties. Relevantly, the courts have long recognised that directors who fail to consider the interests of creditors as the company approaches insolvency risk breaching these duties. Significantly though, the need to consider creditors' interests in this way is not a separate duty owed by directors to creditors. In contrast, the ED Safe Harbour requires that directors act to betterment of the company *and* its creditors.

Given the meaning ascribed by the law of directors' duties to acting in the company's interests during the 'twilight zone of insolvency', we question the utility of the ED Safe Harbour's requirement that directors consider the interests of creditors in addition to, rather than part of, the company's interests.

As we observed in our submission of 27 May 2016 (**2016 Submission**) on the Australian Government's proposals paper titled *Improving bankruptcy and insolvency laws* (**2016 Consultation Paper**), if the safe harbour is inconsistent with directors' principal statutory and general law duties, reasonable steps taken to turnaround an ailing business may attract liability under those duties even though protected from liability for insolvent trading. Such a perverse outcome would create unacceptable uncertainty and risk for directors and clearly undermine the government's goal of encouraging responsible innovation and entrepreneurship.

Thirdly, the requirement that a course of action lead to a better outcome for creditors *in addition to* the company, may have unintended consequences for directors' general duties through a court's analogical use of the ED Safe Harbour in the development of the law of those duties.

We understand that it is not the government's intention for this to occur. However, there is a risk: while the general presumption is that the legislature does not intend to make any

alteration to the law beyond the immediate scope and object of a statute,[8] a court may, in some circumstances adopt analogical reasoning in the development of the common law, particularly where a statute is consistent with or builds upon a fundamental theme of the common law.[9]

Relevantly, the established duty of directors to have regard to the interests of a company's creditors in the twilight of insolvency is a fundamental theme of the common law which is a developing concept within Australian jurisprudence. In our view, there is an appreciable risk that a court could adopt reasoning analogical to the ED Safe Harbour in the development of the law of directors' duties, particularly as the ED Safe Harbour may be seen to build upon this fundamental theme of the common law. As a consequence, the duty to consider the interests of creditors as a company approaches insolvency could be elevated to a duty requiring that directors act in the interests of creditors. If such an expansion of the existing common law requirements in relation to creditors were to occur, it would fundamentally alter the nature of a director's duty to a company and disrupt established jurisprudence.

To address the risk of a potential inconsistency between the ED Safe Harbour and directors' general duties, the AICD recommends that the references to the company's creditors be removed from s 588GA. Alternatively, we believe s 588GA should be amended so that it coheres to the existing case law with respect to a director's duty to consider the interests of creditors when approaching insolvency. These amendments would also reduce the risk of the ED Safe Harbour causing the unintended consequence of a general law duty being owed to creditors directly.

Finally, the ED Safe Harbour does not indicate how directors are to balance the interests of creditors in determining whether a course of action is reasonably likely to lead to a better outcome for 'creditors *as a whole*' [emphasis added]. This is significant given the potential for tension between the interests of existing creditors and new creditors. We note that the Explanatory Memorandum ([1.39] and [1.40]) does provide some guidance for directors on the meaning of the phrase 'creditors as a whole'. However, after consulting with our members, we believe further guidance is required, particularly in relation to the taking on of debt from new creditors.

Recommendation 5: Delete the references to 'the company's creditors' / 'the company's creditors as a whole' in s 588GA.

Alternatively, delete the definition of 'better outcome' in s 588GA(5) and insert the following definition of 'better outcome for the company and the company's creditors':

> '***better outcome for the company and the company's creditors***, means an outcome that is better for the company, having regard to the interests of creditors, than the outcome of the company becoming a Chapter 5 body corporate.'

Recommendation 6: Provide additional guidance in the Explanatory Memorandum in relation to the incurring of new debts. This recommendation stands alone and is not dependent on the reforms set out in Recommendation 5.

