The effect of voluntary administration on business restructuring

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Voluntary administration is the formal corporate rescue mechanism in the Corporations Act and was meant to provide a way to save businesses. However, the numbers of voluntary administration are declining and the returns on deeds of company arrangement are less than 10c in the dollar. Recent public policy inquiries have recommended various law reform measures to facilitate corporate rescue and turnaround. This paper discusses two such measures: insolvent trading reform, and ipso facto clauses in contracts.

INTRODUCTION

Insolvency and restructuring law reform have been hot topics of public policy debate for several years now. Several developed and developing nations such as Germany, Hong Kong, Singapore, Spain and South Africa, have undertaken formal law insolvency law reform to promote corporate restructuring and rehabilitation. The European Commission has also commenced a major reform project to facilitate corporate rescue.1 The United States, often mentioned as a global standard for restructuring laws, has also undergone an extensive law reform exercise with the American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11 delivering its 402-page report in December of 2014, with more than 100 recommended reforms for the Bankruptcy Code of 1978. Suffice it say that many nations with large economies are reviewing their insolvency laws to promote corporate restructuring and rescue.

In contrast, during the past several years Australia’s insolvency law reform initiatives have focused largely on the regulation of insolvency practitioners, with the release of the draft Insolvency Law Reform Bill 2014 by Treasury. This Bill features a move to a licensing regime with periodic reviews and increasing creditor rights over remuneration, provision of information and removal of insolvency practitioners. The shadow cast by notable rogue insolvency practitioner (now convicted criminal) Stuart Ariff continues to drive a highly reactive policy debate that is (overly) obsessed with practitioner regulation and accountability rather than substantive insolvency and restructuring laws.2

Corporate restructuring laws have been included in public policy reform debates, but this has not yet generated any substantive amending legislation. This has included, most notably, a small part of the Financial System Inquiry and a large part of the (still ongoing) Productivity Commission investigation into

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business start-up, transfer and closure. In the time since the Global Financial Crisis there have been a range of attempts to foster law reform to better support restructuring attempts, largely driven by professional bodies such as ARITA and the Law Council of Australia. This is an important issue if Australia is to remain an attractive destination for global capital. Having an effective insolvency and restructuring legal framework is an important factor for global funds looking for investment opportunities both for profitable businesses, and especially for distressed businesses.

The restructuring environment in Australia has changed a great deal since the Australian Law Reform Commission (the Harmer committee) produced its comprehensive report into insolvency law in 1988. Voluntary administration (a key recommendation of the Harmer Report) rose to prominence up until the mid-2000s but since 2007 have dropped to just 13% of companies that enter formal corporate insolvency. Creditors’ voluntary liquidations are now the most common form of insolvency appointment making up 49% of companies that enter formal insolvency.\(^3\) The rates of return on insolvency appointments continue to languish at minimal levels of 10c in the dollar or less.\(^4\) The majority of corporate insolvencies leave no return to creditors.

Restructuring in Australia may use a formal mechanism such as a scheme of arrangement, with major debt restructurings involving Nine Entertainment, Centro and Alinta using this model. However, creditor schemes remain relatively uncommon outside of very large and complex restructurings. There are just over 1,200 voluntary administrations each year with roughly 1/3 of those entering a deed of company arrangement which may be used to restructure or (more likely) to sell the business or its assets. Empirical research suggests that unsecured creditor returns for deeds of company arrangement are less than 6c in the dollar on a weighted average basis.\(^5\)

There is a broad consensus that companies trying to restructure under the current legal framework face a challenging task, as directors (particularly in large companies) express concern and possibly hesitation about participating in restructuring where insolvent trading liability looms large and the appointment of a voluntary administrator can result in a destruction of value as key contracts are terminated by ‘ipso facto’ clauses included in many commercial contracts and leases. Furthermore, the public perception of formal restructuring procedures is one of failure. Voluntary administration is reported in the press as the end of a company, with corporate undertakers sent in to sell the business, often in conjunction with a receivership. The public dialogue concerning insolvency and restructuring is one of failure and determining blame for that failure.

Informal restructuring, usually occurring on a confidential basis, has continued with increasing trading in the secondary debt market and increasing activity by


distressed fund managers in the Australian market. Formal and informal restructuring efforts need to work together to provide for efficient and effective recycling of capital throughout the economy. Foreign investment (both in debt and equity positions) relies upon clear, fair and efficient legal rules.

The goal is not to save every struggling business, but rather to give the business and its managers the necessary breathing room to determine if it should be saved and if so, what the best mechanism is to achieve that. We must allow non-viable businesses to fail, but the concern is that viable businesses may be shut down too soon, or in the absence of an effective corporate rescue framework, may be pushed into trading into oblivion without obtaining professional advice on restructuring options at a time when the business can still be saved. As the common saying amongst restructuring professionals goes: ‘it’s hard for a doctor to save a patient who is dead on arrival at the hospital’. The challenge is to encourage early action to address financial difficulties through restructuring and workouts. Low or nil returns to creditors lowers the confidence that businesses have in the insolvency system and increases transaction costs as creditors take further action to try to protect themselves from an insolvent debtor, which raises the cost of credit and makes it harder to do business.

This paper will consider the potential risks for those involved in trying to restructure a struggling business and will then critically examine a number of significant law reform proposals that have been discussed in recent public policy reviews by undertaking a comparative analysis with aspects of restructuring laws operating in England, New Zealand, Canada and the United States.

LEGAL RISKS DURING RESTRUCTURING EFFORTS

When trying to implement a restructuring, the company, its officers and advisors face a range of potential liabilities that make restructuring difficult. In some cases potential liabilities can derail a rescue attempt with the result that the company fails and enters liquidation, with little return to creditors.

A restructuring plan tends to be formulated over a period of time prior to a formal insolvency appointment, and usually on a confidential basis so that key suppliers, customers and employers do not become concerned about the future viability of the company and withdraw their support. If the restructuring plan is successful it may be that a formal insolvency appointment is not needed. However, an informal restructuring is based on maintaining consensus amongst key lenders (usually senior secured lenders) and therefore carries a risk that one or more holdouts can prevent the implementation of the restructuring plan. It is also possible that returning the business to financial strength will require that certain obligations (such as loss making leases or significant tax debts) be left behind in the corporate shell while the business assets are transferred to a new (solvent) entity in order to maximize returns for all creditors and to preserve jobs. This may necessitate a formal insolvency to cram down dissenting creditors or to obtain legislative sanction for asset or shares transfers, or to implement a debt for equity swap with key lenders across a class of creditors that includes a dissenting minority.
One of the biggest risks that exists during a restructuring effort is that the company may be found (usually years later following expensive litigation) to have continued trading while it was insolvent. This may leave the directors of the company at risk of significant personal liability for all unsecured debts that are incurred by the company during the period. At present there is no defence for insolvent trading where directors are engaging in good faith restructuring efforts, although the courts have granted relief from liability in a small number of cases reasonable restructuring efforts were made to try and save the business. This liability can also extend to advisors and financiers, if they can be found to be de facto or shadow directors under the Corporations Act.

