INSOL International

Developments in Asian Restructuring and Insolvency Regimes

October 2018

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INSOL International
6-7 Queen Street, London, EC4N 1SP
Tel: +44 (0) 20 7248 3333 Fax: +44 (0) 20 7248 3384

Acknowledgement

We are very pleased to present this special report titled "Developments in Asian Restructuring and Insolvency Regimes". This report was written by a group of restructuring specialists and the general editor and project leader is Cosimo Borrelli of Borrelli Walsh, Hong Kong.

In the recent past we have seen significant changes in the legal and regulatory environments in many countries in the Asian Pacific region that were considered essential to foster better commercial activities. This report highlights some key developments in China, Singapore and Australia.

In China, a number of legislative changes have been introduced to liberalise the NPL market and debt for equity swaps. The Singapore Companies Amendment Act 2017 came into force last year which made sweeping changes to the existing Schemes of Arrangement and Judicial Management procedures. Important changes were also introduced that will have long term cross-border implications. In Australia the Companies Act 2001 was amended and new 'safe harbour' provisions were introduced to protect company directors against insolvent trading claims, and a stay on enforcing *ipso facto* clauses was introduced.

The objective of this report is to provide INSOL members with an understanding of these reforms and explore the practical issues encountered when implementing these changes.

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Editor
Cosimo Borrelli
Managing Director
Borrelli Walsh

People's Republic of China

Jonathan Leitch
Partner,
DLA Piper

Stewart Wang
Partner
DLA Piper

Yiyuan Zhang
Legal Assistant
DLA Piper

Singapore

Sarjit Singh Gill, S.C.
Senior Partner
Shook Lin & Bok LLP

Charles Lim
Litigation & Dispute Resolution
Senior Associate
Shook Lin & Bok LLP

Australia

Kristy Zander
Principal
Lipman Karas

Rowan Tape
Special Counsel
Lipman Karas

Developments in Asian Restructuring and Insolvency Regimes

General Editor - Cosimo Borrelli, Borrelli Walsh, Hong Kong
Contributors - Sarjit Singh Gill S.C. and Charles Lim, Shook Lin & Bok, Singapore
Kristy Zander and Rowan Tape, Lipman Karas, Australia
Jonathan Leitch, Stewart Wang and Yiyuan Zhang, DLA Piper, PRC

Introduction

This special report looks at several important developments in the restructuring and insolvency regimes in China, Singapore and Australia.

The topics covered in this paper are relatively diverse, as is to be expected in a region where the restructuring and insolvency regimes, laws and practices remain very much influenced by the wide differences in national economic development, politics, populations and motivations evident across the region.

In China, the key developments include the ongoing development and deregulation in the trading of non-performing loans (NPLs), the increasing role of foreign interests in their trade and the fast-growing size of the NPL market and transactions.

Since the launch of China's NPL sector in 1999, the Chinese government has gradually deregulated the sector with the objective of vitalising the sector and attracting more participants (including foreign acquirers of NPLs). This trend has accelerated in recent years. The Chinese government will likely take further measures to liberalise the NPL market to address the ever-growing NPL pressure faced by banks in China. As a result, offshore investors may see more opportunities for them to participate in this growing market.

Singapore has raced ahead to implement features from the US Chapter 11 debtor-in-possession model. Extensive changes to its schemes of arrangement and judicial management have been introduced, including an automatic worldwide moratorium, moratoriums against holding companies and subsidiaries, super-priority rescue financing, and extending the Courts' jurisdiction over foreign companies.

The Singapore Companies Act (SCA) also gives full-scale effect to the UNCITRAL Model Law on Cross-Border Insolvency. These changes will strengthen Singapore's corporate rescue mechanisms and make them viable options for local and foreign companies.

In Australia, the introduction of the new “safe harbour” protection for directors and the stay on the enforcement of *ipso facto* clauses are intended to address an overarching concern that enterprise value is destroyed when companies are forced into administration or liquidation unnecessarily. The changes instead seek to promote entrepreneurship and allow opportunities for businesses to continue to trade during informal and formal restructurings.

The common theme across these three countries is the weaving of insolvency and restructuring regimes and systems into the business fabric of the relevant economies, thereby facilitating better business – a far cry from the days when insolvency and restructuring regimes existed only to deal with failures and crises.

The Singaporean and Australian Governments have sought to achieve similar business enterprise aims, using different methods to enhance businesses' ability to trade out of trouble. The Singaporean provisions arguably go further by permitting rescue financing and debtor workouts, whereas the Australian changes are more in the nature of tweaks to the existing system.

PEOPLE'S REPUBLIC OF CHINA (PRC)

1. Investment in non-performing loans in China

1.1 Overview of the legal regime applicable to China's NPLs

China's NPL market and the legal regime applicable to it have developed rapidly in recent years and has attracted the attention of international and local investors. China has steadily deregulated the trading of NPLs since the launch of this industry nearly two decades ago. This article will introduce the history of China's NPL market, how it works in practice and summarise some important changes to the legal regime applicable to NPLs.

1.1.1 Role of national level Big Four AMCs

In 1999, the Chinese government established four national level asset management companies (AMCs) - Huarong, Great Wall, Orient, Cinda (collectively, the Big Four AMCs) to absorb NPLs worth approximately USD 500 billion from China's four major state-owned commercial banks (primarily to facilitate the listing of these banks). Each AMC was responsible for accepting, managing and disposing NPLs from one of these banks (Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank), as well as the NPLs from China Development Bank.

In 2004, the Big Four AMCs were permitted to make additional investment in foreclosed assets, offer custodian and agency services, and acquire distressed assets in a market-oriented manner.[1] This marked the beginning of a transition towards market-oriented diversified financial business operations for the Big Four AMCs. Since 2010, the Big Four AMCs have become commercial organisations, including by acquiring NPLs through market-driven mechanisms such as biddings and auctions. Their business scope now allows them to invest in NPLs of banks, non-bank financial institutions and non-financial institutions, and they have been the dominant buyers of NPLs in China.

1.1.2 Role of provincial level AMCs

In 2012, the Ministry of Finance (MoF) and China Banking Regulatory Commission (CBRC) permitted the establishment of provincial level AMCs.[2] Each provincial government was allowed to establish one local AMC to participate in the bulk acquisition and disposal of NPLs from financial institutions within its own province, with the disposal method being limited to debt restructuring. Since 2016, the central government has introduced a series of supportive policies,[3] permitting each provincial government to establish an additional local AMC, and allowing local AMCs to dispose of NPLs by, among other methods, transferring them to other investors without being subject to geographic restrictions (including offshore investors).

Provincial level AMCs are still limited in certain aspects compared to the Big Four AMCs. For example, the Big Four AMCs may set up joint ventures with foreign investors, but it is unclear whether provincial level AMCs may do so.[4]

1.2 Transfer of NPLs

China's NPL market can be classified into the primary market and secondary market, with the key players in these as follows:

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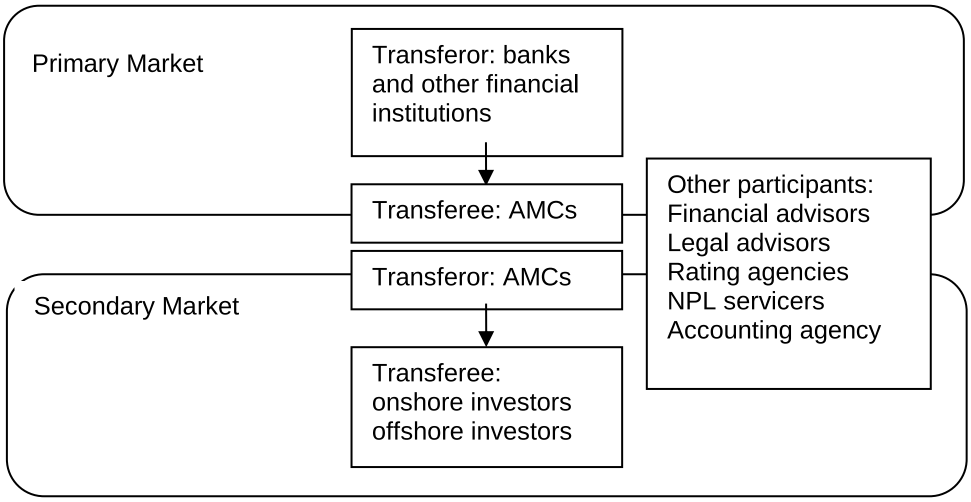
[1] See Administrative Measures for Relevant Business Risks of Financial Asset Management Companies (Cai Jin [2004] No.40) 《金融资产管理公司有关业务风险管理办法》(财金[2004]40 号).

