TMA Turnaround Management Association® Australia

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TURNAROUND MANAGEMENT ASSOCIATION AUSTRALIA (TMA) SUBMISSIONS TO THE NATIONAL INNOVATION AND SCIENCE AGENDA

IMPROVING BANKRUPTCY AND INSOLVENCY LAWS

SAFE HARBOUR – PROPOSED NEW MODEL

1. INTRODUCTION TO TMA RESPONSE

The TMA has confined these submissions to answering the questions set out in the Safe Harbour proposal contained in the Safe Harbour October Consultation Paper (**October Consultation**), and will not address the proposals made in relation to default bankruptcy periods and *ipso facto* clauses.

2. RESPONSES TO QUESTIONS FOR FURTHER CONSULTATION

2.1 Should the onus remain on liquidator (carve out structure) or should it be placed on the director (defence)?

The TMA supports the carve out structure proposed. While a defence is a useful tool to promote the use of Safe Harbour, it may be cold comfort to directors (particularly directors of SMEs and start-ups) who are not properly insured or otherwise cannot afford to take the risk of being sued and defending their conduct in court.

The proposed Safe Harbour regime should be robust. TMA would like to see directors receive a similar level of protection from subsequent litigation under Safe Harbour as they receive by appointing voluntary administrators. The carve out model would achieve this purpose and give directors a real, viable alternative to voluntary administration, that is not informed by fear of personal liability for insolvent trading.

If the Safe Harbour is introduced, the decision about appointing an external administrator will be based on a different set of considerations, and move away from being based on directors' fears over their personal liability, such as whether:

(a) the company is strictly or hopelessly insolvent;

(b) the moratorium on enforcement of unsecured creditor claims and the restriction on enforcement of secured creditor claims that apply in a voluntary administration is necessary in order to effect a restructure;

(c) some creditor claims need to be involuntarily compromised in order to effect a restructure; and

(d) the directors have the ability/expertise to personally implement the turnaround (with the assistance of advisors) or whether the turnaround would be better managed by an external administrator.

In the TMA's submission, the carve out model will not only deliver a more robust and utilised Safe Harbour, but will also allow voluntary administration to be effectively used more effectively for the purpose for which it was intended. To ensure that the carve out does not operate as a defence in practice, NISA could consider imposing a leave requirement on insolvency practitioners who seek to bring insolvent trading claims against directors on behalf of the company. Such a measure would ensure that only insolvency practitioners who have, as a result of their independent investigations into the affairs of the company, proper grounds for alleging that the directors did not properly invoke Safe Harbour would be allowed to issue proceedings.

2.2 What should be indicia of "reasonable grounds"?

The TMA understands that there are two limbs of the proposed Safe Harbour carve out and that the "reasonable grounds" test will apply to both limbs. Our guidance as to the indicia of "reasonable grounds" varies for each limb and is set out below.

(a) First limb - the question of solvency

The first limb of the proposed "Safe Harbour test" is that *a director will not be personally liable for debts where he/she had reasonable grounds to expect (and did expect) that at the time when the debt was incurred, the company would pay or otherwise discharge the debt in accordance with its terms*

This limb is really directed to asking whether there is a reasonable expectation that, on incurrence (i.e *the time when the debt was incurred)*[1]:

(i) the company is solvent; or

(ii) if the company is not presently solvent or is in the twilight zone of insolvency, the company can be restored to solvency as a result of the implementation of the restructuring plan.

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[1] We note that the term "incurrence" is a term of legal complexity. Its precise meaning would need to be clarified if included in the legislation. If that were to be the case, we would expand upon the interpretation issues entailed as part of any consultation process.