Since the conclusion of the Bell litigation there is also potential accessorial liability under the rule in Barnes v Addy where restructuring efforts involve the directors failing to act in the best interests of their company by failing to consider the interests of creditors. It is also possible that third parties (including advisors and potentially financiers) may be liable for being ‘involved’ in the equivalent statutory provision in s 181 of the Corporations Act. The current business judgment rule defence in s 180(2) only covers liability for breaches of the duty of care in s 180(1) and the equivalent general law duty, but neither of these carry accessorial liability.

Where the company is a disclosing entity (such as a listed company) then there is also the requirement that the company keep the market up to date with material information under continuous disclosure obligations. A failure to comply with continuous disclosure obligations gives rise to liability for the entity but may also extend to personal liability for persons involved in the contravention. In recent years, alleged failures by listed companies to keep the market informed of material information has led to investor class actions and this is a real risk for a company involved in restructuring efforts. It is likely however that the restructuring proposal will involve confidential negotiations and will fall within the carve outs to continuous disclosure under the ASX Listing.

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6 Corporations Act 2001 (Cth) s 588H.
8 Admittedly, this is a relatively remote risk with no case finding a major creditor acted as a shadow director for insolvent trading: see the discussion in Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd (2011) 81 NSWLR 47; [2011] NSWCA 109; Emanuel Management Pty Ltd v Foster’s Brewing Group Ltd (2003) 178 FLR 1; [2003] QSC 205 at [264]. Advisors who act purely in a professional capacity will have the benefit of the carve-out in the s 9 definition of a director.
10 The duty of care is not a fiduciary duty and hence Barnes v Addy liability does not arise. The statutory duty in s 180 does not provide for statutory accessorial liability. See further Bathurst T and Merope S, ‘It tolls for thee: Accessorial liability after Bell v Westpac’ (2013) 87 Australian Law Journal 831.
11 Corporations Act 2001 (Cth) ss 674, 675.
12 Corporations Act 2001 (Cth) s 674(2A). This is subject to a due diligence defence in s 674(2B).
Rules (ASX LR 3.1A) as the restructuring negotiations are an incomplete proposal and a reasonable person would not expect them to be publicly disclosed. If the carve out applies then there is no liability under s 674. However, if the restructuring is leaked to the media then the carve out will be lost.\footnote{13}

Even if a formal insolvency appointment is made, there are still risks involved in using a formal appointment for a restructuring attempt. One of the biggest risks to a successful restructuring is the ability of key contractual counterparties to terminate their contracts with the company involved in the restructuring efforts. This occurs using so called ‘ipso facto’ clauses that allow for an automatic default because of the appointment of an insolvency practitioner (such as a voluntary administrator or liquidator). While an ipso facto clause may be used to terminate the contract, they may also be used to alter the rights and obligations under the contract, such as accelerating the payment obligation or imposing more onerous covenants on the borrower. Cross default clauses can also affect restructuring efforts as the default of one company in a group may result in an automatic default across multiple contracts entered into by other companies in the group.

Voluntary administrations provide some degree of protection as suppliers are unable to recover possession of their goods without the administrator’s or the court’s consent, and lessors cannot recover possession of leased equipment or premises during the administration.\footnote{14} However, these measures do not operate during a deed of company arrangement where secured creditors and owners of goods used by the company are not bound by the deed unless they vote for it.\footnote{15} The court may grant an order restricting an owner’s or a secured creditor’s rights in order to preserve the deed of company arrangement, but the interests of the secured creditor or owner must be protected.\footnote{16}

Of greater concern will be the ability of customers of the company in voluntary administration to cancel contracts, which is not prevented by any provision under Pt 5.3A (voluntary administration). As the economy moves away from fixed asset businesses to service and advisory businesses, the ability to extract value from ongoing contracts with customers becomes the key asset for most business (together with valuable employees and intangibles such as intellectual property rights). While the administrator can negotiate with key suppliers and key customers to stop them terminating contracts, the ability to use the mere fact of insolvency as an event of default justifying termination goes against the policy of insolvency law to compromise personal rights against the debtor.

The potential for contractual counterparties to terminate a contract based on an insolvency appoint adds a key execution risk for purchases of distressed business which may contribute to a lowering of value realized through a sale of the business. This risk can also put downward pressure on trades in the secondary debt market. The adverse effect of ipso facto clauses on distressed

\footnote{13} The ASX may also require disclosure if a false market develops, which may occur where rumours are circulating regarding the company’s future.
\footnote{14} Corporations Act 2001 (Cth) s 440B.
\footnote{15} Corporations Act 2001 (Cth) s 444D(2).
\footnote{16} Corporations Act 2001 (Cth) ss 441D, 441H, 444F.
investors is exacerbated by the fact that North American laws prohibit such clauses (as will be discussed below).

LAW REFORM PROPOSALS

The past five years have seen a broad range of inquiries and investigations into aspects of insolvency law that are relevant for restructuring.

In 2010, the Treasury released a discussion paper ‘Insolvent trading: A safe harbour for reorganisation attempts outside of external administration’ which recognized concerns about the effect of insolvent trading on good faith restructuring attempts.

The discussion paper raised three possible outcomes: retain the status quo, introduce a new business judgment rule for restructuring attempts or introduce a moratorium. The moratorium would prevent insolvent trading liability for a limited period and would be subject to termination by creditors. The submissions to the discussion paper were broadly opposed to the moratorium proposal on the basis that a moratorium would be likely to trigger contractual terminations.

The new business judgment rule would allow for the insolvent trading provision to be satisfied where:

- the financial accounts and records of the company presented a true and fair picture of the company’s financial circumstances;
- the director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remained solvent or that it was returned to a state of solvency within a reasonable period of time;
- it was the director’s business judgment that the interests of the company’s body of creditors as a whole, as well as of members, were best served by pursuing restructuring; and
- the restructuring was diligently pursued by the director.

While many submissions were in favour of an improved defence to insolvent trading, there was little support for this specific formulation with each of the elements being critiqued by submissions.17

Despite the support for change demonstrated in the submissions to Treasury, the government announced on 29 September 2011 that there was no evidence that the existing laws produce adverse outcomes and hence rejected amendments to the law.

The perceived problems that the current law posed for restructuring attempts arose again with the Senate Standing Committee on Economics inquiry into the performance of ASIC (2014), which recommended (Recommendation 62) that the government commission an inquiry into Australia’s insolvency laws to

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encourage turnaround. At the time of writing this recommendation had not been adopted by the government, but the issue was raised with the Financial System Inquiry. The FSI Final Report recommended that the government ‘Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty’ (Recommendation 36). This was followed by a call for further submissions by Treasury on all aspects of the FSI final report. 185 submissions were received, most of which were not focused on the insolvency although a number of submissions (such as from the ACCI, AICD and ARITA) supported further consideration of a safe harbor defence to insolvent trading and the introduction of protections against ipso facto clauses.