2.4 The time the ED Safe Harbour begins

Under s 588GA(1), the safe harbour can only be invoked after the director has started to 'suspect the company may become or be insolvent'. We are concerned that this feature of the ED Safe Harbour may unjustly deny protection to the directors of a financially troubled company in circumstances where, although the directors have started taking a course of action

[8] *Potter v Minahan* (1908) 7 CLR 277 at 304 (O'Connor J).
[9] See P D Finn, 'Statues and the Common Law' (1992) 22 UWAL Rev 7, 18-30. See also P S Atiya, 'Common Law and Statute Law (1985) 48 MLR 1; W Gummow, 'Lecture 1 – The Common Law and Statute' in *Change and Continuity: Statute, Equity and Federalism* (Oxford University Press, Oxford, 1999), 1.

that is reasonably likely to lead to a better outcome for the company and its creditors, they do not yet 'suspect that the company may become or be insolvent', bearing in mind that insolvency has a technical meaning.

The potential for this perverse outcome arises because, under s 588G(2), a director may be liable for insolvent trading in circumstances where, irrespective of the director's subjective view of the company's financial position, 'a reasonable person in a like position in a company in the company's circumstances' would consider there were grounds to suspect the company is, or may become, insolvent. To remedy this issue, it is essential that the safe harbour protection be available at the point in time in which liability for insolvent trading potentially arises.

Recommendation 7: Delete the words 'after the person starts to suspect the company may become or be insolvent' from s 588GA(1(a).

2.5 Debts 'incurred in connection with' the course of action

By virtue of proposed s 588GA(1)(b), the ED Safe Harbour would operate to shield directors from liability for debts that are 'incurred in connection with' a course of action that meets the requirements of s 588GA(1)(a). Significantly, these provisions are not precise as to the degree to which a debt needs to be 'connected' with the relevant course of action.

On a narrow reading of s 588GA(1)(b), a director may only be protected by the ED Safe Harbour in respect of debts which are directly incurred in connection with the course of action itself (ie a restructure of the business), but not new debts (or portions of those debts) which are indirect or incidental to the course of action taken (eg operational expenses). On a more expansive view, debts which are directly or indirectly incurred by the company could fall within the protection of the ED Safe Harbour if a person commences a course of action which is reasonably likely to lead to a better outcome.

We are concerned that a narrow interpretation of s 588GA(1)(b) could fetter the ability of directors to incur debts for the purpose of trading on while making reasonable efforts to restructure the business. An inability to continue trading would necessarily hamper, if not be fatal to, restructuring effects. For this reason, an expansive interpretation of when a debt will be connected to a course of action is essential to the success of the safe harbour reforms.

In our view, an ED Safe Harbour that encompasses debts which are 'directly or indirectly' connected with the relevant course of action should not encourage directors to incur debts that have *no* relation to that course of action, as a connection must still be found before the ED Safe Harbour applies. In any event, directors protected by the ED Safe Harbour would continue to be subject to their general law and statutory duties to act with care and diligence, and in good faith in the best interests of the company (which requires consideration of creditors' interests).

Recommendation 8: Amend s 588GA(1)(b) by inserting the words 'directly or indirectly' before the phrase 'in connection with'.

2.6 The phrase 'starts taking a course of action'

Under the Exposure Draft, there is an ambiguity regarding whether a director would be protected by the ED Safe Harbour for deliberations which are required to be made in order to facilitate the decision about whether to take a particular course of action. On the face of the draft legislation, protection would only apply from the time the director 'starts' taking a course of action. Arguably, this would exclude director deliberations or preparations which occurred prior to that time, notwithstanding the statement in the Explanatory Memorandum that the ED Safe Harbour is intended to extend to deliberations and preparations.

We strongly support a safe harbour that can apply to directors' deliberations and preparations for a course of action. This is consistent with the aims of the Proposed Reforms, and ensures that directors could give adequate consideration to any proposed course of action. Accordingly, to avoid any doubt regarding whether deliberations and preparations are protected by the ED Safe Harbour, the AICD believes it is necessary to explicitly address this matter in the Exposure Draft, rather than guidance in the Explanatory Memorandum.

In addition, a company may have started to undertake a course of action before there were reasonably grounds to suspect insolvency. Once concerns regarding solvency arise, the directors would need to determine whether to continue on the current course of action, or embark on a new course of action. Should the directors choose to continue with the existing course of action, it should be possible for that course of action to attract the protection of the ED Safe Harbour.

