Turnaround Management Association: Nextgen Essay

Sam Cole

The current insolvency trading regime in Australia is largely considered to be one of the harshest regimes in the world[1]. The assessment of the solvency of a company is not a black and white exercise; however, a director must maintain an ongoing vigilance for their company's solvency during the "twilight zone" or risk personal liability for all debts incurred since that point. Research indicates the risk of directors personal liability significantly shapes their decision making[2] and is likely to be a key driver of pre-mature insolvencies[3]. An example is the Henry Walker Eltin group, of which the directors cited concerns with incurring an insolvent trading liability caused them to place the company into administration. This highlights the conflict of interest between the key stakeholder groups; the interests of the company and its creditors and the directors personally.

Recent proposed insolvency reform has been driven by concerns that the current laws prevent successful informal restructures and drive the destruction of business value. The stigma of insolvency, limited timeframes associated with the Voluntary Administration ("VA") process, termination of contracts through ipso facto clauses and general uncertainty during the insolvency period all result in an immediate detrimental impact on the enterprise value of a company[4]. The proposed safe harbour defence aims to preserve the value of restructuring by allowing a mechanism for directors to trade a viable company which may be insolvent for the best interests of its company. The successful restructure of General Motors in America during 2010, which traded insolvent for months whilst negotiating and executing a restructure, is a practical example of the potential of safe harbour defences.

The proposed safe harbour reforms discussed in the Australian Government's Proposals Paper dated April 2016[5] ("Proposals Paper") aim to place the emphasis back on conduct in the best interests of the company and its creditors, eliminating the personal liability of directors if specific requirements are met. The key safe harbour requirements as contained in the Proposals Paper, for Model A, which I will focus on throughout this paper are:

> *"that at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring advisor, that the company can be returned to solvency within a responsible period of time, and the director is taking reasonable steps to ensure it does so."*[6]

The Proposals Paper goes further to establish that the above defence would apply where the company appoints a restructuring advisor who:

> (a) *"is provided with appropriate books and records within a reasonable period of their appointment to enable them to form a view as to the viability of the business; and*
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> (b) *is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time."*[7]

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[1] Ben Larkin, *Restructuring and Workouts – Strategies for Maximising Value* (2008)

[2] Australian Institute of Company Directors & King & Wood Mallesons, *Directions 2016: Current issues and challenges facing Australian directors and Boards* (2016)

[3] Commonwealth of Australia, The Treasury*, Review of Sanctions in Corporate Law Discussion Paper Summary of Submissions*, (August 2007)

[4] Ryan Purslowe, *Decisions in the Twilight Zone of Insolvency – Should Directors be afforded a new safe harbor?,* (2010)

[5] Australian Government, *National innovation & Science Agenda, Improving bankruptcy and insolvency laws, Proposals Paper* (April 2016)

[6] Ibid [3]

[7] Ibid [3]

Based on a four year study, the resumption of normal trading post VA only occurs approximately 10 per cent of the time and of the companies that entered VA, 61% had a liquidator appointed or were deregistered[8]. More recently, studies show an increased utilisation of insolvent restructures, up to November 2009, 39% of companies that went into VA successfully executed a DOCA[9]. Despite this, the low success rate indicates the need for reform.

The key advantage of the proposed safe harbour defence is the preservation of enterprise value through a restructure process outside of insolvency, avoiding its detrimental effects, which is likely to benefit all classes of creditors and better support the objective of the voluntary administration regime.

Secured creditors often take a "haircut" on their debt in an insolvency scenario, regardless if a successful restructure is achieved through DOCA or otherwise. Under safe harbour, secured creditors will likely be involved in high level restructuring discussions and negotiations whilst the enterprise value is preserved. If the secured debt is to be refinanced, the secured creditor will have more involvement and further bargaining power than in the insolvent scenario, resulting in a better outcome.

An issue for secured creditors with the safe harbour defence is if we consider a scenario where the secured creditor has concerns or disagreements surrounding management, such as Arrium Ltd, in which it was widely published that there was a disagreement between the parties regarding management's actions and ability to continue to trade the business. Under the safe harbour defence, whilst the company may be trading insolvent the secured creditor may not be able to enforce its rights unless a default or breach of conditions has occurred.

The average estimated return to unsecured creditors (based on s439A reporting) through the current insolvency process was less than 11 cents in the dollar in 97% of the cases, for financial year 2012 to 2014[10]. This minimal return on an unsecured creditor's debt creates a further knock on effect throughout the economy, resulting in further financial pressure and insolvencies. Under the proposed safe harbour defence initiative, a director's focus will be primarily on the restructure and viability of the business rather than their personal liability and may do so at an earlier stage providing the maximum prospects for a restructure alternative. Any successful restructure, would presumably involve in the creditors receiving payment of their debt in full leave them better off than in insolvency scenario.