Most recently, the Productivity Commission has considered insolvency law reform in its investigation on ‘Business set up, transfer and closure’. The draft report recommended the introduction of a safe harbor for insolvent trading. There were more than 70 submissions made to the Commission, most of which supported a safe harbor. Importantly, ASIC gave qualified support for a safe harbor for insolvent trading as did insolvency firms, accounting bodies and the Australian Bankers Association. The Australian Institute of Credit Management was one of the few organisations that argued against a safe harbor reform for insolvent trading or for reform of ipso facto clauses.

This review of official inquiries and reports does not include a discussion of reform proposals suggested by practitioners and professional associations. ARITA, the TMA and the Law Council of Australia recommended a financial business judgment rule that would apply to insolvent trading (as part of the 2010 Treasury review). The thought leadership paper published by ARITA in 2014 (A platform for recovery) further clarified the suggested safe harbor:

- make a business judgment in good faith for proper purpose
- after informing themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate
- rationally believe that the judgment was in the best interests of the corporation
- the director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed
- the director was informed with restructuring advice from an appropriately experienced and qualified professional engaged or employed by the company, with access to all pertinent financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time

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• it was the director’s business judgment that the interests of the company’s body of creditors as a whole, as well as members, were best served by pursuing restructuring, and
• the director took all reasonable steps to ensure that the company diligently pursued the restructuring.

The AICD has recommended a general honest and reasonable director defence that would apply to insolvent trading. Robert Austin and Minter Ellison have also suggested a new business judgment rule that would operate as a presumption against liability for good faith business judgments (and would apply to insolvent trading). Both the AICD and Austin/Minter Ellison proposals provide a broad based provision that would apply to a range of director liability provisions while the ARITA safe harbor provision is focused on restructuring not broader liability.21

We will now discuss how Australian law compares with other common law jurisdictions on these issues.

COMPARATIVE ANALYSIS

Ipso facto clauses

An ipso facto clause is one that operates automatically on the happening of a particular event. In corporate insolvency and restructuring, an ipso facto clause is a contractual provision that gives rise to a right to vary provisions in the contract or to terminate the contract based on the happening of an insolvency event (such as the commencement of an insolvency case or the appointment of an administrator). These are common in commercial contracts, although there is nothing to require the contractual counterparty to exercise their rights under such a clause and it is open to a voluntary administrator or company restructuring officer to negotiate with such a counterparty to ensure that the termination or variation of rights does not occur in order to support the restructuring.

Australia

Ipso facto clauses are not prohibited by Australian corporate insolvency law, although they are prohibited under personal bankruptcy law.22 The Australian Law Reform Commission’s General Insolvency Inquiry in 1988 (The Harmer Report) recommended that the following provision be introduced into Australian corporate insolvency law:23

AT10(1) Where a company is a party to an agreement (other than a charge) that contains a provision to the effect that, if the company commences to be wound up in insolvency or becomes a company under administration, then:

(a) the agreement is to terminate or may be terminated;

(b) the operation of the agreement is to be modified; or

(c) property to which the agreement relates may be repossessed by a person other than the company,

21 See further Harris J and Hargovan A, ‘Revisiting the business judgment rule’ (2014) 66 Governance Directions 634.
22 Bankruptcy Act 1966 (Cth) s 301.
23 Harmer Report Volume 1 at [703]-[705]; Volume 2 at 140-141.
the provision is void, unless the Court otherwise orders, as against the liquidator or administrator.

(2) This section extends to agreements made before the commencement of this section.

This recommendation was not implemented. The issue was raised again in 2004 in two inquiries into insolvency and restructuring. In the Parliamentary Joint Committee on Corporations and Financial Services report ‘Corporate Insolvency Laws: a Stocktake’ (June 2004), the Committee recommended (Recommendation 54) amending the Corporations Act to give an administrator the power to seek a court order preventing a person from terminating a contract, provided that the counterparty’s interests were adequately protected. The Committee expressed concern about balancing restructuring outcomes with the need to protect the rights of innocent parties and uphold freedom of contract. The other report issued in 2004 was the CAMAC report ‘Rehabilitating large and complex enterprises in financial difficulties’ (October 2004) which recommended against changing the law to restrict or ban ipso facto clauses. The reasons given for this rejection were (Recommendation 28):

- it may increase financing costs for businesses;
- counterparties need to be able to protect themselves in long term supply arrangements;
- ipso facto clauses are one relevant factor assessed by directors when deciding whether to use voluntary administration;
- identifying an ipso facto clause with precision is difficult;
- ipso facto clauses are found across a broad range of types of commercial arrangements that the costs of change may outweigh the benefits;
- counterparties may be able to avoid a ban on ipso facto clauses by enforcing prior to formal insolvency or by requiring security;
- any ban would not be comprehensive and would add to complexity;

The draft report (May 2015) by the Productivity Commission contains the following recommendation:24

DRAFT RECOMMENDATION 15.4

The Corporations Act 2001 (Cth) should be amended such that ipso facto clauses that allow termination of contracts solely due to an insolvency event are unenforceable if a business comes under the control of an administrator or receiver (as already applies if a person is in bankruptcy) or if the company is utilising the safe harbour arrangements set out in draft recommendation 15.2.

In circumstances where this moratorium could lead to undue hardship, suppliers should be able to apply to the Court for an order to terminate the contract.

Canada

Since 1992 Canadian restructuring legislation provided protection against ipso facto clauses under the proposal provisions of the Bankruptcy and Insolvency Act 1985 (Can) (‘BIA’). These provisions were substantially copied into the specific debt restructuring statute the Companies’ Creditors Arrangement Act 1985 (Can) in 2008. This was done in order to bring Canadian restructuring

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laws closer in line with the protections offered in the United States against ipso facto clauses.

The BIA is the primary insolvency statute in Canada, which covers both corporate and personal insolvency. Restructuring laws can be found within the proposal regime under Part 3 of the BIA. Proposals may be made under either Division I (general proposals) or Division II (consumer proposals) with the result that business restructuring under the BIA is done using Division I. Proposals must be voted on by the creditors, and if accepted will keep the debtor out of bankruptcy. The debtor may present a notice of an intention to present a proposal, which sets up a stay against enforcement proceedings that covers both unsecured and secured creditors. A bankruptcy trustee notifies creditors of the notice of intention and must file a cash flow statement, a report on the reasonableness of the cash flow statement and a representation from the debtor as to the reasonableness of the cash flow statement. A proposal may separate creditors into separate voting classes, in which case all voting classes must approve the proposal. Creditors vote on a proposal within 21 days of the proposal being filed and must pass the proposal by a majority in number equating to 2/3 in value. If the vote fails the debtor enters bankruptcy and the trustee takes over the business. If the creditors approve of the proposal it must then be approved by the court who may refuse to sanction the proposal where it is not reasonable or not calculated to benefit the general body of creditors.