[2] See Administrative Measures for the Bulk Transfer of Financial Enterprises' Non-performing Assets (Cai Jin [2012] No.6) 《金融企业不良资产批量转让管理办法》(财金[2012]6 号).

[3] See the Circular on Properly Adjusting Relevant Policies of Local Asset Management Companies by CBRC (Yin Jian Ban Bian Han [2016] No.1738)《中国银行监督管理委员会办公厅关于适当调整地方资产管理公司有关政策的函》(银监办便函[2016]1738 号).

[4] The provincial level AMCs were first approved in 2012; but the relevant laws and rules regulating the joint venture set up by AMCs were promulgated before 2012, therefore it is unclear whether these laws and rules apply to provincial AMCs.



In the primary market, banks and other financial institutions transfer their NPLs to AMCs, and AMCs then dispose of the NPLs by various means, including transfer of NPLs in the secondary market to other investors, whether onshore or offshore. The transfer process is subject to a diverse set of laws and regulations in China, and special approval requirements apply in the case of transfers to offshore investors.

1.2.1 General process

In the primary market, banks and other financial institutions may transfer NPLs in batches to AMCs.[5] The bank (transferor) first determines the scope of and carries out due diligence on the NPLs. On the basis of its due diligence, the bank evaluates the NPLs and forms a transfer plan, which is reviewed and approved internally before it invites interested AMCs to conduct due diligence on the target NPLs.

The transfer must be conducted by competitive means, such as bidding and auction, in order to maximise the sale proceeds. The winning bidder will enter into a NPL transfer agreement with the transferor. Public announcements are issued to inform the NPLs' debtors and the guarantors about the transfer.

To transfer NPLs in the secondary market, an AMC is required to disclose basic information on the target NPLs on both its public website(s) and designated newspapers. For any disposal of NPLs with a book value between RMB 10 million an RMB 50 million, an announcement must be made in a newspaper at municipal level or above. Disposals of NPLs with a book value greater than RMB 50 million should be announced in a newspaper at provincial level or above.[6] The announcement period should generally last for at least 10 to 20 working days.
The transfer process in the secondary market should also be carried out by competitive means, including but not limited to bidding, auction, invitation to offer and public inquiry or solicitation. Without a public competition process, AMCs cannot transfer NPLs to non-state-owned transferees. The relevant AMC and the winning bidder should enter into a NPL transfer agreement once the process is concluded. The AMC may issue a public announcement regarding the transfer and notify affected debtors to repay outstanding debts to the relevant transferee.

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[5] *Id.* at 1.

[6] Also note that AMCs must not transfer the following NPLs to buyers other than government authorities and state-owned buyers: where the debtor or guarantor is a government authority; where the debtor is a state-owned enterprise subject to national policy-based bankruptcy plan as approved by the State Council; where the creditor's rights concern national security and sensitive information, i.e., creditor's right involving military or national defence industries; other creditor's rights the transfer of which is restricted by laws and regulations. As a matter of practice, AMCs will first confirm with the relevant regulatory authorities (such as CBRC) regarding any restrictions on the proposed transferee of the target NPLs, and will specify such restrictions in the disposal public announcement.

1.2.2 Special process for transferring NPLs to offshore investors

Transfer of NPLs to an offshore investor is subject to administration by both the National Development and Reform Committee (NDRC) and the State Administration of Foreign Exchange (SAFE). Past practice indicates that the NDRC accepts filings of cross-border transfers from onshore AMCs only, not banks. However, on 1 June 2017, SAFE Shenzhen Branch was authorised to examine and approve a pilot cross-border transfer of NPLs by domestic banks on a case-by-case basis.[7] Nevertheless, as a matter of practice, transfer of NPLs in batches of more than 3 units by banks still need to proceed through AMCs.

In accordance with relevant regulations and rules, after a winning offshore bidder has executed the NPL transfer agreement with the selling AMC, the following additional steps should be taken in connection with the transfer of NPLs:

- *Registration with NDRC by the AMC*[8]

  The AMC is required to file the transfer of NPLs with the NDRC by submitting:

  (i) information on the NPLs (book value of principal, gross interest, main composition, geographical coverage, and third-party evaluation);

  (ii) the transfer agreement;

  (iii) the disposal announcement released on news media;

  (iv) certificate of incorporation, relevant commitment in writing and proof of the offshore investor's credit and business performance;

  (v) notarial certificates issued by the notary authority for the transfer process (brief introduction of the NPLs, the transfer method, main onshore and offshore investors involved in the transfer, and relevant quotation); and

  (vi) legal opinions issued by the law firm representing the AMC.

  The NDRC then decides whether to accept the filing within 5 business days of receipt of the application material and issues a registration certificate within 7 business days of acceptance.

- *Registration with local SAFE*

  After completing the filing with the NDRC, depending on local practice, the AMC may need to complete foreign exchange registration with SAFE in order for the AMC to convert the NPL foreign exchange into RMB (in some localities, SAFE has delegated this authority to commercial banks so the AMCs can process the currency conversion with banks directly).[9] In addition, if any cross-border security issue arises from this cross-border transfer of NPLs, the SAFE cross border guarantee will need to be followed.[10]

- *Foreign exchange settlement by the AMC with bank*

[7] See the Approving Reply to Shenzhen Branch on Developing Pilot Cross-border Transfer of Non-performing Assets Business in its Administered Banks (Huifu [2017] No. 24)《关于深圳市分局开展辖区内银行不良资产跨境转让试点业务有关事项的批复》(汇复[2017]24 号) issued by SAFE on June 1, 2017. This reply shall be valid for one year from the date of the reply.

[8] See Circular of the NDRC on Effectively Conducting the Reform of Foreign Debt Administration concerning Overseas Credit Assignment (Fa Gai Wai Zi [2016] No.1712) 《国家发展改革委关于做好对外转让债权外债管理改革有关工作的通知》(发改外资[2016]1712 号).

[9] *Id.* at 8.

[10] See Notice of SAFE on Issues Concerning the Foreign Exchange Administration of the Disposal of Non-performing Assets by Financial Asset Management Companies to Foreign investors. (Hui Fa [2015] No.3) 《国家外汇管理局关于金融资产管理公司对外处置不良资产外汇管理有关问题的通知》(汇发[2015]3 号).

The AMC may, upon receipt of the proceeds of the cross-border sale, directly process the accounting and settlement of the foreign exchange monies with its bank by submitting:

(i) an application letter;

(ii) the registration certificate;

(iii) a photocopy of the key provisions of the NPLs transfer agreement; and

(iv) any other supplementary documents.

- *Foreign exchange remittance by the offshore investor with bank*

  The offshore investor can remit its income[11] abroad from the recovery or re-sale of NPLs by submitting to the bank:

  (i) an application letter;

  (ii) the registration certificate,

  (iii) a photocopy of the key provisions of the NPL transfer agreement;

  (iv) power of attorney (where applicable); and

  (v) any other supplementary documents.

1.3 Collection and recovery of NPLs

Like many other jurisdictions, enforcement of creditors' rights in China can be a complicated and time-consuming process. Below is a brief introduction to procedures (both litigation and non-litigation) applicable to the enforcement of debt in China, as well as an overview of general enforcement procedures and the treatment of various types of collateral.

1.3.1 Establishment of creditor's rights

Under Chinese law, a creditor may establish its rights against the debtor(s) through litigation proceedings or non-litigation proceedings.

1.3.2 Litigation proceedings

Litigation is commenced by filing the complaint with a court with competent jurisdiction. Normally, the court of first instance is the court in the jurisdiction where the debtor is located. To prevent the debtor from transferring his or her property, the creditor may apply for a property reservation / seizing order either before or after filing the complaint. The hearing will be held at a time chosen by the Court. The Court usually holds only one formal hearing, but it may hold more if necessary. During the hearing, both parties can present evidence, cross-examine witnesses and debate the matters in dispute.

The length of the trial process varies from case to case with an absolute limit of 6 months for a first instance trial, and 3 months for appeals. The terms of the Court's judgment typically provide a grace period for performance, usually around 10 to 15 days. Once this period has expired, the party to whom judgment was awarded can apply to the Court for enforcement. The application for enforcement should be made within 2 years of the expiry of the performance period specified in the judgment (or, in case of non-litigious proceedings, the period specified in the arbitration award, payment order or notarised enforcement certificate). Courts are legally required to enforce judgment within 6 months of receiving an application for

[11] If the foreign investor has not set up organisation or business place within China, or the income is not related to such organisation or business place, the portion of its income exceeding its original investment cost (i.e., any capital gain) will be subject to Chinese withholding tax at a rate of 10% (or a reduced rate available under any tax treaty with China).

enforcement, but there are broad exceptions to this rule and, in practice, enforcement can take years.