Recommendation 9: Amend the Exposure Draft to ensure that deliberations and preparations are clearly included in the ED Safe Harbour protections. This could be done by inserting a new definition in s 588GA(5).

Recommendation 10: Insert a clarification in the Explanatory Memorandum to ensure it is clear that the ED Safe Harbour may apply to a person who 'continues' a course of action (subject to satisfaction of the other requirements of the ED Safe Harbour).

2.7 The phrase 'reasonably likely'

The term 'reasonably likely', which recurs throughout the ED Safe Harbour, could potentially be construed as connoting either:

- the degree of likelihood to which a director must be satisfied (eg to be satisfied that a better outcome is more probable than not); or
- the basis upon which the likelihood is to be assessed, that is objectively as opposed to subjectively.

This ambiguity needs to be addressed.

In the context of ss 45, 46, 47 and 50 of the *Competition and Consumer Act 2010* (Cth) (and its predecessor, the *Trade Practices Act 1974* (Cth)), there is a developed jurisprudence concerning the meaning to be ascribed to the word 'likely' in a counterfactual analysis.

In evaluating the 'likely' effect of a provision of a contract, arrangement or understanding, the court has regard to objective indicia of the effects which will probably (as opposed to speculatively or possibly)[10] flow from the impugned provision. More specifically, the court has regard to the circumstances existing in the relevant market at the time of the provision of the contract being made or given effect to;[11] and then considers whether, as at the date of the impugned conduct, it was likely, having regard to existing circumstances, that the conduct would effect a substantial lessening of competition in the market.[12]

In undertaking this analysis, the relevant probabilities for the court to consider are commercial or economic likelihoods which may not be susceptible to formal proof on the basis of evidence or argument. It will be sufficient that there is a 'real chance' that a substantial lessening of competition will occur:[13]

[10] *Queensland Co-operative Milling Association Ltd; Re Defiance Holdings* [1976] 25 FLR 169 at 183.
[11] *Universal Music Australia Pty Ltd v ACCC* (2003) 131 FCR 529 at [245] – [248].
[12] *Ibid* at [247] citing *TPC v TNT Management Pty Ltd* (1985) 58 ALR 423 at 474.
[13] *Monroe Topple and Associates v Institute of Chartered Accountants* (2002) 122 FCR 110 at [111] (Heerey J) *Universal Music Australia Pty Ltd v ACCC* (2003) 131 FCR 529 at [193].

The word 'likely', in this context, has to be applied at a level which is 'commercially relevant or meaningful as must be the assessment of the substantial lessening of competition under consideration': *Australian Gas Light Co v Australian Competition and Consumer Commission (No 3)*[14] (French J, as his Honour then was).

The view expressed by French J is the prevailing view of the meaning of the term 'likely' in that statutory context. However, some earlier judicial consideration suggested that the correct meaning to be ascribed to 'likely' within s 45 is more probably than not: *Monroe Topple & Associates Pty Ltd v Institute of Chartered Accountants in Australia*[15] and authorities cited therein.

The difficulties that have attended construction of the word 'likely' used in isolation in the competition statute, illustrate the need for the meaning of the compound term 'reasonably likely' in the ED Safe Harbour to be made explicit.

Recommendation 11: Clarify the meaning of 'reasonably likely' by defining it in s 588GA(5) or explaining its meaning in the Explanatory Memorandum.

2.8 Legal characterisation of s 588GA(1) – defence or carve out?

There are differing views among stakeholders as to whether s 588GA(1) would operate as a defence or carve out to a civil contravention of the prohibition on insolvent trading. From a practical perspective, resolution of this issue is very important lest confusion and uncertainty arise as to the burden placed on directors by s 588GA, with negative implications for responsible restructuring efforts.

The AICD has consulted counsel on this issue, and is of the view that the ED Safe Harbour is a defence, although of a different form to the s 588H defences.