Canada also maintains a restructuring statute for larger businesses: the Companies’ Creditors Arrangements Act 1985 (Can) (‘CCAA’), which is limited to debtors who owe more than $5 million. This is the preferred restructuring tool used for large businesses as it provides a less structured, more flexible regime than the detailed regulation provided by the BIA proposal regime. The CCAA is a debtor in possession regime that is commenced by filing a petition in court followed by a preliminary ex parte hearing seeking initial orders. The standard initial orders include a stay of proceedings, authority to enter into debtor in possession financing, conferral of priority to cover payment of professional fees, the authority to repudiate leases and other contracts. The initial orders also involve the appointment of an external, independent monitor who supervises the restructuring and files various reports during the CCAA proceedings. The debtor in possession prepares a reorganization plan (in consultation with the monitor) which is put to the creditors for a vote in separate classes. Approval requires a majority in number and 2/3 in value.

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25 For a detailed analysis, see Houlden L, Morawetz G and Sarra J, Bankruptcy and Insolvency Law of Canada, (looseleaf) Carswell.
26 BIA ss 69, 69.1.
27 BIA s 50.4
28 BIA s 54.
29 BIA s 57.
30 BIA ss 59.
31 CCAA s 3(1).
33 CCAA ss9, 10.
34 CCAA s11.02
35 CCAA s11.2
36 CCAA s 6.
reorganization plan can involve both secured and unsecured creditors. Once the plan is accepted by the creditors it is then necessary to seek court approval, which is based on compliance with the CCAA and overall fairness of the proposal. If the creditors fail to approve the plan then it is possible to reformulate the plan, but secured creditors may seek to have the stay lifted and the company may end up in receivership and/or bankruptcy.

Both the BIA and CCAA contain identical provisions prohibiting ipso facto clauses which state that:

No person may terminate or amend, or claim an accelerated payment or forfeiture of the term under, any agreement, including a security agreement, with a debtor company by reason only that proceedings commenced under this Act or that the company is insolvent

Both provisions also apply to leases, by prohibiting a lessor from terminating or amending the lease ‘by reason only that proceedings commenced under this Act’ (for CCAA proceedings) or by reason only that a notice of intention to present a proposal (or the presentation of a proposal) for BIA proceedings. The lease protection also applies if the termination or amendment is based on the company’s insolvency or for the non-payment of rent in respect of any period before the commencement of proceedings or the filing of the notice of an intention to submit a proposal. In 853571 BC Ltd v Spruceland Shopping Centre Inc [2009] BCSC 1187, Burnyeat J explained (at [31]):

‘The purpose of s. 65.1 of the BIA is to permit a company to avoid being dismantled in a bankruptcy, to allow a company to survive, and to allow a company to be in a position to permit assets including the unexpired terms of leases either to be used by the company or to be available to be assigned and sold so that the sale proceeds can then be distributed for the benefit of the creditors of the company.’

Neither provision prevents a person requiring the payment for the provision of goods or services, or for the use of leased or licensed property after the commencement of the CCAA case or after the filing of the notice of intention under the BIA. The prohibition also does not require that a further advance of money or credit be made. Eligible financial contracts (i.e. derivatives) are also exempt from the regime. Canadian insolvency law has exempted eligible financial contracts from aspects of insolvency regulation since the 1990s.

37 CCAA ss 4(unsecured creditors), 5(secured creditors).
38 CCAA s 5.1(3).
39 BIA s 65.1(1); CCAA s 34(1).
40 For BIA proposals the trigger is the filing of a notice of an intention to submit a proposal or the submission of a proposal where no notice has been given beforehand.
41 BIA s65.1(2); CCAA s34(2). This BIA provision also applies to licenses, but the CCAA provision does not which allows licensors to terminate a license on the basis of non-payment of royalties.
42 This does not prevent a landlord from terminating the lease for non-payment after the filing of a notice: Canadian Petcetera Lt. Partnership v 2876 R. Holdings Ltd [2010] BCCA 469. For the effect on rent claims see: Re Galaxy Sports Inc [2004] BCCA 284.
43 BIA s 65.1(4); CCAA s 34(4).
If a contract contains an ipso facto clause then the clause is of no effect. The court has the power to order that the prohibition either does not apply to a particular contract or only applies in part to the operation of the contract.

The CCAA also provides for a supplier to be designated by the court as a ‘critical supplier’, which will require them to continue supplying the company (on any terms that the court considers appropriate), although the value of their supplies will be protected by a charge over the company’s assets which may be ordered by the court to take super priority over existing charges.

Clearly, the Canadian regime favours giving the debtor breathing space to attempt a restructuring and protects the debtor during that time from having contracts terminated merely because of insolvency.

United States

Bankruptcy and restructuring law is covered by federal legislation in the United States: the Bankruptcy Code of 1978 which appears as Title 11 of the US Code. Chapter 11 of the Bankruptcy Code provides for reorganization plans to be voted on by classes of creditors (including secured creditors). Chapter 11 is often held up as being a model for debt restructuring and corporate rescue laws around the world. Indeed, as demonstrated above, several recent reviews of Australian insolvency law have suggested that further investigations should be undertaken to ascertain whether aspects of Chapter 11 could be adopted in Australia. The protection that US bankruptcy law gives from the exercise of ipso facto clauses is one commonly suggested reform idea.

Protection against ipso facto clauses is not given by the provisions of Chapter 11 but rather by the provisions in Chapter 3 of the Bankruptcy Code, specifically §365 of the Code. Chapter 11 restructuring proceedings do not operate solely on the provisions in Chapter 11 of the Bankruptcy Code. The Code operates as a holistic system with Chapter 1 (general provisions), Chapter 3 (case administration) and Chapter 5 (creditors, the debtor and the estate) all essential components of a reorganization attempt through a Chapter 11 case. A Chapter 11 case is commenced by the filing of either a voluntary (§301) or involuntary case (§303) by petitioning the local district of the federal Bankruptcy Court.

Once a Chapter 11 case is commenced there is no fixed time limit by which it must be completed. The case will remain open until the reorganization plan is confirmed by the creditors and by the Bankruptcy Court, or where the case is terminated by the court or converted to Chapter 7 (liquidation).

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46 BIA s 65.1(5); CCAA s 34(5).
47 BIA s 65.1(6); CCAA s 34(6).
49 §1126 (each class must approve of the plan by a majority in number and 2/3 in value). Classes of creditors who are not impaired by the plan are deemed to have accept it: §1126(f).
50 Filing may be based on domicile, residence, principal place of business or where the principal assets are located for 180 days prior to filing. A bankruptcy filing may also be made where the bankruptcy of an affiliate is already pending: 28 USC §1404 (Venue of cases under title 11).
The initial court application (or a separate motion shortly thereafter) will seek ‘first day motions/orders’ that will include seeking court approval for:

- allowing the debtor to engage professional advisors, and for their initial fees to be approved;
- the maintenance of case management systems;
- the payment of certain pre-petition claims (such as “critical vendor claims” and certain employee wage claims and possibly certain customer claims such as warranties or refunds);
- the payment of certain insurance and utilities obligations;
- allowing for the use of “cash collateral”; and
- allowing for the establishing of post-petition financing arrangements (so called “dip financing”).

There is an extensive stay in §362 of the Code that protects the debtor company during the case, although the court may grant exemptions from the stay in certain cases.

