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Improving Bankruptcy and Insolvency Laws Proposals Paper

17 June, 2016

Australian
Chamber of Commerce
and Industry

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and Industry

WORKING FOR BUSINESS.
WORKING FOR AUSTRALIA
Telephone 02 6270 8000
Email info@acci.asn.au
Website www.acci.asn.au

CANBERRA OFFICE
Commerce House
Level 3, 24 Brisbane Avenue
Barton ACT 2600 PO BOX 6005
Kingston ACT 2604

MELBOURNE OFFICE
Level 2, 150 Collins Street
Melbourne VIC 3000
PO BOX 18008
Collins Street East
Melbourne VIC 8003

SYDNEY OFFICE
Level 15, 140 Arthur Street
North Sydney NSW 2060
Locked Bag 938
North Sydney NSW 2059

ABN 85 008 391 795

Australian Chamber of Commerce and Industry

Summary of recommendations

The Australian Chamber of Commerce and Industry welcomes the opportunity to provide a submission to the Australian Government's Proposals Paper *Improving bankruptcy and insolvency laws*.

The proposals are to:

- Reduce the current default bankruptcy period to one year.
- Introduce a 'safe harbour' for directors from personal liability for insolvent trading if they appoint a restructuring adviser.
- Make 'ipso facto' clauses unenforceable if a company is undertaking a restructure.

Taken together, they have the potential to strike a better balance between encouraging entrepreneurship and protecting creditors.

This submission outlines suggestions on how to strike that balance and provides the following recommendations:

Recommendation 1: Monitoring

- The effects of changing the insolvency and bankruptcy laws are difficult to predict and it is therefore important that all changes be carefully monitored to ensure they do not lead to increases in the losses experienced by creditors.

Recommendation 2: Period of Bankruptcy

- The Australian Chamber supports the proposal to reduce the default period for a bankruptcy from three years to one year in cases where an individual has not previously been bankrupt.
- Similarly, adopting a reduced bankruptcy term in cases where misconduct has occurred has a strong likelihood of raising creditor risk.
- Both cases should therefore be automatically subject to a default minimum bankruptcy period of three years.
- Existing trustee protections, that provide a trustee or the courts with the power to extend the time until the bankrupt is discharged for a period of up to eight years, should be retained.
- Existing obligations (for example, the requirement to assist trustee/s and make income contributions) and restrictions (access to credit, overseas travel and licensing) on bankrupts should also remain in place.

Australian Chamber of Commerce and Industry

Recommendation 3: Safe Harbour Model

- The Australian Chamber supports in principle the adoption of Safe Harbour Model A. However, safe harbour should be a defence for, or protection against, insolvent trading actions, not a regime into which a financially distressed company is placed.
- Significant to safe harbour being valid is the requirement that a restructuring adviser exercises their powers and discharges their duties in good faith in the best interests of the company, informing the Australian Securities and Investments Commission (ASIC) of any misconduct they identify.
- Safeguards are required to ensure an appointed restructuring adviser acts professionally and impartially. They should be appointed from the Court's List which selects a liquidator by rotation. Registered official liquidators are required to accept all appointments which the Court may make.
- The Australian Chamber does not support Safe Harbour Option B because it would not require a restructuring adviser and would give directors considerable latitude to continue to trade in a distressed situation. It also puts the burden of proof on any liquidator bringing a claim to show that a director had breached section 588G of the Act.

Recommendation 4: Ipso Facto Clauses

- The Australian Chamber supports making ipso facto clauses unenforceable in cases where the business is in voluntary administration, but not in liquidation.
- In terms of appeal mechanisms, the Australian Chamber recommends the inclusion of a provision that affected counterparties may apply to the court to vary contract terms on the basis that they *may* suffer hardship. If the requirement is one where parties must show they *have* suffered hardship, it may be too late for many small businesses.
- To provide a safeguard for small business, one option could be for ipso facto clauses to continue to operate for businesses that meet the small business 'effects test'.