Subsection 588GA(3) states that a person who wishes to rely on subsection (1) in a proceeding for, or relating to, a contravention of s 588G(2) bears an 'evidential burden' in relation to that matter. Subsection 588GA(5) defines that notion as meaning, in relation to a matter, the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Under the common law, an evidential burden is the burden on a party to adduce evidence that is capable of being left to the court. Failure to discharge the evidential burden will lead a court to decide against the party that bears that onus without the need to call on the other side. The evidential and the legal burden are, together, the burden of proof. The legal burden is the persuasive burden of proof. The legal burden lies on the party who asserts or alleges an issue. Failure to discharge the legal burden of proof on an issue will cause the trier of fact to decide that issue against that party.

The ED Safe Harbour is similar in structure to other Commonwealth laws such as the due diligence defence conferred by s 12.3(3) of the *Criminal Code 1995* (Cth) (**Code**), in respect of conduct proscribed by of sections 11.5(1) and 70.2(1), being conspiracy to bribe a foreign public official. In that context, the due diligence defence operates to suspend the application of s 12.3(2)(b) (the high managerial agent basis of liability). The burden of proof is an 'evidential burden' which is defined in the Code as involving 'the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist'.

Given this, s 588GA(1) of the ED Safe Harbour operates as a species of defence to a breach of the civil insolvent trading provisions. However, the defence only requires the defendant to

[14] (2003) 127 FCR 317.
[15] (2002) 122 FCR 110 at [111].

provide sufficient *prima facie* evidence to discharge the evidential burden, as defined in subsection 588GA(5).

In the AICD's view, it is not correct to say, as the Explanatory Memorandum does at [1.11], that the ED Safe Harbour is a 'carve out'. A 'carve out' is a colloquial term for the different legal notion of an exception to a norm that otherwise applies. It would be preferable for the Explanatory Memorandum to omit colloquial labels for the legal effect of the provisions, especially where these are apt to mislead.

In addressing this issue, it is very important that the Exposure Draft and Explanatory Memorandum clearly distinguish between the different burdens:

- imposed on directors seeking to rely on the ED Safe Harbour and the party alleging a breach of s 588G(2); and
- imposed on directors by the ED Safe Harbour and the s 588H defences. We understand that there is a proposal to change the heading of s 588H to 'Other defences'. In our view, this is likely to cause further confusion as it implies that the ED Safe Harbour defence and the s 588H defences are of the same form, which is not the case.

A failure to adequately deal with this issue may frustrate the policy aim of encouraging responsible restructuring.

Recommendation 12: The Exposure Draft and Explanatory Memorandum be amended to:

- remove references to 'carve out';
- distinguish the low evidential burden placed on directors by the ED Safe Harbour from the burden on the other party to the cause of action; and
- distinguish the burden on directors under ED Safe Harbour from that imposed by the s 588H defences.

2.9 Relevant considerations in s 588GA(2)

According to paragraph 1.31 of the Explanatory Memorandum, s 588GA(2) 'provides an *indicative* and non-exhaustive list of factors to be considered in determine whether a course of action is reasonably likely to lead to a better outcome for a company and its creditors' [emphasis added]. In our view, it is entirely appropriate for the list of factors to be indicative only, as this recognises that what may be appropriate in one context may not be suitable in another.

For this reason, we are concerned by the lack of permissive prefatory language (eg 'may') in s 588GA(2). The absence of any prefatory language in the phrase 'have regard to' (whether it be 'must', 'may', or 'will') renders the provision more likely to be read in imperative terms. To us, the phrase 'have regard to' in the ED Safe Harbour reads as a command, rather than a list of non-mandatory factor, which appears at odds with the explanation of the operation of the section in the Explanatory Memorandum ([1.31], [1.33]-[1.34]).

To avoid confusion as to the interpretation of s 588GA(2), we recommend that the provision make its permissive nature explicit.

Recommendation 13: In s 588GA(2), replace 'have regard to' with 'regard may be had to'.

Subsection 588GA(2)(a) suggests that whether a director 'is taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all of its debts' may be a relevant consideration to determining whether a course action has enlivened the ED Safe Harbour protection. While we understand the general sentiment behind this consideration, feedback from our members indicates that it would be beneficial for the Explanatory Memorandum to provide guidance on the general nature of the steps and conduct contemplated by the provision.