The Bankruptcy Code provides three provisions that limit the ability of contractual counterparties to terminate or alter contracts because of the commencement of a bankruptcy case (whether under Chapter 11 reorganisation or otherwise): §363(l); §541(c)(1)(B) and §365(e). The protection against ipso facto clauses is supported by the fresh start policy that underpins the Bankruptcy Code.52 As Judge Peck said in the recent Lehman Bros case, ‘“it is now axiomatic that ipso facto clauses are, as a general matter, unenforceable.”53

Section 363(l) provides:

(1) Subject to the provisions of section 365, the trustee may use, sell, or lease property under subsection (b) or (c) of this section, or a plan under chapter 11, 12, or 13 of this title may provide for the use, sale, or lease of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor’s interest in such property.

The reference to the trustee includes a debtor in possession under Chapter 11.54 Section 363 provides rules that allow a trustee (or a debtor in possession in Chapter 11) to deal with the property of the bankruptcy estate. Section 363(b) requires that a sale of the property of the estate outside of the ordinary course of business may only be undertaken after notice and a hearing in the Bankruptcy Court. Section 363(c)(1) allows the trustee (or a debtor in possession in Chapter 11) to deal with the property of the estate in the ordinary course of business without notice or a hearing, although §363(c)(2) requires a party with an interest in cash collateral (as defined in §363(a)) must consent or court approval (following notice and a hearing) have been given. Section 363

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54 §1107(a).
is also the provision that allows for a judicially sanctioned sale of the business assets which has become a popular way for companies that enter Chapter 11 to sell their assets without proceeding to a reorganization plan.\textsuperscript{55}

Section 541(c)(1)(B) provides that:

> ‘an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—

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(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor’s interest in property.

Section 541 deals with the property of the bankruptcy estate, which highlights the links between the anti-deprivation principle in bankruptcy law and protection against ipso facto clauses.\textsuperscript{56}

The primary provision that has been discussed in commentary concerning ipso facto clauses is §365. Section 365(e) provides:

(1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

(2) Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(A)

(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(ii) such party does not consent to such assumption or assignment; or

\textsuperscript{55} Such a sale can be made to be free of any prior liens; §363(f). For a critical review of §363 sales see Wilkerson J, ‘Defending the Current State of Section 363 Sales’ (2012) 86 American Bankruptcy Law Journal 591.

(B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

This provision is designed to assist with rehabilitation efforts, as Congress recognized that allowing ipso facto clauses could 'hamper rehabilitation efforts'.

Section 365(e) is different from the other provisions because it only applies to ipso facto clauses in ‘executory contracts’. The Bankruptcy Code does not define an executory contract, but the courts commonly refer to the seminal article by Bankruptcy Law professor Vern Countryman, which defined it as a contract "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." Thus, if a contract has been validly terminated before the filing of the bankruptcy petition it is no longer an executory contract. Furthermore, if a loan agreement’s only remaining obligation was to repay the loan, that would not be an executory contract as there would not be substantial obligations remaining on both sides.

Section 365 is a lengthy provision in the Bankruptcy Code that deals with the assumption and rejection of executory contracts by a trustee (or debtor in possession in Chapter 11): §365(a). There is an obligation on the trustee (or debtor in possession) to cure any defaults (or provide adequate compensation to the counterparty) before assuming an executory contract. The Code also allows the trustee (or debtor in possession) to assign an executory contract or unexpired lease once it has been assumed. There are distinct rules for non-residential and residential real property, and special rules for IP licensing agreements.

The trustee (or debtor in possession) may not assume or assign an executory contract that is a contract to make a loan or extend other debt financing of financial accommodations to or for the benefit of the debtor, or to issue a security of the debtor. They are also prohibited from assuming or assignment...
an executory contract or unexpired lease where non-bankruptcy law excuses a party from accepting performance and that party does not consent to the assumption or assignment. Furthermore a lease of nonresidential real property which has been terminated prior to the filing of the case under non-bankruptcy law may not be assumed.

Executory contracts for residential real property or personal property of the debtor may be assumed or rejected at any time prior to the confirmation of a plan, although the court may specify a time when the contract must be assumed or rejected on an application by the counterparty to the contract. The trustee (or debtor in possession) must perform all of the obligations of the debtor until the contract is assumed or rejected.

Certain financial contracts (such as securities contracts and derivatives) are not subject to the ipso facto provisions. Ordinary supply contracts are not forward contracts and so don’t fit within these safe harbor provisions.

The US law contains the most comprehensive protection against ipso facto clauses both through executory contracts and through protecting and preserving the bankruptcy estate and the debtor in possession’s ability to deal with the assets in order to restructure the business.

Insolvent trading

Australia has had an insolvent trading prohibition for decades, although in any given year there are relatively few cases that proceed to judgment. The current provision is s 588G which imposes liability where:

- a person is a director at a time when the company incurred a debt;
- the company was insolvent;
- there were reasonable grounds to suspect insolvency;
- the director was aware of those grounds or a reasonable person would have been so aware.

Liability is incurred under s 588G(2) by the mere fact that the director failed to prevent the company from incurring the debt(s) when they had the knowledge of the reasonable grounds to suspect insolvency (or where a reasonable person would have had that knowledge). Criminal liability is also possible under s 588G(3). The degree of culpability required by directors is set at a very low

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68 §365(c)(1). See further Re Catapult Entertainment Inc (1999) 165 F.3d 747 (USCA 9th Cir).
69 §365(c)(3).
70 Unexpired non-residential real property leases must be assumed or rejected within 120 days of the order for relief or by the court confirmation of the plan, whichever is the earliest, although an extension is also possible: §365(d)(4).
71 §365(d)(2).
72 A 60 day extension of the time for performance may be granted by the court: §365(d)(3).
level. Indeed directors may have no control over the incurring of debts and yet still be liable. There is no defence for good faith restructuring.

The Productivity Commission draft report recommends:

**DRAFT RECOMMENDATION 15.2**

The Corporations Act 2001 (Cth) should be amended to include provision for a ‘safe harbour’ to allow companies and their directors to explore restructuring options without liability for insolvent trading. During such a period, the directors would retain control of the company, but receive independent advice from registered advisers.

- Advisers appointed in safe harbour would be disqualified to act as administrators, receivers or liquidators in any subsequent insolvency process for the company.

- The company would be required to inform the Australian Securities and Investments Commission, and the ASX in the case of listed companies, of the appointment of an adviser.

- In informing themselves and the adviser, and determining whether to act on any restructuring advice, directors would be under a duty to exercise their business judgment in the best interests of the company’s creditors as a whole, as well as the company’s members.

- If the positive thresholds above are met (and evidenced), a director’s duty not to trade while insolvent would be considered to be satisfied during the period of advice and for actions directly related to implementing the restructuring advice.

The Australian position will not be compared with two other common law countries that have statutory regimes to address these issues.

**England**

The English *Insolvency Act* 1986 provides for fraudulent trading (s 213) and wrongful trading (s 214). Both of these provisions allow a liquidator to apply to the court for orders that a person make a contribution to the assets of a company in liquidation. It is possible for both provisions to be contravened by the same conduct. Company directors are also subject to potential disqualification where the company becomes insolvent and the court finds that the person is unfit to be a director. This has been held to be broader than wrongful trading claims, so that conduct which does not meet the wrongful trading requirement may still demonstrate unfitness for the purposes of disqualification.

