

October 2009

## The solvency question: Is it time to change the law?

When financial markets are in decline, companies collapsing and corporate insolvency dominates business headlines, insolvency legislation seems to come under increased scrutiny.

We've seen it before. Cast your mind back to The Recession We Had To Have. In the aftermath of the market crash of 1987 – about the time business behemoths like Quintex and Bond Corp were sliding into oblivion – Australians demanded a review of our insolvency law. This lengthy enquiry led to the Harmer Report, and the introduction in 1993 of Part 5.3A of the Corporations Act: Australia's current Voluntary Administration (VA) regime.

The new VA regime provided a simple, cost-effective process to rehabilitate businesses, particularly small businesses, but there were plenty of sceptics critical about its suitability for putting large businesses back on track. In particular, critics said it was ineffective for listed companies because of the destruction of shareholder value and the stigma that resulted from the market learning a business was going into administration.

As a consequence of the Global Financial Crisis (GFC), renewed criticism of our insolvency legislation seems to revolve around the question of insolvent trading. Notwithstanding the importance of this debate, the automatic termination of contracts when a company enters a formal administration – the so-called ipso facto clause – should also be firmly on the agenda if opportunities for restructuring are to be improved.

In this edition of *Ferriers Focus* we look at the effectiveness of Australia's insolvency legislation as a tool for restructuring businesses – both large and small – and specific concerns regarding insolvent trading and ipso facto clauses.

There are plenty of voices in the current debate about insolvency law. We have the leader of the Federal Opposition publicly supporting the adoption of a US-style Chapter 11 approach, while the Institute of Company Directors, the Law Council and the Insolvency Practitioners Association of Australia (IPA) are all weighing in with their own recommendations about how to address the law's perceived shortcomings with a particular focus on insolvent trading.

The objective of Australia's VA regime is to provide a template that allows the business,

property and affairs of an insolvent company to be administered in a way that maximises the chances of the company surviving or – at worst – maximises the return for the company's creditors and members.

Following its introduction in 1993, the VA regime quickly took over Australia's insolvency landscape. During the good times, receivership appointments were rare and despite the continuing high numbers of Court Liquidations, the VA was embraced as the appointment of choice. As a result, Official Management



disappeared and Schemes of Arrangement were relevant only to academics, historians and special cases.

Over the next 14 years, there were no fewer than 17 enquiries into the effectiveness of the legislation, the last of these, the Joint Parliamentary Enquiry, completed in 2004, led to the formative amendments which took effect early in 2008. The IPA made several submissions to this and other enquiries regarding the effectiveness of the legislation and highlighted the difficulties insolvency practitioners were experiencing in administering the law.

Because of the enormous success of the VA regime, the changes suggested by the IPA were minor. One of the few recommendations not adopted had to do with the ipso facto clauses that are common in many commercial contracts – something that should certainly be reconsidered.

These clauses give a party the right to terminate a contract based merely on an insolvency appointment such as that of a voluntary administrator. The IPA argued that it was the termination of these contracts that destroyed value and, by prohibiting these automatic terminations or providing some limited protection, the potential for restructuring large businesses would be improved.

This was particularly relevant in the collapse of One.Tel in 2001, when the appointment of voluntary administrators resulted in the immediate termination of the company's reseller contracts with Optus and Telstra – effectively signing the company's death warrant.

Currently, large receiverships like ABC and ADR are taking advantage of the VA process to gain a moratorium from landlords by extending the VA convening period by 12 months or more. If protection from ipso facto clauses was generally available, this expensive and aggressively contested process may not be necessary.

Notwithstanding the significant impact of ipso facto clauses, it is the issue of trading-whilst-insolvent that has generated the most vocal debate during the GFC; sparking heated argument in the Letters to the Editor pages of the *Australian Financial Review*. Surprisingly, this concept barely registered a mention in the debates that led up to the reforms introduced in 2008.



The focus of recent debate has been whether the threat of personal liability that hangs over the heads of company directors who might breach the insolvent trading provisions is so onerous as to force them to drive a company into liquidation prematurely in order to protect their own interests at the cost of other stakeholders.