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Given the similarities of this test to the existing "solvency" defence to insolvent trading under s 588H(2) of the *Corporations Act*, and the significant body of judicial guidance on in that regard, the TMA considers that the indicia of reasonable grounds for Safe Harbour should be similar to the indicia applied to that provision. By way of high level summary:

(i) The "reasonable expectation" of the ability to pay debts as and when they fall due should be interpreted to mean more than a mere hope or possibility or suspicion.[2] In the case of *Hall v Poolman* (2007) 215 FLR 243, Pamer J said that when considering a company's solvency, a reasonable director would ask:

> *How sure are we that this asset can be turned into cash to pay all our debts…Is that outcome certain, probable, more likely than not, possible, possible with a bit of luck, possible with a lot of luck, remote, or is there no real way of knowing..*

(ii) If the answer using the above test is "certain" or "probable" then the director can have a reasonable expectation of solvency. If the answer is "possible" or "no" then the director can have no expectation of solvency. In his honour's view, if the answer is "more likely than not" there is a risk for the director that a court would hold to the contrary in an insolvent trading claim. **However, in the TMA's view, the Safe Harbour carve out should be interpreted more broadly, and where it is *more likely* than not that the company will be able to pay its debts following the implementation of the restructuring plan, Safe Harbour should be afforded to the board.** The purpose of the broad interpretation of the Safe Harbour carve out is discussed further below.

(iii) The question of whether the director could have reasonably held the expectation of the company meeting its liabilities should be considered in light of all the circumstances of the company, including its practical business environment and the timeframe in which the directors must make the trade-on decision.[3] Relevant considerations for the board include:

 (A) whether the company's anticipated current and future cash flows will be sufficient to enable current and future liabilities to be paid as and when they fall due for payment;

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2 *Tourprint International Pty Ltd (in liq) v Bott* (1999) 32 ACSR 201.

3 *New World Alliance Pty Ltd, Re; Sycotex Pty Ltd v Baseler* [No 2] (1994) 51 FCR 425.

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(B) whether additional money can realistically be raised in a timely manner from the issue of additional share capital, or from future borrowings;

(C) whether there are surplus assets that can be sold in a relatively short period of time to help pay debts without damaging the company's ongoing ability to trade and pay all its debts when they fall due;

(D) taking into account the company's assets and liabilities as a whole, including the company's ability to collect debts owed to it within agreed terms, and whether arrangements have been negotiated with creditors to defer payment of outstanding debts; and

(E) whether the company is suffering from a mere temporary lack of liquidity that may be overcome in the short term.

The proper test is one of "commercial realities", hence when assessing whether liquidity, debts are payable according to terms unless the company has in place (or the board reasonably expect there to be in place because of prior estoppels, industry course of conduct or high probability of) arrangements with creditors changing those terms.[4]

It goes without saying that the directors have a duty to positively monitor the company's financial position in terms of its ability to pay its debts. Directors must turn their minds to the financial position of the company and make a positive decision to trade on, as opposed to simply maintaining the status quo and hoping for the best.

Satisfaction of the first limb of the test by directors will usually involve complex accounting or legal questions that are beyond the personal expertise of the board members. Where the board is contemplating the company's solvency, depending on the expertise and training of the board members, appropriate advice (internal or external) will ordinarily be required to satisfy the first limb of the Safe Harbour test. Such advice will ordinarily need to be independent, robust and detailed.

(b) Second limb – the restructuring plan

The second limb of the proposed "Safe Harbour test" is that *a director will not be personally liable for debts where they had reasonable grounds to expect (and did*

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[4] *Hall v Poolman* (2007) 65 ACSR 123; *Carrello (as liquidator of Perrinepod Pty Ltd(in liq)) v Perrine Architecture Pty Ltd* (2016) 112 ACSR 448.

expect) that the interests of the company and the creditors as a whole would be better served than by proceeding to formal insolvency.

One of the key criticisms of debtor in possession regimes (such as the US Chapter 11) is that they leave the incumbent management in control of the workout process. This may cause concern to stakeholders because, after all, the company has become distressed under the supervision of its existing management. In order to protect creditors and other stakeholders, such as shareholders, the board needs to do more than merely trade-on the company. The company does in some way need to "change course" and steer into the zone of Safe Harbour rather than perpetuating the status quo. In the TMA's submission, there should be four elements to the second limb of the test:

(i) a restructuring plan must be formulated - relevantly here s189 *Corporations Act*, allows a board to take advice from various internal and/or external advisors having regard to competency and reasonableness concepts;[5]

(ii) the board must have a reasonable expectation that the plan can be implemented;

(iii) the board must have a reasonable expectation that the implementation of the plan will produce a better result for the company and creditors than VA and/or liquidation; and

(iv) the board must take reasonable steps towards implementing the plan.