Fraudulent trading applies to carrying on a business with intent to defraud creditors and the business eventually enters liquidation. Fraudulent trading allows the court to order that any person who knowingly engages in fraudulent

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77 For a summary of the principles applied in determining what compensation should be payable see Brooks v Armstrong [2015] EWHC 2289 (Ch) at [287] (‘The increase in the net deficiency from the hypothetical insolvent liquidation on the date of wrongful trading to the date of the usual compulsory order or resolution to wind-up will normally reflect the loss to the Company as a result of the liquidation having been delayed’).

78 Insolvency Act 1986 (UK) s 214(8).

79 Directors’ Disqualification Act 1986 (UK) s 6.

80 Re Bath Glass Ltd [1988] BCLC 329 at 333 per Gibson J (choosing to pay only selective creditors).

81 Insolvency Act 1986 (UK) s 213(1).
trading to make a contribution to the company’s assets in liquidation as determined by the court.\(^{82}\)

Wrongful trading only applies to directors\(^ {83}\) or former directors of a company that enters insolvent liquidation.\(^ {84}\) The provision is engaged when (s 214(2)(b)): 

‘at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation’

The person must have been a director at the relevant time.\(^ {85}\)

There is a defence in s 214(3):

The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimizing the potential loss to the company’s creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

The reference to minimizing losses to creditors is to the creditors as a whole and not to individual creditors.\(^ {86}\)

In ascertaining whether the director had the requisite knowledge and whether they have taken reasonable steps to minimize loss, the court is to take into account both subjective factors (i.e. the actual knowledge and skills the director had)\(^ {87}\) and objective factors (i.e. what a reasonable director should have known\(^ {88}\) and what reasonable skills the director should have had) by reference to the role and responsibilities undertaken by the director and by those entrusted to the director.\(^ {89}\) Thus, the reasonable steps requirement depends on the director acting as a reasonable person would in the circumstances.\(^ {90}\) This takes into account that directors of large companies will have different knowledge and skills from those running small businesses.\(^ {91}\) Minimum standards such as maintaining adequate financial records are recognized.\(^ {92}\)

\(^{82}\) Insolvency Act 1986 (UK) s 213(2). There is also a similar criminal provision: Companies Act 2006 (UK) s 993. This provision does not require that the company end up in liquidation however.

\(^{83}\) This includes shadow directors: s 214(7).

\(^{84}\) Insolvency Act 1986 (UK) s 214(1). Insolvency in this context is determined by an application of an assets over liabilities test: s 214(6).

\(^{85}\) Insolvency Act 1986 (UK) s 214(2)(c).

\(^{86}\) Brooks v Armstrong [2015] EWHC 2289 (Ch) at [276].

\(^{87}\) See for example Re Produce Marketing Consortium (In Liq) Ltd (No.2) (1989) 5 BCC 569 where directors who were experienced property developers should have understood when a project would be unlikely to be completed and hence should have known when the company would be unlikely to avoid insolvent liquidation.

\(^{88}\) This will include financial information contained in management accounts: Brooks v Armstrong [2015] EWHC 2289 (Ch) at [182]. Directors should know if the accounts are in a poor state and this will be relevant for assessing their reasonable knowledge of the likelihood of avoiding insolvent liquidation: Re Kudos Business Solutions Ltd (In Liq) [2011] EWHC 1496 (Ch)

\(^{89}\) Insolvency Act 1986 (UK) s 214(4),(5).

\(^{90}\) Re Produce Marketing Consortium (In Liq) Ltd (No.2) (1989) 5 BCC 569 at 594-595 per Knox J.

\(^{91}\) Re Produce Marketing Consortium (In Liq) Ltd (No.2) (1989) 5 BCC 569 at 594-595 per Knox J.

\(^{92}\) Re Produce Marketing Consortium (In Liq) Ltd (No.2) (1989) 5 BCC 569 at 595 per Knox J.
The liquidator bears the onus of proving that the company was insolvent and that the director had the requisite knowledge (i.e. that there was no reasonable prospect of avoiding liquidation). Directors who demonstrate willfully blind optimism or whose optimism is reckless can be said to have the requisite knowledge.93

The directors bear the onus of proving the defence (i.e. that they took every step to minimize potential losses).94 As to what taking every step involves, that will depend on the circumstances of the case but in the recent Brooks v Armstrong case the following matters were identified as being relevant to the assessment (at [259]):

‘Ensuring accounting records are kept up to date with a budget and cash flow forecast; preparing a business review and a plan dealing with future trading including steps that can be taken (for example cost cutting) to minimise loss; keeping creditors informed and reaching agreements to deal with debt and supply where possible; regularly monitoring the trading and financial position together with the business plan both informally and at board meetings; asking if loss is being minimised; ensuring adequate capitalisation; obtaining professional advice (legal and financial); and considering alternative insolvency remedies.’

In Brooks, the court held that directors who received an adverse tax assessment did not engage in wrongful trading by continuing to trade while trying to restructure the business having regard to the fact that liquidating the business would produce a negligible return to creditors at that point. The court noted (at [63]) however that ‘the Directors needed to ensure the trading position did not deteriorate. Regular review was required…’ The company subsequently received an adverse rent review determination that would make continued profitable trading difficult and would adversely affect a sale of the business. Wrongful trading occurred because the directors failed to reasonably respond to this significant change.

It is necessary for the directors to demonstrate that they had some plan to minimize the losses to creditors, and to return the business to profitability. The lack of a realistic plan to restructure the business and a failure to respond to deteriorating financial circumstances are common features in successful wrongful trading cases. For example, in Re Idessa (UK) Ltd (In Liq) [2012] BCC 315, the directors of a heavily indebted company failed to take any action to reign in expenses when the company lost its major contract and source of revenue and this gave rise to wrongful trading (at [120]):

‘all of the evidence points to the fact that the respondents continued to use (and as I have found in several instances abuse) the company’s money in much the same way as they had done previously. The respondents continued to pay themselves the same salaries and continued to incur the same type of expenses as before. There was no “tightening” of the corporate belt or any evidence that they or their employees were encouraged to implement cost savings or do anything differently. In short, there is no evidence that the respondents gave any thought at all to the company’s creditors or to the impact on them of continuing to trade. There is no material at all from which I can infer that they had in place any strategy to enable the company to repay the sums owed to creditors (or for that matter, its investors).’

While consulting external advisors in an attempt to formulate a plan for restructuring or rescuing the business is useful, this of itself is not sufficient to demonstrate that the directors took ‘every step’ to minimize losses for creditors so as to come within the defence to wrongful trading. The advice given by the advisor must be viewed in the context of the directors state of knowledge about the company’s finances and the likely prospects for a successful restructure.95

In contrast to the Australian insolvent trading provision (s 588G), the British wrongful trading is not based on the specific event of trading at a time when the company was insolvent and the director knew or should have suspected insolvency.96 The Australian provision imposes virtual strict liability and allows little room for restructuring attempts if the company is insolvent or likely to become insolvent.