In the event a restructure is not successful and the directors have continued to incur trading debts of the company throughout the potential restructure period, the return to unsecured creditors will have deteriorated. Further, in a safe harbour defence scenario, there would be no additional insolvent trading claim against the directors to provide potential upside to unsecured creditors. Concerns have also been raised regarding restructuring advisors effectively supporting phoenix activities through these provisions[11]. The Proposal Paper proposes to mitigate this risk by

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[8] Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, Corporate Insolvency Laws: A Stocktake (2005). Of the 5760 companies that entered into voluntary administration over the four years from 1993 to 1997, 592 resumed normal trading.

[9] Cliff Sanderson, *The Business Stress Report* (January 2010)

[10] ARITA, *Discussion Paper: Business Set-up, Transfer and Closure, Productivity Commission Draft Report May 2015* (6 July 2014)

[11] Jason Harris & Anil Hargovan, *Productivity Commission safe harbor proposal for insolvent trading,* (February 2016)

requiring a restructuring advisor to provide an opinion that the company is "can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time" and will require the registration of an advisor with a recognised organisation (discussed further below).

In a restructure under the safe harbour provision, creditors will not have the personal liability protection that they would be afforded under an insolvent restructure in the current system. In this scenario, directors can continue to incur debts, which the company may not have the ability to pay, with impunity. If the restructure fails, creditors may be left in a worse situation than if the company had entered insolvency.

In light of the above, it is important to note the safe harbour defence is not applicable to all companies; rather it is only to be used as restructure solution for "viable businesses". SME's businesses which are undercapitalised or have inadequate cash-flow may not be suitable candidates for an informal restructure and will need to be dealt with under the current insolvency regime.

Employees, as a whole, will benefit from the implementation of the safe harbour provisions through the retention of their jobs. Although, the cornerstone of any restructure strategy plan is the assessment and potential reduction of headcount, the alternative to place the company into insolvency would place all employees' jobs at risk. Further, any redundancies would involve the payment of entitlements in an orderly timeframe unlike the significant delays which can be experienced in an insolvency scenario.

Shareholders, whose value is generally lost in full, are very adversely affected and often blindsided by the current insolvency process. Prior to or upon entering insolvency, a company's shares are placed into a trading halt and cannot be transferred without the consent of the insolvency practitioner. Shareholders are not entitled to receive reports to creditors or other information on the process of the insolvency, without the consent of the appointee, and are not entitled to vote in the Administration process. Further, under s444GA of the Corporations Act and as demonstrated in recent case law (*Mirabela Nickel, Nexus Energy*) the shares in the company can be forcibly transferred through the Court.

The proposed safe harbour provisions provide a means for the preservation of enterprise value of the company. If a director has relied on the safe harbour provisions and the subsequent restructure has been successful, shareholders will retain their interest in the company, providing a maximised return when faced with the alternative. For a public company, this will result in shareholders being able to realise their investments in the ordinary course.

If we consider one of the most successful and recent restructures in Western Australia, Atlas Iron Ltd, the safe harbour defence would have eased the directors' reliance on numerous forbearance and debt re-negotiations from the secured creditors. This may have resulted in a shorter and simpler process for the restructure than the c12-15 month process which was widely published (although it would also have its own intricacies).

The most pertinent issue with the current proposal is the lack of definition of what exactly constitutes a "restructuring advisor". The Proposal considers that a restructuring advisor must be an accredited member of an organisation, approved by the Minister, with its own (i) disciplinary framework, (ii) educational framework, and (iii) ethical standards[12]. This is in stark contrast to the current regulation regime for restructuring advisors which is non-

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[12] Ibid [5]

existent, although must advisors are members of ARITA, CAANZ, TMA or related body. This would result in restructuring advisors being held to varying and inconsistent codes of conduct. A universal regulation resume most likely through ASIC in conjunction with a professional body upholding professional code of conduct such as TMA, would be the most appropriate form of regulation.

As identified by Jason Harris[13], the implementation of any regulation regime will result in a reduced pool of advisors which may inadvertently increase the costs associated with a restructure; although the viability of a business for restructure should not be hindered by these increased costs.

In consideration of all of the above, the safe harbour reforms represent a significant step in the right direction for promoting successful restructure and preserving value. The implementation of the defence is likely to provide an improved outcome for all stakeholders, although not without the risk of failure.

[13] Ibid [11]