Formulating the restructuring plan

The directors, after turning their minds to the question of the company's solvency under the first limb, then need to develop a plan or strategy to facilitate the turnaround. The TMA is not in favour of a prescriptive test as to what constitutes a restructuring plan. This is a question that the Courts will consider over time and having regard to the individual circumstances of each case. For major commercial enterprises, the restructuring plan may be contained in a formal document, prepared in consultation with a range of external advisors, including lawyers, accountants, insolvency practitioners and/or restructuring advisors and cover a wide range of strategic aspects.

In the SME space, depending on the circumstances, it may be that the restructuring plan does not need to be contained in a formal document and,

5 Albeit s 189 of the *Corporations Act* does not apply to insolvent trading concepts, however, this is an analogous principle and could be applied to Safe Harbour.

further, that external advice may not be required. The restructuring plan may involve various aspects of the business, or it may be more straightforward and focus on just one element of the business, such as the sale of a redundant or less profitable asset, diversifying into a new product or service, implementing cost cutting measures or acquiring of infrastructure required to make the business profitable.

Whilst the TMA is not in favour of a prescriptive test as to what constitutes a restructuring plan, the directors should as a minimum by resolution reference the plan, what key actions they will take to affect the plan, over what timeframe and that the restructuring plan is reasonably capable of implementation and that it was in the best interests of the company, and the creditors as a whole.

Considering whether the plan can reasonably be implemented

The restructuring plan must be reasonably capable of implementation. The company cannot continue to trade and incur debts, in circumstances where the restructuring plan is a mere hope or an unrealistic dream. The TMA is not in favour of a prescriptive set of circumstances that define when a restructuring plan can be said to be reasonably capable of being implemented. The TMA encourages the use of Safe Harbour to enable innovation and entrepreneurship in the formulation of a restructuring plan by a company.

However, the TMA notes that for the implementation of many restructuring plans to be successful, debtor in possession financing or at least a form of liquidity will be required. This may be in the form of a fresh facility or a renegotiation of arrangements with existing lenders. Where the restructuring plan requires a major capital investment, and the company has already defaulted on loans, has been denied new credit and/or cannot realise assets to fund the restructuring plan, the plan may not be reasonably capable of implementation. Furthermore, if reasonably unforeseen circumstances arise and derail the implementation of the restructuring plan then this should not affect the availability of the Safe Harbour protections. The reasonable expectation should be based on information reasonably available to the board at the time of resolving or deciding to pursue the restructure as opposed to invoking an external administration procedure.

Considering whether the plan will produce a better result for creditors than external administration

A restructuring plan should only be implemented if the board has a reasonable expectation that implementation of the restructuring plan will produce a better result for creditors than liquidation/voluntary administration. In relation to this

limb of the test there is judicial guidance readily available, as the test is substantially similar to the factors that a Court will take into account in terminating a Deed of Company Arrangement (DOCA).

(i) A better result than liquidation?

Under s 445D of the *Corporations Act*, the Court may terminate a DOCA where it is contrary to the interests of the creditors as a whole. There is judicial guidance of what is in the best interests of creditors in the context of this provision. They key principle is that *the benefit of the proposed course of action should be weighed against the alternative, usually liquidation.*[6]

In the TMA's submission, in order for a board to satisfy itself that its proposed course of action is a better alternative than liquidation, an analysis of the return to creditors upon immediate liquidation must be undertaken (**Liquidation Analysis**). This should then be compared against an account of the likely return produced by the proposed course of action (**Restructure Analysis**).

The TMA does not advocate for the imposition of restrictions on who must produce these analyses (ie, by a restructuring adviser or insolvency practitioner). However, the TMA considers that this is likely the most appropriate course in the case of a complex or major corporate turnaround and it would afford greater protections for directors than if it is prepared by, for example, the company's management.

However, in the SME space, a board member may have the accounting skills to produce the analyses for the enterprise. Equally, the SME board may seek advice from an internal accountant, obtain the views of the company's auditor or engage an independent accountant or auditor to review the financial position of the company and produce the Liquidation Analysis and Restructure Analysis.

The onus of seeking advice (if required) and selecting appropriate advisers (whether they are internal or external) should remain with directors, further recognising that the purpose of Safe Harbour is to facilitate the continued control of directors while the affairs of the company are being resolved.