1.3.3 Non-litigation proceedings

Creditors may choose non-litigation methods, such as payment order and notarisation of the loan agreement, which aim to be more efficient and cost-effective.

A payment order is a special legal proceeding available for disputes in connection with monetary or securities payments and is essentially a court-sanctioned demand for payment. The following conditions must be met before a court can accept a payment order application: (i) the debt is due, and the amount is definite and clearly supported by evidence; (ii) the lender has no outstanding liability to the borrower; and (iii) the payment order can be duly served to the borrower. If the borrower cannot be found, the court will not accept the application. The time limit for the Court to issue the payment order is 15 days after the application is accepted. The debtor has 15 days from receiving the payment order to file an objection to the order which renders it ineffective. If he does not do so or fails to repay the debt as requested, enforcement proceedings can be initiated.

If an executed loan agreement is notarised by a public notary office, with the debtor confirming his willingness to be subject to judicial compulsory enforcement upon failure to repay the debt when due, then, on default of the debt, the creditor can apply to the court with competent jurisdiction for enforcement based on the enforcement certificate issued by the public notary, without going through a trial. In practice, notarisation of loan agreements is widely adopted by commercial banks.

1.4 Enforcement and auctions

Where a debt is secured by collateral, Chinese law prohibits the parties to a mortgage or pledge agreement from agreeing in advance that the title to collateral will automatically, upon the debtor's default, be transferred to the creditor who holds the security interest. However, the parties may freely agree to settle the outstanding debts after the occurrence of an event of default by transferring the title to the collateral.

If the parties cannot reach a settlement agreement, the creditor may enforce against the collateral by requesting the Court with competent jurisdiction to put the collateral up for auction. The Court is required to engage a commercial auction agency to carry out the auction and to pay the agency's fees from the auction proceeds. In practice, courts usually give a floor price to the auction agency after consulting with the creditor.

All the interested parties (including the creditor) may participate in the auction and the highest bidder should win. Where all the bids are lower than the floor price during a given round of an auction and the creditor refuses to accept the property to settle the debtor's debt, the auction is deemed to have failed. In such a case, the court may hold another round of the auction within 60 days, in which the floor price may be lower subject to agreement by the creditor. Generally, personal property cannot be subject to more than two rounds of auctions, while real property and other property rights may not be subject to more than three rounds of auctions. If the collateral is successfully sold at an auction, the proceeds are paid into the Court, with the creditor having priority claim to the proceeds. Any surplus is returned to the debtor.

Normally, the property subject to enforcement (excluding gold, silver and products made thereof, personal property whose market price is available, perishable articles, seasonal goods and other articles which are either difficult to preserve or incur extremely high preservation expenses) must be sold through auction. If the auctions fail to secure a buyer after three rounds, the Enforcement Court can decide to sell the property for a sum below the auction price.

Some of the rules governing the creation and enforcement of security interests on key categories of collateral are set out below.

1.4.1 Real property

The general rule under Chinese law is that the building and the land on which the building stands should be transferred together. Therefore, when a building is mortgaged to secure debt, the land underneath should be mortgaged too. When default occurs, and the court enforcement procedure begins, the Enforcement Court can seal the building and the land use rights. The Enforcement Court may do so by attaching tape across the property or its entrance, making an announcement to this effect or holding the relevant title certificates, if necessary. Where the debtor fails to perform its duties under the loan agreement after a sealing, the real property can be auctioned or sold off in enforcement proceedings, and the creditor will be entitled to proceeds equivalent to the amount of the outstanding debt.

Normally, the title to real property transfers when the title registration is updated. When the real property is auctioned, its title transfers to the winning bidder when the Enforcement Court delivers the auction ruling. The right of a court to auction or sell off real estate in satisfaction of a judgment is subject to some restrictions. For example, if real property is essential to the living of a debtor, whilst it may be sealed it cannot be auctioned or sold off to satisfy a creditor's claim.

Chinese law allows the mortgage of the completed part of a construction-in-progress and the underlying land. For this to be effective, the owner of the construction-in-progress must have achieved the land use right certificate, the construction land zoning certificate and the construction project planning certificate. The mortgage is created upon registration with the relevant land and housing administration authority. The security interest of the mortgagee is subject to the construction contractor's right to construction costs. If the owner of the construction-in-progress defaults on construction costs, the contractor has the right to apply to the court for auction of the construction-in-progress and has priority in respect of the auction proceeds.

1.4.2 Personal property

In addition to being sealed, personal property can also be detained and frozen. In this case, the Court can take possession of the personal property or assign a third party to do so. In the case of a debtor's bank account, the Court can freeze the account. Personal property cannot be sealed or detained for a period exceeding one year and bank accounts cannot be frozen for more than six months. For certain personal property whose title is subject to registration, such as motor vehicles, vessels and aircrafts, the applicable property registration authority should be notified of the sealing.

If the personal property is sold at auction, the title transfer occurs when it is delivered to the winning bidder. As is the case with the enforcement of real property, necessities (necessary clothing, cooking and dining utensils, furniture or living expenses equal to the minimum living standards) are exempt from enforcement measures.

1.4.3 Intellectual property

Although pledges over intellectual property have been allowed since 1995, until recently they were rarely used in practice. The increase in their use is partly due to a series of regulations from central and local governments on the creation, perfection and foreclosure of pledges over various types of intellectual property rights. Only registered intellectual property which is assignable can be used as collateral. According to the PRC Property Law, a pledge over intellectual property is created when the pledge agreement is registered with the applicable intellectual property authority. The registration authorities for trademarks, patents and copyright are the State Trademark Office, the State Intellectual Property Office and the Copyright Protection Centre of China respectively.

To date, there is no national law regulating the enforcement of pledges over intellectual property, but some localities have developed general regulations. For instance, in both Chongqing Municipality and Jiangsu Province, local rules provide for the exercise of the right to have the trademark sold or auctioned upon the default of the debtor.

1.5 Debt-to-equity swap

Debt-to-equity swap is an often-used resolution for NPLs. A creditor may convert its rights into equity in the debtor, and then realise returns from a future sale of equity, trade sale or other distribution from the debtor. A debt-to-equity swap is allowed under one of the following circumstances:

- the creditor has performed its contractual obligations and not violated any laws, regulations, administrative decisions or the prohibitive provisions of the debtor's articles of association;
- the proposed conversion has been approved by effective court judgments; or
- the proposed conversion through bankruptcy reorganisation plans or settlement agreements has been approved by court.[12]

Both onshore and offshore investors are allowed to process debt-to-equity swaps by applying to the Administration of Industry and Commerce (AIC) with jurisdiction over the debtor. To address the growing NPLs faced by Chinese banks, in September 2016, the Chinese government expressly encouraged commercial banks to carry out debt-to-equity swaps through AMCs and other acquirers of NPLs.[13]

In addition, to complete the debt-to-equity swap process: (i) the creditor and the debtor should enter into a debt-to-equity swap agreement; (ii) the creditor's rights should be evaluated by an independent and qualified accounting firm or evaluation institution; (iii) the target company (debtor) should complete the registration with the AIC for change of shareholders, capital increase and transformation of the company, if the creditor is a foreign investor, from a domestic company to a foreign-invested company.[14]

1.6 China's NPL market

Since the launch of China's NPL sector in 1999, the Chinese government has gradually deregulated the sector with the objective of invigorating the sector and attracting more participants, including foreign acquirers of NPLs. This trend has accelerated in recent years. For example, in February 2016, a group of Chinese ministries and commissions jointly released a document,[15] calling for, among other things, improved efficiency in NPL disposals. We anticipate further measures to liberalise the market to address the ever-growing NPL pressure faced by banks in China. As a result, offshore investors may see more opportunities for them to participate in this market.

SINGAPORE

2. Strengthening Singapore’s statutory restructuring regime with features from the US Chapter 11 regime

2.1 Introduction

The Singapore Companies Act (Amendment) Act 2017 (SCA Amendments) made several revisions to the SCA which came into force on 23 May 2017. This section explores these

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12. See *Administrative Provisions on the Registration of the Registered Capital of Companies*《公司注册资本登记管理规定》2014-02-20.

