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MANAGING GOVERNMENT CONTRACTS THROUGH FINANCIAL DISTRESS

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WHAT THIS NOTE COVERS

Government agreements

— *How can we safeguard against the risks posed to an agency by the other party to the agreement facing financial distress or collapse?*
— *What provisions in an agreement may be of use to an agency in the case of financial distress or collapse?*

Bankruptcy and insolvency law

— *What is the effect of corporate insolvency law on the agency?*
— *What are the legal rights of the agency and competing creditors?*
— *How will this law affect the agency's rights to recover money paid under the agreement?*

The Financial Management and Accountability Framework

— *What Commonwealth accountability obligations under the Financial Management Framework are relevant for an agency official managing an agreement with an insolvent party?*

In this note we refer to 'the other party', who could be a contractor to the agency or the recipient of a Commonwealth grant, and we refer to an 'agreement', which could be a contract for goods or services or an agreement in which the agency provides funding to a recipient of a grant.

GOVERNMENT CONTRACTS

Introduction

Officers who manage agreements and senior managers need to be alert to the risk that the other party to an agreement may experience financial distress or corporate collapse during the performance of the agreement. This is likely to impact adversely on the performance of the agreement – that is, the quality of the goods or services, the other party's ability to complete the project for the agency, the project schedule and the cost to the agency. Officials responsible for agreements need to consider this risk particularly when planning, tendering, agreeing to and managing higher value, higher risk agreements. This note sets out some strategies for managing this risk.

It is important to consider the nature of the agreement in each case. In the case of grants, the principle of 'proportionality' as set out in the Commonwealth Grant Guidelines (CGGs) will be applicable to the assessment of risk and any measures taken in response to manage this risk. The proportionality principle

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provides that consideration will need to be given to the purpose, value and duration of the grant, enforceability considerations and the nature and level of risks involved. In addition the CGGs state that any reporting and accountability frameworks that focus rigidly on outputs over outcomes can potentially stifle innovation and the introduction of best practice by grant recipients (for example, not-for-profit organisations in receipt of government funding) (see Chapter 3 of the CGGs). The risk mitigation and management methods outlined in this note should be viewed in light of the principle of proportionality and decisions appropriate to the situation should be made on a case-by-case basis.

Proactive assessment and management of risk

When parties start a project they are usually focused on the positive outcomes they hope to achieve, but it is critical that the risk of financial distress or corporate collapse is considered and addressed. As a first step in planning, agencies should conduct a risk assessment[1] that includes consideration of these risks.

Potential risks include:

— the agreement cannot be completed

— the goods, services or activity do not meet the required standard

— the project is delayed

— the agency is unable to recover money paid or obtain assets to be acquired under the agreement

— the reputation of the agency is damaged.

The likelihood that the need to find another party to complete the agreement will result in further costs and impact on project delivery also needs to be considered. The risk rating will depend on factors such as:

— the value and complexity of the project

— the payment structure (for example, financial exposure may be significant where the agency makes significant up-front instalment payments for a major capital acquisition rather than payment on completion of services)

— the strategic importance of the agreement to the agency (for example, the risk rating will differ between an outsourced mission-critical agency function and an agreement for the provision of office supplies)

— the importance of the project to Government (for example, if it is a project to implement an important Government policy a higher risk rating may apply)

— the nature of the activities (for example, the risk rating may change if the activity is new).

In identifying and rating these risks, procurement officers should think carefully about how they will mitigate and manage the risk.

In identifying and rating these risks, agencies should think carefully about how they will mitigate and manage the risk. They should seek advice on the tendering approach and provisions for the agreement that will most effectively safeguard their project against these risks.

Selection process

Where financial viability is considered a risk which needs to be mitigated, it will be important to consider financial viability as part of any selection process such as a tender or grant application process. In these cases it may be appropriate to:

- include financial viability as an evaluation criterion in request documentation
- require submission of all the relevant information needed by the agency to assess financial viability. This may extend to information on major subcontractors, related entities, guarantors or parent companies.
- consider getting expert advice on these matters from a financial adviser early in the planning stage.

A useful resource on assessing financial viability is the Department of Finance and Deregulation's 'Assessing Financial Viability Guide' (available at http://www.finance.gov.au/procurement/procurement-policy-and-guidance/buying/contract-issues/assessing-financial-viability/practice.html).

Drafting and negotiating the contract

This section provides examples of some mechanisms that can be included in an agreement to protect against the impact of financial distress.