[6] *University of Sydney v Australian Photonics Pty Ltd* (2005) 53 ACSR 579.

Once both analyses are produced, the board must form a view as to the appropriate next step, having regard to the outcomes foreshadowed in the Restructure Analysis and the Liquidation Analysis.

(ii) A better result than Voluntary Administration?

Further, the board should also consider whether implementation of the restructuring plan would produce a "better result" than entry into voluntary administration.

In most cases, where there is a restructuring plan that is reasonably capable of implementation and which is expected to produce a better result for creditors than liquidation, the informal workout will be a better option than voluntary administration. This is because voluntary administration will necessarily involve the costs associated with the appointment of administrators. There is also the adverse impact on the value of companies that often follows the appointment of administrators. However, the following factors may be relevant to the board's assessment of whether voluntary administration is a better option than the implementation of a proposed restructuring plan:

(A) whether the expertise of the administrator is required in order to implement the restructuring plan;

(B) whether debtor in possession finance is available to the company, but may not be available to or accepted by an administrator;

(C) whether the insolvency practitioner who is to be appointed as administrator was involved in the development of the restructuring plan and is able/willing in accordance with their duties to effectively implement the restructuring plan as a "pre-pack"; and/or

(D) the attitude of unsecured creditors towards the restructuring plan and whether a moratorium on enforcement of their claims and/or the ability to involuntary bind dissenting creditors to the restructuring plan is necessary for it to succeed.

Balancing the competing interests of creditors and the company

In many informal workouts, the interests of creditors and the company will be aligned, as the continuation of the company in existence provides scope for creditors and shareholders to receive their full entitlements in due course.

However, where the interests are not aligned, the interests of creditors should be paramount, given the risk of actual or imminent insolvency.

Further, in accordance with judicial interpretation of the *Corporations Act*, when balancing the competing interests of various classes of creditors, the anticipated benefit to creditors of one option over another does not have to be equal across all classes of creditors if there are reasonable grounds for any differentiation.[7]

Taking reasonable steps towards implementation of the restructuring plan

The board must take reasonable steps towards implementing the restructuring plan. The steps to be taken will depend on the nature of the business and the requirements of the restructuring plan. Generally speaking, however, a prudent board should meet often, monitor the implementation of the plan, maintain good financial records, maintain a ongoing dialogue with customers and other counterparties, monitor and regularly forecast short and longer term cashflows. Large proprietary companies and ASX-listed companies should also regularly assess their disclosure obligations. In particular, the board should consider whether it is necessary to release earnings guidance to the market. Further, if, during the course of the restructuring, the directors form the view that the company is strictly insolvent, or an independent opinion is given that the company is insolvent, appropriate disclosure should be made to the market to avoid breaches of the *Corporations Act* continuous disclosure obligations and/or the ASX Listing Rules[8]. Naturally, in addition, consideration would have to be given to the appointment of voluntary administrators.

The onus of seeking advice (if required) and selecting appropriate advisers (whether they are internal or external) should remain with directors during the implementation phase of the restructuring plan.

Of course, perhaps if reasonably unforeseen circumstances arise and derail the implementation of the restructuring plan, this should not affect the availability of the Safe Harbour protections for the relevant plan. If such circumstances do arise, it may be appropriate for the directors to develop a new restructuring plan or adapt the existing plan to address the change, rather than simply placing the company into external administration. In this scenario, it would be appropriate for the directors to have to satisfy the second limb of the Safe Harbour test having regard to the new or adapted plan.

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[7] *Fleet Broadband Holdings Portinex Pty Ltd* (2000) 156 FLR 453, [102]; *Lam Soon Australia Pty Ltd v Molit* (No 55) Pty Ltd (1996) 70 FCR 34.

[8] *Grant Taylor v Babcock & Brown Limited (in liq)* [2016] FCAFC 60.

The TMA is in favour a broad interpretation of Safe Harbour protection

The TMA considers that the Safe Harbour test should be interpreted broadly. The purpose of Safe Harbour is to encourage innovation, entrepreneurship and ensure that ideas, jobs and viable businesses are not lost unnecessarily. Directors should be afforded flexibility in their approach to turnaround and should not be judged unduly harshly where a bona fide restructuring effort fails. In the TMA's view, the goals of Safe Harbour should be to positively impact the Australian economy by promoting a turnaround culture in the local market and de-stigmatising business failure. The proposed Safe Harbour provisions should be interpreted with these goals in mind.