13. See *Guidelines on Market-Oriented Debt-to-Equity Swaps at Banks* (Guo Fa [2016 No.54]《关于市场化银行债权转股权的指导意见》(国发[2016]54 号).

14. Through our most recent inquiries with several local AICs, we understand that the process for debt-to-equity swap would not be much more cumbersome for offshore investors than onshore investors.

15 See Several Opinions on *Financial Support to Maintain Steady Industrial Growth, Adjust Industrial Structure and Improve Industrial Efficiency* (Yin Fa [2016] No.42) 《关于金融支持工业稳增长调结构增效益的若干意见》(银发[2016]42 号).

legislative changes introduced by the Amendment Act 2017, although their full impact remains to be tested and developed before the Singaporean courts.

2.2 Schemes of Arrangement (debtor-in-possession regime)

Schemes of Arrangement are commonly used by companies to compromise trade and financial debts. The distressed company (the Company) presents a debt restructuring proposal to its creditors. The proposal must be approved by each class of creditors, representing (in each class) 75% in value and a majority in number present and voting, before it becomes binding on all the creditors. Broadly, creditors are divided into separate classes if their rights are so dissimilar that they cannot sensibly consult together with a view to their common interest.

The SCA amendments introduce several enhancements to this regime including:

- an automatic moratorium of 30 days, triggered upon application to Court for a moratorium under Section 211B of the SCA;
- provisions for rescue financing;
- “cram-down” provisions empowering the Court to approve a scheme despite one or more dissenting classes of creditors, where at least one class of creditors has approved the scheme (therefore allowing the Court to push through a scheme even where there are hold out classes of creditors); and
- the option for pre-packaged restructuring plans that the Court can approve without convening meetings of creditors.

2.2.1 Enhanced moratorium regime

The moratorium prevents creditors from taking action against the Company, such as commencing legal proceedings or enforcing security rights, and gives the Company breathing space to put forward a restructuring proposal. The key enhancements to this regime under the SCA Amendments are:

- automatic moratorium;
- worldwide effect of moratorium; and
- related entities.

2.2.1.1 Automatic moratorium

Under the previous regime, a moratorium would become effective only once the Court granted an order under Section 210(10) of the SCA. Now, an automatic moratorium arises upon the filing of an application for a moratorium under Section 211B(1) of the SCA. This automatic moratorium shall end on whichever is earlier of:

- 30 days from the date on which the application is made; or
- the date on which the application is decided by the Court.

In practice, the Court will fix the hearing for a moratorium application under Section 211B within 30 days of the date of application.

2.2.1.2 Moratorium extending to related entities of the company

Where the Court has granted an order for a moratorium under Section 211B of the SCA, a related company of the Company, that is a subsidiary, holding company or ultimate holding company of the Company subject to the order, may apply for a moratorium on similar terms in respect of itself under Section 211C of the SCA. The related company seeking such a moratorium must show to the Court's satisfaction that:

- the related company plays a necessary and integral role in the compromise or scheme of arrangement relied on by the Company to make the application for the order under Section 211B (1);

- the proposed compromise or scheme of arrangement relied on by the Company will be frustrated if actions against the related company are not restrained; and

- the creditors of the related company will not be unfairly prejudiced by the granting of the extended moratorium.

2.2.1.3 Worldwide effect

The Court is now empowered under Sections 211B (5) and 211C (4) of the SCA to grant a moratorium extending to creditor actions outside Singapore, so long as the creditor is within the *in personam* jurisdiction of the Singaporean courts. This is in addition to the Court's express power to grant the moratorium on such terms as the Court deems fit to impose. There is no requirement for the applicant to show that the creditors are acting in an oppressive, vexatious or otherwise unfair manner.

2.2.2 Rescue financing

Rescue financing is defined in the SCA to be[16]:

- financing necessary for the survival of a company that obtains the financing, or of the whole or any part of the undertaking of that company, as a going concern; or

- financing necessary to achieve a more advantageous realisation of the assets of a company that obtains the financing, than on a winding up of that company.

The SCA amendments recognise that viable companies may be unable to restructure without rescue financing, and that lenders are often reluctant to provide additional financing to troubled companies.[17] The new provisions facilitate rescue financing[18], whereby new loans may be provided to the Company, including with the benefit of priority over other / existing creditors and possibly security interests. Such loans may provide the necessary working capital for the Company's restructuring efforts.

On application by the Company under Section 211E of the SCA, the Court may make orders to the effect that:

- if the Company is wound up, the debt arising from any rescue financing obtained by the Company is paid in priority to any preferential debts arising under the Companies Act and in priority to other unsecured debts; and / or

- the debt arising from any rescue financing obtained by the Company be secured by a security interest over the Company's property that is equal to or higher than any existing security interest so long as adequate protection for the existing security interest is provided for.

2.2.3 Cram-down provisions

Previously, a compromise or an arrangement proposed by the Company (a Scheme) would only bind all creditors and members of the Company if the proposed scheme of arrangement

[16] Section 211E(9) and Section 227HA(10), SCA.
[17] Companies (Amendment) Bill Second Reading Speech by Senior Minister of State for Law and Finance, Ms Indranee Rajah.
[18] Section 211E, SCA.

was approved by a majority in number representing three quarters in value of creditors present and voting in each class of creditors (Scheme Approval Condition). This meant that the Court could only sanction a scheme if the requisite majority approval had been obtained from all classes of creditors.

Where the creditors to be bound by the Scheme were placed in 2 or more classes for the purposes of voting on the compromise or arrangement, the Scheme would not be binding if one of the classes of creditors did not meet the Scheme Approval Condition (a Dissenting Class).

The new cram-down provisions prevent a minority dissenting class of creditors from unreasonably frustrating a restructuring that benefits creditors as a whole[19]. Under Section 211H of the SCA the Court can approve a Scheme even if there are objections from one or more class / classes of creditors, so long as at least one class of creditors has met the Scheme Approval Condition. The Court will only grant such an order if[20]:

- A majority in number of the creditors and representing three quarters in value of creditors present and voting have agreed to the arrangement; and

- The Court is satisfied that the Scheme does not discriminate unfairly between 2 or more classes of creditors and is fair and equitable to each Dissenting Class.

A Scheme is considered fair and equitable in respect of the Dissenting Class if the following conditions are met:[21]

- no creditor in the Dissenting Class receives, under the terms of the Scheme, an amount that is lower than what the creditor is estimated by the Court to receive in the most likely scenario if the compromise or arrangement does not become binding on the company and all classes of creditors meant to be bound by the Scheme; and

- if the creditors of the Dissenting Class are secured creditors:

    - such creditors receive deferred cash payments totalling the amount of the creditor's claim that is secured by the security held by the creditor, and the terms of the Scheme preserve that security and the extent of that claim.

    - where the security is to be realised by the Company, secured creditors are granted a charge over the proceeds of the realisation to satisfy the creditor's claim that is secured by that security; or

    - such creditors in the Dissenting Class are entitled to realise the indubitable equivalent of the security held by the creditor in order to satisfy the creditor's claim that is secured by that security.

- if the creditors of the Dissenting Class are unsecured creditors, the Scheme:

    - provides for the unsecured creditors to receive property of a value equal to the amount of the creditor's claim; or

    - does not provide for any member or a creditor with a subordinate claim to the Dissenting Class to receive or retain any property on account of either the member's interest or the subordinate claim.

[19] Companies (Amendment) Bill Second Reading Speech by Senior Minister of State for Law and Finance, Ms Indranee Rajah.
[20] Section 211H(3), SCA.
[21] Section 211H(4), SCA.

2.2.4 Fast-track approval of pre-negotiated schemes

Under the new regime (Section 211I of the SCA), the Company may bypass the requirement for a meeting of creditors to be convened where it has reached an agreement with its key creditors on a pre-negotiated restructuring compromise or arrangement (pre-negotiated Scheme). In making such an order, the Court must be satisfied that a company meeting of the creditors had been summoned, a majority in number of the creditors and representing three quarters in value of creditors present and voting would have agreed to the Scheme.[22]

2.3 Judicial Management

Judicial Management is a rehabilitative procedure that aims to achieve the survival of the Company or a more advantageous realisation of the Company's assets than would be the case in a liquidation. The Court appoints a judicial manager to administer the Company's operations and assets in place of the existing management.

The SCA Amendments enhance the Judicial Management regime through:

- relaxing the eligibility criteria for the Company to apply for Judicial Management; and
- provisions for rescue financing.