The British wrongful trading provision is based on the culpability of the director in unreasonably continuing trading at a time when they should have known that the company would not avoid liquidation. It is not necessary to prove that the company was insolvent at a particular time, provided it eventually enters insolvent liquidation. This gives directors much more flexibility to engage in restructuring attempts. As was said recently in Brooks v Armstrong [2015] EWHC 2289 (Ch) at [180]:

‘There is no duty upon directors not to trade whilst insolvent or to ensure that a company does not trade at a loss. There will always be cases where companies legitimately trade at a loss because the directors anticipate profit to the benefit of the existing creditors… Therefore directors can cause the company to trade whilst commercially insolvent without being in breach of Section 214 provided the Knowledge Condition is not satisfied.’

The wrongful trading provision respects the power of the directors to decide whether it is in the best interests of the company and its creditors to continue trading, while the Australian insolvent trading does not recognize this—it forces directors’ hands by imposing personal liability for all debts arising after insolvent trading.

In Re Cubelock [2001] BCC 523 Park J said:

‘The law has to leave room for cases where it was acceptable for the directors to take the view that their company, although insolvent in balance sheet terms for the present, was going to trade its way back into credit so that all creditors would be paid … here has to be room for cases like that even if in the event the directors turn out to have been wrong’

As Chadwick J pointed out in Secretary of State for Trade and Industry v Gash [1997] 1 BCLC 341:

‘The companies legislation does not impose on directors a statutory duty to ensure that their company does not trade while insolvent; nor does that legislation impose an obligation to ensure that the company does not trade at a loss. Those propositions need only to be stated to be recognised as self-evident. Directors may properly take

95 See for example, Rubin v Gunner [2004] B.C.C. 684 (advisor’s advice based on statement by directors that they believed in good faith that company would receive further funds when they knew this was unlikely).
96 Re Hawkes Hill Publishing Co Ltd (in liq) [2007] EWHC 3073 (Ch) at [28] per Lewison J (‘The question is not whether the directors knew or ought to have known that the company was insolvent. The question is whether they knew or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation.’)
the view that it is in the interests of the company and of its creditors that, although insolvent, the company should continue to trade out of its difficulties. They may properly take the view that it is in the interests of the company and its creditors that some loss-making trade should be accepted in anticipation of future profitability. They are not to be criticised if they give effect to such view.'

One significant problem with insolvent trading is that establishing solvency is notoriously difficult. The policy that underpins wrongful trading is based on unreasonable conduct and reasonable knowledge of the prospects of avoiding future liquidation. The courts are mindful of the risk of hindsight bias. As was said in Brooks v Armstrong at [180]:

‘the court must be careful not to approach the Knowledge Condition with hindsight. Not only are directors not clairvoyant but it must also be remembered that there is a real difference between the court analyzing events in the court room and the directors having to reach decisions on the ground, at the time and under the pressures their office brings’

The courts in England are reluctant to impose hindsight judgments on directors as was demonstrated in Re Hawkes Hill Publishing Co Ltd (in liq) [2007] EWHC 3073 (Ch) at [47] per Lewison J:

‘Of course, it is easy with hindsight to conclude that mistakes were made. An insolvent liquidation will almost always result from one or more mistakes. But picking over the bones of a dead company in a courtroom is not always fair to those who struggled to keep going in the reasonable (but ultimately misplaced) hope that things would get better.’

Justice Lewison also said at [41]:

‘The answer to [the question as to whether the director had the requisite knowledge] does not depend on a snapshot of the company’s financial position at any given time; it depends on rational expectations of what the future might hold. But directors are not clairvoyant and the fact that they fail to see what eventually comes to pass does not mean that they are guilty of wrongful trading.’

The flexibility that British wrongful trading gives directors is demonstrated by comments in the recent case of Brooks v Armstrong at [180]:

‘the court must bear in mind that directors will often be faced with decisions for which there is no obvious right or wrong answer. The fact that it may subsequently prove that the wrong decision was made, does not necessarily mean they failed to act as reasonable directors in the prevailing circumstances of the time.’

These comments are consistent with sentiments expressed by Palmer J in the leading Australian case of Hall v Poolman (2007) 65 ACSR 123; [2007] NSWSC 1330 at [266]:

‘The law recognises that there is sometimes no clear dividing line between solvency and insolvency from the perspective of the directors of a trading company which is in difficulties. There is a difference between temporary illiquidity and “an endemic shortage of working capital whereby liquidity can only restored by a successful outcome of business ventures in which the existing working capital has been deployed... The first is an embarrassment, the second is a disaster. It is easy enough to tell the difference in hindsight, when the company has either weathered the storm or foundered with all hands; sometimes it is not so easy when the company is still contending with the waves.”

However, the Australian provision is still based on relatively strict liability. While relief may be possible, that is still involves a contravention of the law. It seems that the English law gives directors greater scope to attempt a restructuring.
New Zealand

It is also useful to look at the similar provision in New Zealand company law (reckless trading) under Companies Act 1993 (NZ), which provides:

A director of a company must not—
(a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors; or
(b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors.

This was explained by the New Zealand Court of Appeal in Mason v Lewis [2006] 3 NZLR 225 as follows:

[51] The essential pillars of the present section are as follows:

• the duty which is imposed by s 135 is one owed by directors to the company (rather than to any particular creditors);
• the test is an objective one;
• it focuses not on a director’s belief but rather on the manner in which a company’s business is carried on, and whether that modus operandi creates a substantial risk of serious loss;
• what is required when the company enters troubled financial waters is...a “sober assessment” by the directors...of an ongoing character, as to the company’s likely future income and prospects.97

The fact that this is wholly objective assessment marks a difference with the British wrongful trading provision.

The Court of Appeal also explained the concept of substantial risk by quoting from a book for directors:98

‘The first phrase, “substantial risk” requires a sober assessment by directors as to the company’s likely future income stream. Given current economic conditions, are there reasonable assumptions underpinning the director’s forecast of future trading revenue? If future liquidity is dependent upon one large construction contract or a large forward order for the supply of goods or services, how reasonable are the director’s assumptions regarding the likelihood of the company winning the contract? Even if the company wins the contract, how reasonable are the prospects of performing the contract at a profit?’

The provision has been described as being aimed at those who take ‘illegitimate business risks’.99 This distinction is based on whether the company had any prospects of continuing to trade profitably in accordance with ordinary commercial practice. As Young J said in Re South Pacific Shipping Ltd (in liq) (2004) 9 NZCLC 263,570 at [125]:

It is not suggested that a company must cease trading immediately upon becoming insolvent. However, it is clear that there are limits to the extent to which directors can trade companies while they are insolvent in the hope that things will improve.

This quote was subsequently discussed in Mountfort v Tasman Pacific Airlines of NZ Ltd [2006] 1 NZLR 104 at [25], where Baragwanath J said:

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97 This will not be satisfied if the directors have failed to maintain proper financial records: Grant v Johnston [2015] NZHC 611
98 Quoting from M Ross, Corporate Reconstructions: Strategies for Directors, CCH New Zealand 1999 at p 40.
the law must recognise that assessments of the ability of a company to survive are a matter of judgment and a substantial margin of tolerance must be allowed to directors to perform their function of taking legitimate risks.

