

26 August 2014

Mr David Murray AO
Chair
Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

By email: fsi@fsi.gov.au

Dear Mr Murray

Submission to Financial System Inquiry (FSI) – Funding: External Administration

This submission is made in response to the Interim Report released by the FSI on 15 July 2014.

Introduction

KordaMentha has made several submissions to the government and relevant authorities regarding the external administration and insolvency regime in Australia. We have appended for your reference:

- Letter dated 2 March 2010 made to Treasury in response to their paper entitled 'Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration'
- Letter dated 11 February 2010 made to the Senate Committee on Corporations and Financial Services regarding the role of liquidators and administrators.

Our observations expressed in this submission reflect our extensive experience in working on complex and large restructurings and insolvencies in the Australian market. We note that many of our senior team have had extensive experience working in other jurisdictions including the US, UK, Western Europe and Asia.

We are aware that the Australian Restructuring Insolvency and Turnaround Association (ARITA) and the Turnaround Management Association Australia (TMAA) intend on making detailed submissions in response to the Interim Report. We broadly are in agreement with the TMAA report. The ARITA report is based on a proposed framework that is only a work in progress.

We are broadly in support of the principles that TMAA recommends. The purpose of this submission is to highlight some key areas of focus for the FSI to consider in its final report.

We support the existing external administration regime in Australia and encourage regular reviews to ensure continuous improvement.

We do not recommend wholesale adoption of the Chapter 11 regime, due to the significant cost and length of the process arising out of this court-led approach and other well documented issues. Currently, a rethinking of Chapter 11 is under way in the US and so it would be prudent to wait until the US review has been undertaken.

However, there are several facets of the Chapter 11 approach which may be suitable to adopt in Australia to encourage early intervention to restructure and turnaround distressed companies. Potential changes in the existing administration regime in Australia could be:

- Safe harbour provisions / directors personal liability – Compared with other jurisdictions (US, UK) Australia employs a strict approach to trading whilst insolvent. Whilst this ensures directors and boards are very focussed on this matter, our view is that it may also prevent directors from considering consensual restructuring opportunities when they are in the ‘zone of insolvency’. On insolvency, directors obligations shift from a duty to shareholders to a duty to creditors.

Our recommendation is to incorporate well balanced ‘safe harbour’ provisions into the Australian law (similar to UK law) that in effect allows a ‘business judgement’ rule be applied in the event that the directors are making good faith efforts to restructure the business ultimately fail. Well advised directors pursuing a consensual restructuring on an achievable restructuring plan that preserves enterprise value should not be penalised should their good faith efforts not succeed.

- *Ipso facto* clauses – The current Australian law allows *ipso facto* clauses to be triggered on insolvency at the counter party’s discretion. In Chapter 11, suppliers are subject to a moratorium which prevents them from terminating contracts under *ipso facto* so long as they aren’t subject to ‘hardship’.. Our previous research recognises a real problem exists in the workout of companies whose value is dependent on public goodwill and/or reliant on critical contracts, licences or agreements that can be terminated through the operation of *ipso facto* clauses (eg. technology software, telecommunications etc). Whilst the issue of *ipso facto* clauses is avoided in a consensual restructuring, once an external administrator is appointed, the prospect of continued trading of the business (to preserve enterprise value) can be seriously impeded.

Our recommendation is that law reform be considered to prevent *ipso facto* clauses from causing value destruction in external administration. So long as the external administrator is in a position to ensure the contract is not in default and the supplier is not exposed to ‘hardship’, we believe that having a moratorium in place similar to Chapter 11 would enhance the external administration regime.

- Chief Restructuring Officer (CRO) – the skills and expertise required to lead and direct a company through an informal restructuring, where the business is distressed but viable, is often not held by existing management. As a result, situational expertise is often required by companies restructuring outside external administration, with professionals skilled in the area of restructuring and turnaround (CRO). The current trading whilst insolvent laws make taking on this role very difficult.

Our recommendation is to consider ‘safe harbour’ provisions that do not abdicate directors’ personal liability and responsibilities but enables a company in distress to appoint a suitably qualified CRO to enable the CRO to restructure the company without the personal liability for doing so.

Concluding Remarks

Ultimately, changes to the current external administration regime should be focussed on promoting a culture of early intervention and turnaround in the situation of distressed but still viable businesses. Directors should be encouraged to seek professional advice from suitably qualified professionals to undertake consensual restructurings of viable businesses that result in a better return to creditors through preservation of enterprise value, than would occur in external administration. In instances where the business is not viable, we believe that the external administration regime is efficient in its purpose, but can always benefit from continuous improvement.

Yours sincerely



Mark Korda
Partner