2.3.1 Relaxation of the eligibility criteria

2.3.1.1 Removal of Insolvency Criteria

Previously, a Company was only able to apply for Judicial Management if it satisfied the Court that it would be unable to pay its debts. Section 227B(1)(a) of the SCA lowers this threshold to:

> "the Company is likely to become unable to pay its debts".

This allows for earlier intervention for financially distressed companies to arrest problems sooner.

2.3.1.2 Removal of automatic veto rights of debenture holder

Previously, the holder of a floating charge over the whole (or substantially the whole) of a Company's property (the Debenture Holder) had a right to veto a Judicial Management application. Under Section 227B (5) of the SCA, the Debenture Holder may now only veto the Judicial Management application if the Court is satisfied that the prejudice that would be caused to the Debenture Holder if the order were made is disproportionately greater than the prejudice that would be caused to unsecured creditors of the company if the application were dismissed. The Court is likely to take the following factors into account:

- The legal and commercial interests of the unsecured creditors;
- Whether there is a viable chance for the Company to be rehabilitated through judicial management; and
- Whether the opposing Debenture Holder is over- or under-secured.

2.3.2 Rescue financing

The rescue financing provisions in the context of a Judicial Management under Section 227HA of the SCA mirror closely the Rescue Financing provisions of the Scheme of Arrangement regime as described above.

[22] Section 211I(3)(d), SCA.

Rescue financing is defined in the SCA to be:[23]

- financing necessary for the survival of a company that obtains the financing, or of the whole or any part of the undertaking of that company, as a going concern; or

- financing necessary to achieve a more advantageous realisation of the assets of the Company that obtains the financing, than on a winding up of the Company.

On application by the Company under Section 227HA of the SCA, the Court may make orders to the effect that:

- should the Company be wound up, the debt arising from any rescue financing obtained by the Company be paid in priority to any preferential debts arising under the Companies Act and in priority to other unsecured debts; and / or

- the debt arising from any rescue financing obtained by the Company be secured by a security interest over the Company's property that is equal to or higher than existing security interest(s) so long as adequate protection for existing security interest(s) is provided for.

2.4 Cross-border insolvency

Cross-border cases have become increasingly common as companies conduct their business across jurisdictions. The SCA Amendments facilitate the application of the insolvency framework to companies with international business interests.

2.4.1 Extension of insolvency regime to foreign companies with a substantial connection with Singapore

The SCA Amendments clarify that foreign companies may apply to the Singapore Court for relief under the debt-restructuring framework so long as they have a "substantial connection" with Singapore.

In the context of Schemes of Arrangement, Section 211A expressly defines a "company" as any corporation liable to be wound up under the SCA. Section 227AA of the SCA applies the same definition of a company in the context of Judicial Management.

The Court has jurisdiction to wind up a foreign-incorporated company if it can be shown that the foreign company has a substantial connection with Singapore[24]. Section 351(2A) of the SCA provides certain non-exhaustive factors the Court can take into account in determining if the foreign company has a substantial connection with Singapore. These include:

- Singapore is the centre of the Company's main interests;

- the Company is carrying on business in Singapore or has a place of business in Singapore;
- the Company is a foreign company registered under Division 2 of Part XI of the SCA;

- the Company has substantial assets in Singapore;

- the Company has chosen Singaporean law as the law governing a loan, other transaction or the resolution of one or more disputes arising out of or in connection with a loan or other transaction; and

- the Company has previously submitted to the Court's jurisdiction for the resolution of one or more disputes relating to a loan or other transaction.

[23] Section 227HA(10), SCA.
[24] Section 351(2A), SCA.

2.4.2 Enactment of the UNCITRAL Model Law on Cross-Border Insolvency

Sections 354A – 354C of the SCA have been introduced to enact the Model Law (with certain modifications to adapt it for application in Singapore). The Model Law sets out a comprehensive framework for international cooperation. It is intended to lower the risks and costs of international financing, reduce the overall cost of insolvency litigation and reduce the overall costs of obtaining recoveries from cross-border insolvency processes.

This paper does not explore the impact of the Model Law in detail. Generally, the Model Law treats multinational insolvency as a single process with other courts assisting the foreign main proceeding. The Model Law does not attempt to unify substantive insolvency laws of different countries. Instead, it attempts to achieve the following:

- identify the most relevant jurisdiction in relation to a cross-border insolvency (the foreign main proceeding / principal jurisdiction);
- ensure that insolvency officials from that jurisdiction are recognised in other states; and
- ensure that other states provide the necessary cooperation to facilitate the insolvency process in the principal jurisdiction.

In *Re Zetta Jet Pte Ltd and others*[25] [, the Singaporean High Court (the High Court) issued its first reported decision on an application under the amended SCA for recognition of Chapter 7 insolvency proceedings commenced in the United States of America. In summary, the Zetta Jet companies (Zetta Jet Pte Ltd and Zetta Jet USA, Inc) had applied for and proceeded with Chapter 7 bankruptcy proceedings in USA, with a Chapter 7 trustee (the Trustee) appointed by the US Bankruptcy Court as a result. This however was in contravention of an earlier injunction issued by the Singaporean Court enjoining the Zetta Jet companies from further pursuing bankruptcy proceedings in the USA (the Injunction). The Trustee subsequently applied in Singapore for recognition of the US bankruptcy proceedings.

The High Court considered that it would be contrary to the public policy of Singapore (under Article 6 of the Model Law) to grant recognition to the Trustee. The Court considered that granting of recognition to the Trustee, in the face of the breach of the Injunction by the pursuit of the US bankruptcy proceedings, would undermine the administration of justice in Singapore. The High Court therefore only granted limited recognition of the Trustee to the extent necessary for him to set aside or appeal the injunction. The High Court left it open to the Trustee to revisit the issue of wider recognition if he was successful in proceedings in respect of the Injunction.
The full impact of the enactment of the Model Law in Singapore remains to be explored by subsequent case law, but it is clear that foreign proceedings undertaken in contravention of an order of a Singaporean court will not be recognised under the Model Law as enacted by the SCA.

2.4.3 Abolition of ring-fencing in favour of local creditors

Previously, the SCA mandated that the Singaporean liquidator was to apply the Company's assets in Singapore to satisfy the preferential debts set out in the SCA and debts and liabilities incurred in Singapore, before the residual balance could be remitted to a foreign liquidator. This provision has now been repealed.

2.5 Carve-outs from the enhanced moratorium regime

The enhanced moratorium regime as set out above have prompted concerns that the wide moratorium may have a disproportionately adverse effect on financial markets. The insolvency of a market participant may trigger a chain reaction of insolvencies, where financial transactions are threatened by the suspension of the obligations of a party subject to the moratorium.

[25] [2018] SGHC 16

To prevent the amendments unduly disrupting financial markets, the Companies (Prescribed Arrangements) Regulations 2017 (Regulations) have been passed which exclude certain security interest arrangements from a moratorium. The Regulations aim to ensure the continued enforceability of all legal rights and remedies against corporate borrowers, their holding companies and subsidiaries under any "security interest arrangement".

The apparent inspiration for the Regulations are the safe harbour provisions in the US Bankruptcy Code. US safe harbour provisions exempt certain financial and derivative contracts from an automatic moratorium, thereby allowing banks, stockbrokers, and other financial institutions to exercise their contractual rights to terminate, liquidate or accelerate contracts.

The Regulations define a "security interest arrangement" as an arrangement under which:

- a security interest is created; and
- that security interest secures any of the following transactions:
  - a securities contract;
  - a derivatives contract;
  - a master netting agreement; or
  - a securities lending or repurchase agreement.

Secured parties to contracts for the sale of securities, derivative contracts, securities lending and repurchase contracts and master netting agreements are now not subject to the moratorium. Parties to security interest arrangements (as defined) can continue to enforce all security and contractual rights, including rights of set-off and netting off.

2.6 Conclusion

In many jurisdictions and across many industries, the liquidation of a company has serious implications for all stakeholders involved, such as employees, creditors and investors. This is particularly true for large, multinational companies with operations across the globe and a restructuring will typically allow the Company to carry on as a going concern and the Company's stakeholders to achieve more positive outcomes than they would in a liquidation.

The enhanced restructuring regime introduced by the SCA Amendments offer companies in financial distress more tools and greater flexibility to restructure. With the extension of the Singaporean insolvency regime to foreign companies with a substantial connection to Singapore, foreign companies will also have the option of applying to the Singaporean courts for assistance in implementing their restructuring proposals.

These legislative enhancements promise to mitigate the adverse effects of liquidation on stakeholders of companies in financial distress and will continue to develop as the new regime is implemented and benefits from practical input and judicial interpretation. These developments will contribute to a more robust economic climate in the region and beyond.

