AMENDMENTS TO INSOLVENCY REGIME: SAFE HARBOUR AND IPSO FACTO

By Shaun McGushin, Director Ash St.[1] - February 2018

Following the Government's implementation of the National Innovation and Science Agenda, there has been much focus on promoting a culture of entrepreneurship and innovation in Australia. As part of this agenda, the *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (Cth) (**Amending Act**) was passed on 11 September 2017 to reform Australia's insolvency laws contained in the *Corporations Act 2001* (Cth) (**Corporations Act**) and with an aim of striking a better balance between encouraging entrepreneurship and protecting creditors. Regardless of the final catalyst, this legislation has been a long time coming but has created a safe harbour for directors from personal liability where the company is attempting a recovery from insolvency, as well as limiting the enforceability of certain "ipso facto" clauses.

WHAT IS INSOLVENT TRADING?

Insolvent trading is a civil penalty provision under the Corporations Act which can impose personal liability on a director if he or she fails to prevent the company from incurring a debt, where:

(a) the director is a director of the company at the time the company incurred the debt;

(b) the company is insolvent at that time or becomes insolvent by incurring that debt or debts including that debt; and

(c) the director is aware at the time that there are grounds for so suspecting, or a reasonable person in a like position would be so aware.

Insolvent trading becomes an offence if the director's conduct was dishonest.

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SAFE HARBOUR PROVISIONS

The Amending Act introduces a new section 588GA to the Corporations Act, which provides that a director does NOT breach the insolvent trading civil penalty provision if:

(a) after the director starts to suspect the company may become or be insolvent, the director starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and

(b) the debt is incurred directly or indirectly in connection with any such course of action during the period starting at that time, and ending at the earliest of any of the following times:

i. if the director fails to take any such course of action within a reasonable period after that time—the end of that reasonable period;

ii. when the person ceases to take any such course of action;

iii. when any such course of action ceases to be reasonably likely to lead to a better outcome for the company;

iv. the appointment of an administrator, or liquidator, of the company.

"Better outcome" is defined as "an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company".

Further, the Amending Act now sets out a list of non-exclusive factors when considering whether a course of action is "reasonably likely" to lead to a "better outcome". These include whether the director:

(a) is properly informing himself or herself of the company's financial position;

(b) 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 its debts;

(c) is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or

(d) is developing or implementing a plan for restructuring the company to improve its financial position.

Similarly, a holding company of a company, which fails to prevent insolvent trading, will not be liable if the holding company has taken reasonable steps to ensure that the safe harbour applies to each of the directors of the company and the debt, and the safe harbour does, in fact, apply.

The safe harbour acts as a carve-out to liability and the director will bear the evidential burden of proving that the safe harbour should apply. It is worth noting also that the safe harbour only protects a director from liability under the civil penalty provision, and not where he or she has committed an offence.

These provisions should allow some space for directors to have a company undertake a restructure before formal insolvency and attempt to make the company viable in the longer term. It is also aimed at addressing director's concerns over inadvertent breaches of insolvent trading laws and encouraging further engagement from angel investors and professional directors in start-ups and SMEs.

The safe harbour provisions will be independently reviewed in 2 years as to their impact (s588HA).

CONDITIONS OF SAFE HARBOUR

In order to rely on the safe harbour provisions, the company must, at the time the debt is incurred, be compliant with its employee entitlement and tax reporting obligations. Where such non-compliance leads to less than "substantial compliance", or is one of two or more failures by the company in the last 12-month period, the safe harbour will not be available.

However, the Court may make an order to exempt the company from these conditions if the failures were due to exceptional circumstances, or the exemption would be in the interests of justice.

The safe harbour may also not be available if the director fails to fulfil its statutory obligations to provide certain reports or provide books or information to the administrator, liquidator or court although again, there are certain exceptions to this.

WHAT IS AN IPSO FACTO CLAUSE?

An ipso facto clause is a common clause in commercial contracts, which typically allows one party to terminate the contract if the other party is subject to an insolvency event. Parties utilise this provision to protect themselves from being continued to be bound to a contract in circumstances where the future of the other party or its ability to pay or perform is uncertain.

RESTRICTION ON ENFORCEABILITY OF IPSO FACTO CLAUSES

The Amending Act will insert provisions into the Corporations Act which will restrict counterparties to a contract from enforcing their contractual rights during a "stay period", for the sole reason that the company has entered into administration, a scheme of arrangement or receivership or similar arrangement. The stay will apply to all contracts, however the Corporations Regulations may prescribe, or the minister may direct that certain contracts or rights not be subject to the restriction on enforceability.

As ipso facto clauses may severely disrupt a company's business if they are able to be enforced, the restriction on enforceability operates to protect a company's value and improve the likelihood of a successful restructure.

The ipso facto regime will not apply to contracts entered into before the commencement of the regime.

The restriction on the enforceability of ipso facto clauses are yet to commence, and will only commence upon proclamation (which has not yet occurred), or 1 July 2018.

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Shaun leads the Ash St. Projects & Finance team. He is one of Australia's most experienced advisers on infrastructure and finance, including buying and selling infrastructure assets, public private partnerships, project finance, corporate finance, acquisition finance, capital markets and workouts.

Formerly a partner of both Corrs and Freehills, Shaun has over thirty years' experience advising local and international corporates on a wide range of transactions with particular focus on the infrastructure, power, energy and resources industries. He has a reputation for successfully completing major transactions, no matter how complex, and is sought for his strategic and negotiating skills.