Western Australia's Chief Justice, Wayne Martin, described these laws as some of the strictest in the world and "arguably ... discourages financial restructuring and trading out of difficulty". Some voices in the debate called for the easing of these laws in order to provide further options to help struggling companies. Others suggest the current laws are designed to help companies (and their creditors) – not punish directors – and that because most directors delay appointing an administrator until the company is a lost cause, there is an argument for toughening the laws.

Certainly the debate in the media raises questions about the lack of a simple solvency test under the current regime – how do directors know when a company has crossed the line and that they may be culpable of trading whilst insolvent? There is no question that it is the cash flow test of solvency that dominates the analysis rather than the balance sheet test, and as a result, the status of banking facilities is vital. Over the last 12 months, this has led to media coverage of many tense negotiations between high-profile companies and their bankers: Elders; OZ Minerals; Centro; ABC and Allco. Some have emerged triumphant. Others have been introduced to a Receiver, a Voluntary Administrator or both.



We have seen no empirical evidence that Australia’s insolvent trading laws prematurely force businesses into formal insolvency administration. It is difficult to point to a single example of such an event occurring purely because directors were nervous about their insolvent trading liability. However, insolvency practitioners will tell you that the reverse is true, that many businesses they have nursed through liquidation could have survived if restructuring opportunities had been explored earlier.

This issue was closely considered in *Hall v Poolman*. Although Palmer J did not set out to

lay down a prescriptive test of directors’ liabilities regarding insolvent trading, he did set down a series of reasonable questions and answers as a useful yardstick for directors on the issue.

Palmer J argued a director would be justified in expecting solvency if he believed an asset could be realised to pay creditors within about 90 days, but the position becomes murkier the less certain the realisation outcome. He said a reasonable director would ask: “How sure are we that this asset can be turned into cash to pay all our debts ... within three months? Is that outcome certain, probable, more likely than not, possible, possible with a bit of luck, possible with a lot of luck, remote, or is there is no real way of knowing?”

He reasoned that if the answer is “certain” or “probable”, the director can have a reasonable expectation of solvency; if the answer is anywhere from “possible” to “no way of knowing”, the director can have no reasonable expectation of solvency; and if the answer is “more likely than not”, the director runs the risk that a Court will hold to the contrary in any subsequent insolvent trading claim.

In these circumstances, there is an argument for the introduction of a “business judgment rule” to enable directors to exercise their judgment for the benefit of all stakeholders. Last month Victorian Supreme Court judge Justice Ross Robson called for changes to the law in order to shield from liability those directors honestly trying to salvage a company teetering on the brink of insolvency. Of course, if what Palmer J said in *Hall v Poolman* gains general acceptance, that rule may already be in place.

The IPA is continuing to press for legislation enshrining a business judgment rule; as is the Institute of Company Directors which has long been concerned that the existing trading-whilst-insolvent legislation scares off suitably qualified individuals, making it difficult for companies to fill board seats.

## Conclusion

There are three issues to address here:

- Is insolvent trading legislation influencing company directors to place companies into administration prematurely and dissuading them from taking up board positions?
- Could this be addressed by legislating a business judgement rule?
- If the ipso facto clause causes significant value destruction, should insolvent businesses be afforded some limited protection?

In our view, there is no empirical evidence that the insolvent trading legislation under the current VA regime drives company directors to prematurely appoint administrators. In fact, our experience suggests the opposite: directors generally delay appointing administrators until the point where funding is no longer available to trade the business. Changing the insolvent trading provisions to incorporate a business judgment rule may give directors greater confidence to back their own (and their advisers') judgment. The only proviso will be the need for the Court to apply the law strictly and make it clear that a director's duty to creditors when a company enters an insolvency context remains a significant one.

Notwithstanding the significance of the issue, we believe the insolvent trading debate is drawing the focus of interested parties away from the greater issue which we contend should be the central debate: the destruction of value through the termination of contracts. This issue prevents formal insolvencies from acting as effective restructuring tools. The GFC could prove to be the catalyst for change. If insolvency professionals and others can agree a way forward on ipso facto clauses and engage government on the need for change, the Australian insolvency system would again lead the way in international best practice.

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