AUSTRALIA

3. Recent developments in Australian insolvency law

Recent changes in Australian insolvency law aim to encourage a cultural change in Australian boardrooms in favour of entrepreneurship and innovation. Legislative changes include:

- "safe harbour" provisions to protect company directors[26] against insolvent trading claims, in circumstances where the director is planning a course of action to lift the Company out of financial difficulty; and

- the introduction of a stay on enforcing so-called *ipso facto* clauses which would otherwise allow a counterparty to vary or terminate a contract purely by reason of the Company entering into a formal restructuring.

The new directors' safe harbour provisions and stay on *ipso facto* clauses arise through amendments to the Australian Corporations Act 2001 (ACA), made through the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017 (the TLA). The amendments regarding the safe harbour provisions came into force on 19 September 2017 and the amendments regarding *ipso facto* clauses apply to new contracts created after 1 July 2018.

The stated purpose of the reforms is to encourage innovation in business and to prevent premature administration and the associated destruction of enterprise value.

Separately, as part of substantial reforms to the laws surrounding personal and corporate insolvency, the Australian Government has sought to enhance creditors' rights and control over insolvency practitioners. Most recently, the Government has released a number of proposals, which remain under development, designed to protect creditors from illegal "phoenix" behaviour.

The new legislation raises a number of issues which may arise in practice, as well as uncertainties which remain to be examined by the Courts.

3.1 Safe harbour

These new provisions (Sections 588GA-588X of the ACA) provide directors with protection from claims that they have caused the Company to incur debt while the Company was insolvent (known as insolvent trading). They apply if a director

> "588GA (1)(a) …starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and
>
> (b) the debt is incurred directly or indirectly in connection with [such a] course of action…"

Prior to the introduction of the safe harbour provisions, such directors may have been caught by the insolvent trading provisions in Section 588G of the ACA, which are discussed below.

3.1.1 Insolvent trading prior to the reforms

Many readers will be familiar with the concept of imposing personal liability on directors for debts incurred when a company is insolvent or near insolvency. In *Woodgate v Davis*,[27] Barrett J of the Supreme Court of New South Wales summarised the purpose of Australia's then insolvent trading provisions as follows:

> *"Section 588G and related provisions serve an important social purpose. They are intended to engender in directors of companies experiencing financial stress a proper sense of attentiveness and responsible conduct directed towards the avoidance of any increase in the company's debt burden. The provisions are based on a concern for the welfare of creditors exposed to the operation of the principle of limited liability at a time when the prospect of that principle resulting in loss to creditors has become real."*

[26] Although the legislation refers to a "person", rather than a director, the focus of this paper is the impact of the provisions on company directors.

[27] (2002) 55 NSWLR 222

The insolvent trading provisions apply to a director if:

- the Company is insolvent at that time, or becomes insolvent by incurring the debt, or by incurring at that time debts including the debt;
- at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent; and
- either (a) the director is aware at that time that there are such grounds for suspecting that the company is insolvent, or would become insolvent by incurring the debt, or (b) a reasonable person in a like position in the company's circumstances would be aware that there are such grounds for suspecting that the company is or would become insolvent by incurring the debt.

Prior to the reforms, the available defences applied if:

- the director had reasonable grounds to expect, and did expect, that the Company was solvent at the time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time;
- the director had an expectation of solvency based on information provided by a person reasonably believed to be competent and reliable, who was responsible for providing adequate information about whether the company was solvent and who was fulfilling that responsibility;
- the director did not take part at that time in the management of the company because of illness or for some other good reason; or
- the director took all reasonable steps to prevent the company from incurring the debt.

3.1.2 The need for reform

The safe harbour reforms have created a carve out[28] from the operation of the insolvent trading provisions, to address criticism that Australia's existing insolvent trading laws were unduly strict on company directors and discouraged entrepreneurs from taking acceptable risks.[29] In particular, the previous laws were criticised for:

> "driving directors to seek voluntary administration even in circumstances where the company may be viable in the longer term".[30]

The Government's concern was that where an honest director acknowledged the risk of insolvency, there were few options available to them other than putting the company into administration which would meet the "all reasonable steps" test.

On the other hand, directors operating on the borderline of acceptable practice who wished to avoid administration were arguably encouraged to take an overly optimistic view of their company's fortunes, such that they could later testify to a genuine belief that the company was solvent. Arguably, under the previous regime, such directors lacked the incentive to confront the reality of their company's situation and take appropriate action for the benefit of creditors.

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[28] The new provisions technically operate as a "carve out" rather than a defence, since the director bears only an evidential, rather than legal, burden: see s 588GA (3).

[29] See, for example, the second reading speech of the Treasury Laws Amendment (2017) Enterprise Incentives No. 2 Bill 2017 in the House of Representatives, given on 1 June 2017, *House of Representatives Hansard*, pp.6011-6012 and the National Innovation & Science Agenda Proposals Paper on Improving Bankruptcy and Insolvency Laws, dated April 2016 at p.10.

[30] Explanatory Memorandum to the Treasury Laws Amendment (2017) Enterprise Incentives No. 2 Bill 2017 at p3.

Notwithstanding these criticisms, it is worth noting that in practice, it was difficult to make out a case of insolvent trading even under the old provisions. It is therefore questionable whether honest directors were really at risk under the old laws.

A plaintiff seeking to prosecute an insolvent trading claim (whether before or after the reforms) faces the following key difficulties:

- Under the ACA, the test for insolvency is a cash flow test (that is, whether a company is able to pay all of its debts when they become due and payable). A company may therefore be regarded as solvent if it claims to be able to borrow or to rely on funds from related companies notwithstanding a substantial net asset deficiency. Availability of such funds can be difficult to analyse retrospectively, particularly by a liquidator plaintiff who is an outsider to the company. This can make it difficult to prove that the company was insolvent at the relevant time.

- Even if cash flow insolvency is established, if a director testifies that he had a genuine expectation (a subjective belief) that the Company, it is difficult to prove otherwise. In such circumstances a plaintiff is often forced to rely on cross examination at trial, given that a claimed subjective belief is rarely disproved by documents.

- The major question then turns to whether, objectively, there were reasonable grounds for an expectation of solvency. Providing that the director properly informed himself of the Company's position they may have had reasonable grounds to expect solvency, even if, with the benefit of hindsight, the company was objectively insolvent.

In light of these challenges, even under the old regime, it is open to question whether directors were in fact operating in fear of liability for insolvent trading and placing their companies in premature administration, or whether any such fears were justified. It has been noted that such a fear was supported by anecdotal evidence only, with little or no empirical evidence available.[31]

Nonetheless, as is explored further below, the new provisions make it even more difficult to make out a case of insolvent trading and, in particular, provide honest directors who face up to the reality of the company's position and attempt to address it, with an alternative to administration.

3.1.3 The new safe harbour provisions

These new provisions apply where the director does suspect that the Company is insolvent, but nevertheless wishes to incur debts in connection with a plan to improve the Company's financial position.

The stated intention of the new provisions is to -

> *"strike a better balance between the protection of creditors and encouraging honest, diligent and competent directors to innovate and take reasonable risks."*[32]

The main elements of the safe harbour provisions, each of which is described in detail below, are:

- the director has started to suspect the company may become or be insolvent;

- the director was developing one or more courses of action;

[31] Boothman *"Safe Harbour or Shipwreck? A critical analysis of the proposed safe harbour for insolvent trading"* (2016) 34 C&SLJ 520.

[32] The Explanatory Memorandum to the Treasury Laws Amendment (2017) Enterprise Incentives No. 2 Bill 2017 at [1.12].

- the course(s) of action were reasonably likely to lead to a better outcome for the company than the immediate appointment of a liquidator or administrator;
- the debt was incurred directly or indirectly in connection with the course(s) of action; and
- the debt was incurred within a period in which the safe harbour applies.

3.1.3.1 Suspicion of insolvency

The safe harbour provisions only apply:

> "after the [director] starts to suspect the company may become or be insolvent".

Reliance on the provision effectively requires the director to admit that they held this suspicion.

One important consequence of this admission is that, in complying with the directors' broader fiduciary duty to act in the *bona fide* best interests of the company, the director will likely be required to take into account the interests of the Company's creditors: see for instance: *Walker v Wimborne* [33]at 6-7; *Kinsela v Russell Kinsela Pty Ltd* (in liq)[34] (at 730. It follows that a restructuring envisaged during the operation of a safe harbour should be one planned with the interests of creditors in mind.