2.3 **What behaviours would mean that directors would no longer have reasonable grounds to be carved out of s588G?**

Any actions contrary to the guidance prescribed in 3.2 above (*indicia of reasonable grounds*) would negate the directors' Safe Harbour protection. In particular, a trade-on, absent the proactive turnaround steps, including an assessment of the company's financial position and the formulation and implementation of a reasonable restructuring plan, should result in Safe Harbour being unavailable. Safe Harbour is not intended to protect directors who simply trade-on through distress, wilfully blind or ignorant to that distress and/or without a clear turnaround strategy.

The TMA agrees that, as priority creditors under the liquidation regime in the *Corporations Act*, employees should also be afforded special consideration in respect of the restructuring plan. A plan that without employee consent defers or compromises employee entitlements, including wages and superannuation, should not attract the protection of Safe Harbour.

2.4 **"Better served" is not a term of art. In drafting, what would be an appropriate standard or threshold?**

To give effect to the expression 'better served' in the drafting of legislation, the following wording could be used (relevant text in **bold**):

That a Director will not be personally liable for debts where they had reasonable grounds to expect, and did expect:

(a) *that at the time when the debt was incurred, the company would pay or otherwise discharge the debt in accordance with its terms; and*

(b) *that it was in the* ***best interests of the company, and the creditors as a whole****, to continue trading in order to implement a restructuring plan, as an alternative to placing the company into external administration.*

As mentioned above, the board needs to do more than merely trade-on the company. The reasonable formulation and implementation of a restructuring plan is essential to the concept of Safe Harbour. The turnaround plan must be concrete and capable of being managed, and the implementation must be capable of being reported against by the company's staff who are on the ground implementing the plan. Any subsequent controller of the company, whether an insolvency practitioner or a newly constituted board, should also then be able to assess whether the plan was appropriate and whether reasonable steps were taken to implement it.

The TMA submits that all the factors set out in 3.2 above (*indicia of reasonable grounds*) should also be imported into this revised test.

2.5 **Is it preferable to have further guidance in legislation (Act or Regs) or somewhere else?**

The TMA would prefer any guidance to be in the form of RGs issued by ASIC rather than in regulations because of political difficulties in revising regulations to meet changing markets.

Some considerations for market practice guidance the regulator may wish to consider are the steps required to properly invoke Safe Harbour, namely that for Safe Harbour to be properly afforded to directors:

(a) the directors to have, at the time of trading on the business, reasonable expectations that:

(i) the company is solvent;

(ii) if the company is not presently solvent (or is in the twilight zone of insolvency) the company can be restored to solvency as a result of the implementation of the restructuring plan;

(b) a restructuring plan must be formulated;

(c) the directors must have a reasonable expectation that the restructuring plan can be implemented;

(d) the directors must have reasonable expectations that it was in the best interests of the company, and the creditors as a whole, to continue trading in order to

implement a restructuring plan, as an alternative to placing the company into external administration; and

(e) the board must take reasonable steps towards implementing the restructuring plan,

(together, the **Safe Harbour Steps**).

The TMA considers that any further legislative guidance (either in the Act or Regulations) may be too prescriptive. In our view, the goal of Safe Harbour should be clearly articulated in the legislation, ie that it is to provide a viable alternative to voluntary administration for *all* Australian companies. In this way, the test should be able to be flexible and agile and applicable to the full range of Australian businesses and turnaround scenarios. Appropriate places for further guidance on Safe Harbour are:

(a) the explanatory memorandum / second reading speech for the Bill;

(b) ASIC guidance notes; and

(c) over time, judicial consideration of the provisions.

The TMA welcomes the inclusion of any of its guidance on what will constitute satisfaction of the Safe Harbour Steps (set out in 3.2 above *indicia of reasonable grounds*) in any published materials.

2.6 **What consequential amendments would be required to ensure the integrity of Safe Harbour?**

The TMA does not propose any further amendments to the *Corporations Act*.