Recommendation 14: Consider amending the Explanatory Memorandum to provide guidance on the intended meaning of s 588GA(2)(a).

2.10 A safe harbour for holding companies

Under s 588V of the Corporations Act, a holding company may be liable for the insolvent trading of its subsidiary. Significantly, while the ED Safe Harbour affords some protection to directors from the operation of s 588G, it does not similarly shield holding companies from s 588V. Consequently, the situation may arise where the directors of a financially distressed subsidiary have the benefit of a safe harbour from which to carry out a restructure, but the holding company does not. The Exposure Draft needs to remedy this anomaly. A failure to do so would, in our view, undermine the policy aim of encouraging distressed companies to take reasonable steps to trade out of their difficulties.

Recommendation 15: Extend the protection afforded to directors under the ED Safe Harbour to holding companies exposed to liability for a contravention of s 588V.

2.11 Authority of individual directors

In a company with more than one director, the position of director does not carry with it authority to act on behalf of the company. Directors act collectively as a board, although the board may delegate powers to a committee of board members or to an individual director. This feature of corporations law is of relevance to a court's assessment of the course of action undertaken by a director. Consideration should be given to acknowledging the limits of a director's authority in the Explanatory Memorandum.

Recommendation 16: In the Explanatory Memorandum's guidance on the 'course of action', acknowledge that in the absence of delegated authority, directors act collectively.

2.12 Phoenix activity

The AICD is aware that the safe harbour proposal has led to questions regarding the possible implications of its introduction on fraudulent phoenix activity. In our view, the relevant considerations in s 588GA(2), together with the exclusions in s 588GA(4) and restrictions in s 588GB, would likely render the effect of the ED Safe Harbour on fraudulent phoenix activity neutral. In any event, we note that a range of legislative and regulatory measures already exist to combat improper phoenix activity. We further note that a 'Phoenix Taskforce' (comprised of over 20 Federal, State and Territory government agencies) is working on other initiatives to address such activity.

3. STAY ON ENFORCING RIGHTS MERELY BECAUSE OF ARRANGEMENTS OR RESTRUCTURES

3.1 Overview of the AICD's position

As we observed in our 2016 Submission, it has long been a cause for concern in Australia that a counterparty's enforcement of an *ipso facto* clause can devalue a financially troubled company and seriously hinder, if not destroy, prospects of a successful restructure or going concern sale. For this reason, many countries have restricted the use of such clauses.[16]

While imposing a stay on the operation of *ipso facto* clauses would, to some extent, restrict the contractual rights of individual creditors of distressed companies, creditors as a whole

[16] Productivity Commission, *Business Set-up, Transfer and Closure,* Inquiry Report No 75 (30 September 2015) 25.

would benefit from the increased prospect of a meaningful turnaround of the business or of a higher return should a restructure ultimately be unsuccessful.

With a view to preserving enterprise value and jobs for the benefit of the nation, the AICD supports a stay on the operation of *ipso facto* clauses that permit unilateral variation or termination due to the commencement of formal insolvency proceedings, regardless of the continued performance of the contract. Provided all other contractual terms are being met, a counterparty should not be able to terminate the contract, accelerate payment, impose new terms of payment, require additional security for existing obligations, or claim forfeiture of the contract term.

Broadly speaking, we endorse the ED Stay and the approach taken in the legislation to:

- ensure that, notwithstanding the operation of the ED Stay, a counterparty maintains the right to terminate or amend an agreement for any other reason, including for a breach of non-performance; and
- exclude certain classes of contracts from the operation of the ED Stay.

In reviewing the Exposure Draft we have focused primarily on the temporal application of the ED Stay, anti-avoidance mechanisms and the phrase 'provision of additional credit'. These issues are detailed below. We acknowledge that there may be other issues with the ED Stay (eg its non-application to receiverships), and are aware that other stakeholders intend addressing them.

3.2 Temporal application of the ED Stay

The ED Stay would only apply to 'rights arising under contracts, agreements or arrangements entered into at or after the commencement of [Schedule 1 Part 2]' of the proposed legislation. Paragraph 2.52 of the Explanatory Memorandum indicates that the commencement date will be 1 January 2018.