3.1.3.2 Developing one or more courses of action

There is an evidential burden on the director to adduce evidence that suggests a "reasonable possibility" that the elements of the safe harbour set out above apply.

Accordingly, at a minimum, the director will be required to produce (ideally documentary) evidence of the particular course(s) of action they were planning and sufficient financial information to allow comparison with the appointment of a liquidator. As suggested in the explanatory memorandum (the Memorandum):

> "[a] mere statement that a course of action was being developed or taken and that it would be reasonably likely to lead to a better outcome … would not be sufficient".[35]

As long as evidence of the proposed courses of action is available, the threshold for demonstrating a "reasonable possibility" of establishing the elements of the safe harbour appears low. The plaintiff would then need to prove on the balance of probabilities that the director is not entitled to rely on the safe harbour provisions.

3.1.3.3 Reasonably likely to lead to a better outcome

Perhaps the most significant question to be considered is whether the proposed course of action was "reasonably likely to lead to a better outcome for the company" than the immediate appointment of a liquidator or administrator.

This appears, on the wording, to be an objective question.[36] That is, would an objective observer have considered the course of action to be reasonably likely to lead to a better outcome for the company?

However, Section 588GA (2) provides a non-exhaustive list of factors which may be considered in answering this question, and which focus on the conduct of the director himself, namely whether the director:

[33] (1976) 137 CLR 1
[34] (1986) 4 NSWLR 722
[35] Explanatory Memorandum to the Treasury Laws Amendment (2017) Enterprise Incentives No. 2 Bill 2017 at [1.76].
[36] The Explanatory Memorandum to the Treasury Laws Amendment (2017) Enterprise Incentives No. 2 Bill 2017 does not contain anything to contradict an objective test.

"S.588GA (2)

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

(b) is taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts; or

(c) is taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company; or

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

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

If the test is objective, it is unclear how the above matters will be taken into account by a court. It could be said that a director who has taken the above steps is more likely to implement a course of action which is reasonably likely to lead to a better outcome, but this is not necessarily the case. It is possible to envisage an honest director who takes the above steps, but nonetheless implements a misconceived plan that is not, objectively speaking, reasonably likely to lead to a better outcome for the company. On the other hand, it is possible (although unlikely) that a director may develop a course of action that is objectively likely to lead to a better outcome for the company, without having taken the listed steps.

Accordingly, the matters listed in Section 588GA (2) appear to provide better guidance as to whether the director has complied with their general law duties, rather than the operation of the safe harbour. In this regard the Memorandum states at [1.64]:

> *"These indicia provide a useful signpost as to how a director may continue to meet their general duties to the company to act with care and diligence, in good faith and in what they consider to be the company's best interests while in safe harbour."*

There remains a disjuncture between the objective test and the subjective factors listed in Section 588GA (2). In the course of public consultation on the legislation, the Economics Legislation Committee received submissions that the matters listed in s 588GA (2) should be taken as *prima facie* evidence that a proposed course of conduct would lead to a better outcome for the company.[37] However, the Committee did not recommend any amendments following the consultation process and stated that it:

> "considers that a number of the matters raised in submissions would be best clarified in regulations accompanying the legislation".[38]

As matters stand, on a strict reading of the legislation, the likely outcome of a proposed course of action could be considered a question for expert evidence, regardless of whether or not the director took the steps identified in Section 588GA (2). Directors are nevertheless encouraged to take those steps in order to obtain the best outcome for the company and to have the best chance of obtaining safe harbour protection.

Notwithstanding the disjuncture identified above, in practice courts are likely to be reluctant to conduct a detailed examination of the merits of a proposed course of action, particularly in view of the low threshold as to what is "reasonably likely" to lead to a better outcome. The Memorandum equates the phrase "reasonably likely" with "not fanciful or remote" but "fair", "sufficient" or "worth noting".[39] In other words, it is likely to be only where the prospect of success of a director's planned course of action can be shown to be fanciful or remote, that he will be prevented from relying on the provisions.

[37] Senate Economics Legislation Committee Report, August 2017 at [2.25]-[2.27].
[38] Senate Economics Legislation Committee Report, August 2017 at [2.76].
[39] Explanatory Memorandum to the Treasury Laws Amendment (2017) Enterprise Incentives No. 2 Bill 2017 at [1.52].

Given the low threshold required for a director's proposed course of conduct, it is suggested that, in practice, the utility of expert evidence will be limited. If a plan's prospects of success cannot be shown to be fanciful or remote without expert evidence, plaintiffs will face a difficult task in defeating reliance on safe harbour.

A further evidential difficulty that may arise is the need to compare the proposed course of action with a hypothetical liquidation at that date, which could be a number of years before the claim is commenced, to determine whether the director's plan will lead to a "better outcome" than the immediate appointment of a liquidator.
For example, a director may be able to adduce sufficient evidence to show a reasonable possibility they are entitled to rely on a safe harbour, but that evidence may not be sufficient to allow a critical analysis of the result of a hypothetical liquidation.[40]

Although the legislation also provides for an alternative comparison with a hypothetical administration, it is difficult to see when this would apply. The director's plan need only be reasonably likely to lead to a better outcome than whichever is worse of hypothetical liquidation or administration. Logically this should be liquidation.

3.1.3.4 Debt incurred "in connection with" a course of action

The safe harbour provisions require that debt incurred is directly or indirectly in connection with a proposed course of action. The Memorandum envisages that this will include trade debts, and this interpretation appears to be supported by the breadth of the provision. Arguably, as long as the directors' proposed course of action assumes the incurring of further trade debts, such debts would be at least indirectly connected with the course of action, and thus covered by the safe harbour.

For further certainty, directors may wish to make contemporaneous records confirming that the incurrence of further trade debts is a necessary part of their strategy.

3.1.3.5 Debt incurred in relevant period

Application of the safe harbour requires the relevant debt to be incurred during the period starting when the director begins developing a course of action and ending at the earliest of:

- the end of a reasonable period during which the director fails to take any such course of action;
- when the director ceases to take any such course of action;
- when any such course of action ceases to be reasonably likely to lead to a better outcome for the company; and
- the appointment of an administrator, or liquidator, of the company.

In effect, directors seeking to restructure their company without entering an insolvency process will need to be reasonably diligent in implementing a proposed plan and monitoring the effectiveness of any such plan to ensure it is still reasonably likely to lead to a better outcome.

3.1.3.6 Other restrictions

In the absence of exceptional circumstances,[41] directors will generally be debarred from relying on the safe harbour provisions if at the time the debt is incurred the company is failing

[40] However, the legislation does provide some safeguards against directors who fail to permit inspection or to deliver books and records, who conceal, destroy or remove evidence or who fail to provide certain information: see s 588GB.

[41] A director may apply for an order that s 588GA (4) or (5) do not apply on the basis of exceptional circumstances or in the interests of justice: s 588GA (6).

to pay employee entitlements or to provide required documents under taxation laws, or if the director fails substantially to comply with relevant duties relating to reports as to the affairs of the Company, delivery of books and records and assistance to liquidators.

If a director does not cooperate and provide information to the company's liquidators, or conceals, destroys or removes the Company's books, they will, in most circumstances, be unable to rely on these documents to support his claim of reliance on the safe harbour provisions.

3.1.4 Likely impact of the safe harbour reforms

In conclusion, the safe harbour reforms offer the chance of a change in directors' conduct, by removing the incentive for directors to take an overly optimistic view of their companies' financial position. Instead they are encouraged to confront the reality of their situation and to actively search for a solution which will benefit the creditors as a whole.

While the legislation's drafters may have intended that an honest director who takes the steps identified in Section 588GA (2) should have the benefit of the safe harbour, given the operation of an objective test there is doubt as to the relevance of these steps. On a strict reading, the focus is on the reasonably likely result of a plan, rather than conduct or honesty of a director.

Given the historical difficulties in bringing insolvent trading claims, the new provisions may not have a significant impact on the number or success rate of claims brought against directors. However, provided that directors are aware of the reforms, they may feel empowered to avoid premature administration or liquidation and to instead take active and reasonable steps to improve the Company's financial position.

3.2 *Ipso facto* clauses

The second major change implemented by the TLA is to provide a stay on enforcing contractual rights arising from what are commonly known as *ipso facto* clauses. These clauses give a party termination or other rights purely by reason of the Company entering into a formal restructuring, even if the counterparty is otherwise complying with the contract.

The Australian Government introduced stay provisions to address a concern that these clauses destroy enterprise value during formal restructurings as important contracts, for example, with key suppliers, may be varied or terminated, affecting the Company's ability to continue as a going concern.