Australian Chamber of Commerce and Industry

Table of Contents

Australian Chamber of Commerce and Industry

1 Introduction

The Australian Chamber of Commerce and Industry welcomes the opportunity to provide a submission to the Australian Government's Proposals Paper *Improving bankruptcy and insolvency laws*.

The Australian Chamber recognises the proposals have a potentially important role in underpinning the Australian Government's Innovation and Science Agenda by encouraging entrepreneurship.

The Innovation and Science Agenda is front and centre of the Government's economic narrative for good reason: innovation is key to sustainable economic growth, employment creation and competitive success in the global marketplace.

Efforts to lift Australia's innovation performance are therefore welcome and the Government's willingness to reassess the nature and operation of existing insolvency laws timely.

The Proposals Paper puts forward three key measures to improve bankruptcy and insolvency laws:

- Reducing the current default bankruptcy period from three years to one year.
- Introducing a 'safe harbour' for directors from personal liability for insolvent trading if they appoint a restructuring adviser to develop a turnaround plan for the company.
- Making 'ipso facto' clauses, which have the purpose of allowing contracts to be terminated solely due to an insolvency event, unenforceable if a company is undertaking a restructure.

According to the Government, these measures are designed to strike a better balance between encouraging entrepreneurship and protecting creditors.

Striking the appropriate balance between these two priorities is not straightforward. Overly strict bankruptcy and insolvency laws may lead many businesses to be excessively risk-averse, to the detriment of the overall economy. Similarly, often rules designed to protect creditors can have perverse consequences that lead to more frequent insolvency events or to less money being recovered. On the other hand, those who lose most from insolvency and bankruptcy events are often other businesses. The effects of changing the insolvency and bankruptcy laws are difficult to predict and it is therefore important that all changes be carefully monitored to ensure they do not lead to increases in the losses experienced by creditors.

The remainder of this submission outlines the Australian Chamber's response to each of the individual proposals.

Reducing the current default bankruptcy period from three years to one year.

The Australian Chamber supports the proposal to reduce the default period for a bankruptcy from three years to one year in cases where an individual has not previously been bankrupt.

Similarly, adopting a reduced bankruptcy term in cases where misconduct has occurred has a strong likelihood of raising creditor risk.

Both cases should therefore be automatically subject to a default minimum bankruptcy period of three years.

Existing trustee protections, that provide a trustee or the courts with the power to extend the time until the bankrupt is discharged for a period of up to eight years, should be retained.

> Current obligations (for example, the requirement to assist trustee/s and make income contributions) and restrictions (access to credit, overseas travel and licensing) on bankrupts should also remain in place. It is also necessary to maintain sufficient safeguards for financial misdeed or behaviour that may lead to multiple bankruptcies.

While we acknowledge that not all bankruptcies are a result of misdeed, those that are can significantly damage the interests of creditors, which includes business suppliers of goods and services. Data from the Australian Securities and Investments Commission shows that 'possible misconduct' was reported in 78.5 per cent of external administrators' reports of business failure[1].

Introducing a 'safe harbour' for directors from personal liability for insolvent trading if they appoint a restructuring adviser to develop a turnaround plan for the company.

Recognising that a safe harbour is designed to preserve enterprise value and offer a cost effective and flexible mechanism to work through liquidity issues outside of formal administration, the Australian Chamber supports in principle the adoption of Safe Harbour Model A.

Under this model, directors would be provided with a restructuring option that allows them to retain control of the company if they have '…an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does'[2].

Safe harbour, therefore, should be a defence for, or protection against, insolvent trading actions, not, as the Australian Restructuring Insolvency and Turnaround Association (ARITA) points out, '…a regime into which a financially distressed company is placed'[3].

Significant to the safe harbour defence being valid is the requirement that a restructuring adviser exercises their powers and discharges their duties in good faith in the best interests of the company, informing the Australian Securities and Investments Commission (ASIC) of any misconduct they identify.

Safeguards are required to ensure an appointed restructuring adviser acts professionally and impartially. Their appointment should be from the Court's List which selects a liquidator by rotation. Registered official liquidators are required to accept all appointments which the Court may make.