In our 2016 Submission we expressed the view that delaying the application of the ED Stay would unnecessarily defer the benefits sought by its introduction because many contracts, such as leases and franchises, operate over long periods. Further, considerable uncertainty and disputes would likely arise as many contracts include options to extend or renew (with or without other rights of variation). In our view, unpredictable application of a stay would have the potential to undermine confidence in the efficacy of the reforms. For these reasons, we advocated against the reforms applying on the basis of when contracts were entered into.

We note that the Law Council of Australia has similarly advocated for a 'bright line' commencement date, although with a 12 month transition period to permit commercial contracts to be amended to accommodate the new law. We believe the Law Council's suggestion has merit.

Recommendation 17: Amend Schedule 1, Item 7 of the Exposure Draft so that the ED Stay applies to all contracts, agreements or arrangements already in existence on, or formed after, the expiration of a transitional period (say 12 months from the date of commencement of the legislation).

3.3 Anti-avoidance mechanism

We are supportive of the ED Stay being triggered by a formal insolvency process. However, we are very concerned that the effectiveness of the stay would be compromised by termination or variation provisions that are enlivened by the circumstances giving rise to the company's entry into the formal insolvency process, such as the company's financial condition (eg an inability to pay debts as and when they fall due).

Relevantly, the 2016 Consultation Paper noted that '[t]here will always be a temptation for counterparties to strengthen their contractual position by including terms designed to work around any prohibition on the operation of *ipso facto* clauses.' It went on to propose an anti-avoidance mechanism that would render 'any provision in an agreement that has the effect of providing for, or permitting, anything that in substance is contrary [to the stay] of *no force or effect*' [emphasis added].

In our 2016 Submission we strongly endorsed the inclusion of such an anti-avoidance mechanism. Without it, a stay could be frustrated through *ipso facto* clauses triggered by the circumstances giving rise to the formal insolvency process or through other clever drafting.

We note that proposed new s 425F and s 425G include several generic protections, arising through Court orders. However, in our view, these protections are oblique and inadequate.

Recommendation 18: Amend Schedule 1, Part 2 of the Exposure Draft to include a more explicit anti-avoidance mechanism which reflects the principles outlined in Section 3.2.1 of the 2016 Consultation Paper.

3.4 Provision of additional credit

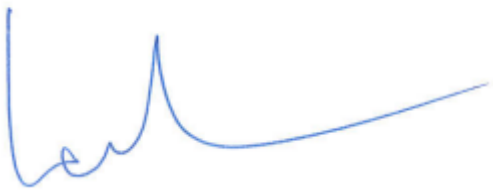
Proposed new sections 415D(6) and 451E(6) essentially provide that a counterparty would not be required to provide 'additional credit' when restricted from exercising their *ipso facto* rights due to the operation of the ED Stay. While we agree that the ED Stay should not oblige counterparties to make new advances of money or credit, the Explanatory Memorandum needs to provide greater clarity on the meaning of the phrase 'provision of additional credit'. As HSF has pointed out in a recent article, that phrase is capable of various meanings.[17]

Recommendation 19: Elaborate upon the explanation of ss 415D(6) and 451E(6) in paragraphs 2.11, 2.27 and 2.45 of the Explanatory Memorandum to provide greater clarity of the meaning of the phrase 'provision of additional credit'.

4. CONCLUSION

We hope our comments will be of assistance to you. If you would like to discuss any aspect of this submission, please contact Lysarne Pelling, Senior Policy Adviser, on (02) 8248 2708 or lpelling@aicd.com.au, or Matt McGirr, Policy Adviser, on (02) 8248 2705 or at mmcgirr@aicd.com.au.

Kind regards



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[17] Paul Apathy, Sarah Spencer, Lisa Filippin, 'Australian Government Releases Draft Insolvent Trading and Ipso Facto Legislation', 5 April 2017, Herbert Smith Freehills, < https://www.herbertsmithfreehills.com/latest-thinking/australian-government-releases-draft-insolvent-trading-and-ipso-facto-legislation>