The stated aims of the new provisions include to:

> "allow breathing space for a company to continue to trade during a formal restructure [and to] assist in protecting asset values for the benefit of the company, its employees and its creditors which in turn will assist to promote a culture of entrepreneurship and reduce the stigma of failure".[42]

3.2.1 The new stay on enforcement of ipso facto clauses

The stay under the revised ACA only applies to new contracts entered into on or after 1 July 2018. It prevents a counterparty from enforcing its rights merely because the Company takes steps to formally restructure or enter into a compromise or arrangement under the ACA, and can be implemented when:

- a company comes under administration;
- a managing controller is appointed; or

[42] Explanatory Memorandum to the Treasury Laws Amendment (2017) Enterprise Incentives No. 2 Bill 2017 at [2.10].

- the Company is or will be subject to a compromise or arrangement under Section 411 of the ACA for the purpose of avoiding being wound up in insolvency (including where an announcement is made that a company will apply to enter into a compromise or arrangement).

The stay prohibits the enforcement of rights, including the operation of self-executing provisions, for reasons relating to the above matters or for "a reason that, in substance, is contrary to [the relevant] subsection".

The stay ends (depending on the circumstances) if:

- the administration ends, or at the end of a period extended by the court;
- the managing controller's control of company property ends, or at the end of a period extended by the court;
- there is no further announcement regarding a compromise or arrangement within 3 months after an initial announcement (or such longer time as the Court may order);
- an application for a compromise or arrangement is withdrawn;
- a compromise or arrangement is effected; or
- the company has been fully wound up.

Rights may be unenforceable indefinitely after a formal insolvency where they relate only to the company's entry into formal insolvency or its financial position before or during formal insolvency. This avoids a party being able to enforce a right after formal insolvency where they could not do so beforehand.

Administrators or persons administering a compromise / arrangement or liquidators may consent to lift the stay on enforcement of rights. Otherwise, the Court retains a discretion to allow a right to be enforced if doing so would be appropriate in the interests of justice, or to order that rights are enforceable in certain circumstances.

The Government has regulated that the *ipso facto* stay should not apply to certain kinds of arrangements. Broadly, such arrangements include where:[43]

- arrangements are required or contemplated by Australia's laws or where international obligations would be disturbed;
- markets have evolved to depend on established systems and expectations and the *ipso facto* stay would significantly disrupt those markets;
- sophisticated counterparties traditionally negotiate their own arrangements in relation to complex transactions or complex financial products and the *ipso facto* stay would undermine those arrangements;
- the *ipso facto* stay would lead to unintended consequences or would severely disadvantage some contracting parties;
- parties have already entered into arrangements to attempt to alleviate a business' financial stress and staying *ipso facto* clauses would undermine or significantly change the terms of those arrangements; or
- the operation of an *ipso facto* clause is inherent to the operation of a contract and staying it would lead to a perverse outcome.

[43] Corporations Amendment (Stay on Enforcing Certain Rights) Regulations 2018 and the Explanatory Statement thereto at p.2.

3.2.2 *Likely impact of the new stay*

The stay on the operation of *ipso facto* clauses is intended to permit companies to continue to operate (or be sold as a going concern) during a formal restructuring process without facing the termination of critical contracts purely because of that process, thereby preventing premature liquidation and ultimately leading to better outcomes for the Company and creditors.

The changes are expected to have a significant impact on the drafting of contracts in many different areas of business. The express application of the stay to rights enforced for reasons which are "in substance" contrary to the new provisions presents significant challenges for any drafters seeking preserve a right to vary or terminate contracts on grounds solely relating to formal restructuring.

Given that the new provisions only apply to new contracts created on or after 1 July 2018, some businesses may look to extend existing contracts to maintain their ability to vary or terminate in the event of a formal restructuring. The Government has provided a period of five years, during which novated or varied contracts entered into before 1 July 2018 are excluded from the operation of the stay, explaining that:

> "this five year period for the operation of the provision will allow parties to consider how to structure their affairs in the future."[44]

After the five year period has expired, it may remain debatable whether an existing contract which is varied and / or novated are considered "new" contracts subject to the stay.

Otherwise, in order to protect against a perceived risk of continuing to trade with a company which is undergoing a formal restructuring, businesses may consider tying the performance of their contract to other matters which allow variation or termination in circumstances of financial difficulty short of a formal restructuring.

Where the provisions apply, businesses seeking to terminate their contracts with a company undergoing a formal restructuring may wish to clearly document the reasons for their termination, to provide evidence that it is not in substance contrary to the new provisions.

Finally, given that the stay only applies in the event of a formal restructuring process, directors will need to consider whether the company's interests are best served by a formal restructuring, instead of taking advantage of the safe harbour provisions discussed above. Conceivably, a situation could arise where the safe harbour applies, because an informal restructuring would likely lead to a better result than immediate liquidation, but creditors' interests are better served by a formal restructuring due to the operation of the stay.

3.3 Creditor rights and protection

On the flip-side to the culture shift in favour of entrepreneurship and innovation which is envisaged by the safe harbour and *ipso facto* reforms, the Insolvency Law Reform Act 2016 introduced a range of additional creditor rights in the event of administration and liquidation. Recent discussion in Australia has also shifted to creditor protection measures, in particular a focus on preventing "phoenix" behaviour.

3.3.1 *Insolvency Law Reform Act 2016*

The Insolvency Law Reform Act 2016 which commenced in stages on 1 March 2017 and 1 September 2017, introduced a range of amendments to create common rules relating to insolvency and to better align the personal bankruptcy and insolvency regimes in Australia.

[44] Corporations Amendment (Stay on Enforcing Certain Rights) Regulations 2018, reg 5.3A.50(2)(zf); Explanatory Statement at p.21.

As to the rights of creditors in the event of administration or liquidation, the explanatory memorandum to the Insolvency Law Reform Bill 2015 states that during the Senate Inquiry:

> "[c]oncerns were raised that creditors lacked the ability to influence the actions taken by insolvency practitioners and to monitor the actions taken by insolvency practitioners".[45]

Notable changes to creditors' rights include:

- the power to direct an administrator or liquidator to convene a meeting (either by resolution, in writing in certain circumstances, or through a committee of inspection), which must be complied with unless it is unreasonable;
- the power by resolution or through a committee of inspection to give directions to the administrator or liquidator, which are not binding, but if not followed the administrator or liquidator must document the reasons why;
- providing for creditors' rights to make reasonable requests for information and records in connection with the administration or liquidation, requests which must be met unless the document or information is irrelevant, if compliance would breach the administrator's or liquidator's duties or where there are insufficient funds to meet the request;
- the power to remove an administrator or liquidator without the need to obtain Court approval, subject to that person's right to seek the court's intervention; and
- the power of creditors, the Australian Securities and Investments Commission and the Court to appoint a registered liquidator to review and report on the reasonableness of the remuneration and costs incurred during part or all of an administration or liquidation.

Another change that may ultimately benefit creditors is clarifying the law to allow liquidators to assign certain statutory rights of action (such as voidable preference actions and insolvent trading claims) to third parties. Previously it appeared that such statutory claims could only be brought by the liquidator themselves, which inhibited the successful realisation of value. Assignment is subject to provision of written notice to creditors of the proposed assignment or obtaining leave from the Court.

3.4 Conclusion

In Australia, the introduction of the new safe harbour protection for directors and the stay on the enforcement of *ipso facto* clauses are intended to address an overarching concern that enterprise value is destroyed when companies are forced into unnecessary administration or liquidation. The changes instead seek to promote entrepreneurship and allow opportunities for businesses to continue to trade during formal and informal restructurings.

There is, however, a balance to be achieved between honest entrepreneurship and not permitting directors to get away with taking unnecessary risks with creditors' money. Australian legislators have sought to maintain this balance by recent changes permitting liquidators to assign statutory rights of action to third parties and giving creditors more rights and control over administration and liquidation processes.

Looking forward, we expect that the next wave of reforms in Australia will focus on protecting creditors from dishonest directors who strip and transfer assets from one company to another to avoid paying liabilities (known as "phoenix" behaviour). The Australian Government has recently released for consultation an exposure draft of legislation addressing this issue.[46]

[45] Explanatory Memorandum to the Insolvency Law Reform Bill 2015, at [3.3].
[46] Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2018.

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INSOL International

6 – 7 Queen Street, London EC4N 1SP
Tele: +44 (0)20 7248 3333
Fax: +44 (0)20 7248 3384
www.insol.org