It seems that in both New Zealand and in England the focus of liability is not on the mere fact of insolvency and a reasonable suspicion of insolvency, but on the failure to have a reasonable plan to avoid insolvent liquidation. This is in stark contrast to the Australian law which can punish directors severely for continuing to trade, even in the hope of achieving a better outcome for creditors.

**CONCLUSION: OPTIONS FOR AUSTRALIAN LAW REFORM**

Australian insolvency laws are in need of a detailed review. The recent spate of inquiries and investigations have all looked at restructuring law reform as just one of many (mostly non-insolvency related) issues. This has meant that broad based consultation has either not been achieved or has not been given sufficient policy breathing space due to other competing issues. Insolvency took up less than 5 pages of the Financial System Inquiry and the discussion of restructuring reform in the Senate Economics Committee report was included at the end of the report with little explanation of the recommendation.

Good policy reform needs a more robust approach. Another comprehensive insolvency review in the nature of the Harmer Report is long overdue. If we are to make significant changes to our insolvency and restructuring laws we must be mindful not to simply deal with whatever interest group speaks the loudest. Any significant change needs to be fully integrated into the legislation to ensure that inconsistencies and unfairness are not generated inadvertently by the change. That said, it is unlikely that there will be a comprehensive review of insolvency law given the lack of a dedicated cabinet minister with responsibility for the portfolio and the limited resources available to Treasury, particularly now that the CAMAC has been stripped of its resources and closed down in all but name.

With a view to advocating reforms that could be implemented even in the absence of a comprehensive review, the topics of ipso facto clauses and insolvent trading liability are clearly in need of reform. Australian law is seriously out of step with other developing nations and substantial anecdotal evidence (in the absence of detailed statistics on the issue) suggests that these threats of liability and value destruction do skew restructuring decisions and make viable restructuring much more difficult. There also seems to be a growing consensus in the business community (at least based on submissions to inquiries) that these issues need reform to provide better restructuring outcomes for Australian businesses and their creditors.

*Reforming Ipso Facto Clauses*

In the author’s view, ipso facto clause protection should be introduced for restructurings efforts, but not for liquidation. This would include protections against ipso facto clauses during voluntary administration and also during creditors’ schemes of arrangement. Such protection could take the form of the
original Harmer recommendations or could simply adopt the provision that currently exists in s 301 of the Bankruptcy Act 1966 (Cth):

(1) A provision in a contract or agreement for the sale of property, in a lease of property, in a hire-purchase agreement, in a licence or in a PPSA security agreement to the effect that:

a) the contract, agreement, lease, hire-purchase agreement, licence or PPSA security agreement is to terminate, or may be terminated by the vendor, lessor, owner, licensor or PPSA secured party; or

b) the operation of the contract, agreement, lease, hire-purchase agreement, licence or PPSA security agreement is to be modified; or

c) property to which the contract, agreement, lease, hire-purchase agreement, licence or PPSA security agreement relates may be repossessed by or on behalf of the vendor, lessor, owner, licensor or PPSA secured party;

if the purchaser, lessee, hirer, licensee or PPSA grantor or debtor becomes a bankrupt or commits an act of bankruptcy or executes a personal insolvency agreement under this Act is void.

The words ‘becomes a bankrupt or commits an act of bankruptcy or executes a personal insolvency agreement under this Act’ could be replaced by ‘has a voluntary administrator or deed administrator or scheme administrator appointed over it’. It may also be useful to include insolvency (as defined in s 95A) as a trigger event that could not terminate or vary a contract or other arrangement. As is clear from the wording, this provision would not only protect against termination but would also protect against variations based on insolvency or insolvency appointments.

There would need to be carve-outs for certain types of contracts, with financing and derivatives contracts an obvious example (and ones that are exempt from the protections under the US and Canadian laws).

It is not argued that voluntary administrators, deed administrators or scheme administrators would need to have personal liability imposed on them. Where they are acting as agents of the company and the ipso facto protections merely prevent existing contracts from being terminated or varied, the company should continue to be liable. This is consistent with the existing position for voluntary administrators under s 443A. Of course, if an administrator entered into a new contract, then that would be a personal liability.

It is not suggested that the provision apply to non-insolvency or insolvency appointment related events so a default prior to a formal appointment and not tied to insolvency should not be invalidated by the proposed protection. There would be nothing preventing a supplier from setting up their supplies as distinct contracts so as to avoid termination (a refusal to enter into a new contract not being classified as a termination), but this is an ordinary right to enter into a contract and is not tied to insolvency or an insolvency appointment and so the justification for modification is not present. The law should prevent parties from seeking to leverage off the event of insolvency for individual gain. Insolvency has long held up the value of pari passu (albeit subject to numerous qualifications) and of creditors giving up private contractual enforcement rights in return for obtaining a right to participate in a collective process. Reforming ipso facto clauses for restructuring is consistent with those policy approaches.

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Insolvent Trading Reform

As for insolvent trading reform, it is suggested that introducing a new business judgment style defence for insolvent trading, whether by way of a pre-appointment moratorium period or by way of a new defence, will not address director concerns about liability. A pre-appointment moratorium would be not only useless but positively harmful to restructuring unless ipso facto clauses were protected against. If this could be done it is legitimate to ask why voluntary administrations could not simply be appointed earlier?

A pre-appointment moratorium that was publicly announced could cause the company’s decline to accelerate as good employees looked elsewhere and suppliers toughened up on terms (where an ipso facto protection either did not exist or where they had entered into a series of separate contracts).

Introducing a modified business judgment rule defence would also not provide sufficient protection as it would still involve directors getting sued, potential findings of liability and then arguments regarding the defence (just as the current business judgment rule operates in s 180(2)). For good faith restructuring efforts it may be that a new defence would reduce the risk of being sued, but relief from liability is already available and yet does not appear to have had that effect on litigation.

Furthermore, the suggested business judgment rule defences from both the Productivity Commission and professional bodies seem too detailed and are open to different interpretations (such as those concerned with adequate records, and recognition of suitable professional qualified advisors). It should be remembered that the onus of proving the defence will fall on directors. The more elements involved in the defence the harder it will be to satisfy. The difficulty of establishing the current defences in s 588H is one of the existing criticisms of the regime. It would be advisable to reduce, rather than increase the complexity of the provisions.

In the author’s view, the preferred model should be to reform the underlying prohibition against insolvent trading so that it is focused (like the New Zealand and English models) more on the culpability of the director in failing to shut down a company that has past the tipping point of avoiding insolvent liquidation. The current prohibition is too strict and creates a disincentive to participate in restructuring. We need to implement a set of incentives that encourages directors to act early and to seek advice to determine if a restructuring is possible and if so whether it should be implemented. The models in New Zealand and in England give directors much greater flexibility to engage in good faith restructuring than the Australian provision and warrant further consideration as a viable law reform option.