The Australian Chamber does not support Safe Harbour Option B because it would not require a restructuring adviser and would give directors considerable latitude to continue to trade in a distressed situation. It also puts the burden of proof on any liquidator bringing a claim to show that a director had breached section 588G of the Act.

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[1] Australian Securities and Investments Commission. Report 456: Insolvency Statistics: External Administrators' Reports (July 2014 to June 2015), November 2015. Page 19.

[2] Improving bankruptcy and insolvency laws, Proposals Paper, Australian Government, April 2016. Page 11.

[3] Submission to the Productivity Commission Draft Report on Business Set Up, Transfer and Closure, Australian Restructuring Insolvency and Turnaround Association (ARITA), July 2015. Page 9.

Making 'ipso facto' clauses, which have the purpose of allowing contracts to be terminated solely due to an insolvency event, unenforceable if a company is undertaking a restructure.

Ipso facto clauses bring a contract to an end, or alter its operation, because a company has become insolvent or entered into external administration. A company may be refused goods or services that are essential to the continued operation of its business, even though it has no outstanding payments and can continue to make payments.

The Australian Chamber agrees with the Government that the operation of current ipso facto clauses can diminish the value of a business entering insolvency and may reduce the scope for a successful restructure or prevent the sale of the business as a going concern, with consequential impact on the returns to creditors in any subsequent liquidation[4].

The Australian Chamber therefore supports making ipso facto clauses unenforceable in cases where the business is in voluntary administration, but not in liquidation. Given that the purpose of liquidation is to wind up a company, it would not be prudent to require businesses to continue to supply goods and services when the likelihood of receiving payment are low.

In terms of exclusions, the Australian Chamber considers the operation of ipso facto clauses should not be void in contracts to extend new debt financing.

To ensure effective anti-avoidance, we urge the Government not to extend the operation of the provision beyond ipso facto clauses. Counterparties need to maintain the right to terminate, amend, accelerate or vary an agreement with the debtor company for any other reason, such as for a breach involving non-payment or non-performance.

In terms of appeal mechanisms, the Australian Chamber notes that the Government intends to include a provision that affected counterparties may apply to the court to vary contract terms if they can show that they have suffered hardship.

However, this provision may not be an appropriate safeguard. It requires counterparties to have already been adversely affected. Unless matters before a court can be heard quickly, it may well be too late for many small businesses operating under tight cash-flow conditions.

The Australian Chamber therefore recommends that the provision allows affected counterparties to apply to the court to vary contract terms if they can show they *may* suffer hardship.

Recognising that many small businesses do not have the capacity to go to court, the Australian Chamber encourages alternatives to court involvement for straightforward procedural matters in voluntary administrations; for example, for requests for extensions of time, approval of contracts over 3 months, or compromises of debts[5].

To provide a safeguard for small business, one option could be for ipso facto clauses to continue to operate for businesses that meet the small business 'effects test'.

[4] Improving bankruptcy and insolvency laws, Proposals Paper, Op. cit. Page 17.
[5] ARITA, Op. cit., Page 13.

Australian
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2 About the Australian Chamber

The Australian Chamber of Commerce and Industry speaks on behalf of Australian business at home and abroad.

Our membership comprises all state and territory chambers of commerce and dozens of national industry associations. Individual businesses also get involved through our Business Leaders Council.

We represent more than 300,000 businesses of all sizes, across all industries and all parts of the country, making us Australia's most representative business organisation.

The Australian Chamber strives to make Australia a great place to do business in order to improve everyone's standard of living.

We seek to create an environment in which businesspeople, employees and independent contractors can achieve their potential as part of a dynamic private sector. We encourage entrepreneurship and innovation to achieve prosperity, economic growth and jobs.

We focus on issues that impact on business, including economics, trade, workplace relations, work health and safety, and employment, education and training.

We advocate for Australian business in public debate and to policy decision-makers, including ministers, shadow ministers, other members of parliament, ministerial policy advisors, public servants, regulators and other national agencies. We also represent Australian business in international forums.

We represent the broad interests of the private sector rather than individual clients or a narrow sectional interest.

Australian Chamber of Commerce and Industry

Australian Chamber Members

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