Structured payments

An agency can limit its risk of financial exposure by structuring payments to be made on successful completion of services, delivery of goods or completion of activities – often referred to as 'milestone' payments. Milestone payments may be based on the value of the services, goods or activities delivered, so that the agency's financial exposure is limited to the value it has obtained under the agreement at the time of payment.

In some cases, agencies will decide against structuring payments this way – for example, if there is a benefit in 'financing' a major capital project, a decision may be made to make up-front instalments to cover up-front capital costs of the other party. In this case, additional risk mitigation, such as obtaining guarantees, should be considered.

Agencies should consider including clear provisions to address the risk of a milestone not being met by the other party – for example, by reserving the right to withhold a milestone payment until proper completion of a milestone and, potentially, the right to stop all payments under an agreement until the milestone is completed.

Agencies should consider including clear provisions to address the risk of a milestone not being met by the contractor.

Securities

In some cases it may be prudent for the agency to reserve the right to take security over assets or require the other party to provide other forms of security to cover risk exposure under an agreement.[2]

Title to property

The agreement should specify when the agency takes ownership, or 'title', over any deliverables. For example, the agreement should be clear as to whether the agency takes progressive ownership of deliverables or only takes ownership when the project is completed. Where the agency takes progressive ownership, then it could be entitled to the item at any stage, in priority over other creditors, in the event that the other party ran into financial difficulty.

A performance (or 'bank') guarantee
Where significant instalments are required under an agreement before goods, services or activities are delivered (for example, where money is paid for the purchase of long lead items or plant and equipment), the agency may wish to consider obtaining a bank guarantee from the other party covering all or a proportion of the amounts to be paid to the other party under the agreement.

A parent guarantee
A parent guarantee (sometimes referred to as a performance guarantee) may be suitable where the other party lacks financial resources to cover its liability exposure under an agreement (for example, where the other party is a special-purpose vehicle or a subsidiary of a parent company of substance). The agency may require a parent company to guarantee performance by the other party and, in certain cases, to 'step into the shoes' of the other party and accept liability under the agreement.

A mortgage over properties and buildings
In some cases an agency may take a security such as a mortgage over an interest in land. This will prevent other creditors taking security over the property and provide legal remedies to recover payments under the agreement. The agency would then be able to sell, enter into possession, receive any rents and profits of the land or appoint a receiver without a court order. The agency would also have priority over unsecured creditors where the other party is wound up. It is important to consider registration requirements for securities over land – see AGS Commercial Notes 33 *Securities: ensuring payment of debts to the Commonwealth* for more information.

A charge over personal property
In some cases security over personal property may be appropriate. As with land there are registration requirements including those that will apply under the *Personal Property Securities Act 2009* (Cth) when it comes into effect. See AGS Legal Briefing 94 *Personal Property Securities Act* to be issued shortly.

Separate accounts and proper accounting for payments of funding

In grants, where funding is to be paid to the other party for a particular activity, it may be appropriate in some cases to require the other party to keep separate accounts for that funding and provide the agency with audited financial reports so the agency can ensure the funding is being properly applied and managed. In some situations it may also be prudent for the agency to take a charge over the account until the activity is properly completed. Whether or not such a measure is taken will depend on the risk profile of the activity, the amount of funding to be provided by the agency and other considerations outlined in the CGGs.

Financial distress provisions

In high-value, high-risk agreements it may be prudent for the agency to include detailed financial distress provisions addressing the triggers, obligations, rights and remedies to apply in the event of financial distress of the other party. These provisions may also extend to the major subcontractors and guarantors as applicable.

Triggers might include:

— the other party/guarantor publicly announcing to a stock exchange material deterioration in its financial position

— a public investigation into improper accounting

In major Government contracts it may be useful to include detailed financial distress provisions addressing the triggers, obligations, rights and remedies to apply in the event of financial distress.

- suspected fraud
- a breach of the other party's obligations to lenders
- default on a payment to a major subcontractor
- litigation against the other party (or guarantor) for recovery of a debt
- changes in credit rating for the other party or its guarantor
- other triggers relating to default on a debt.

Obligations, rights and remedies might include requiring the other party to meet with the agency, provide information about the event or provide a risk assessment of the event, including the other party's intended risk mitigations.

The agency may reserve the right to terminate the agreement. The trigger for termination will depend on the drafting of the agreement. Commonwealth agreements usually contain an express right for the Commonwealth to immediately terminate the agreement if the other party is insolvent or comes under some form of external administration. In some agreements, the agency may wish to have stronger termination rights which provide it with a right to terminate at an earlier point such as if there is a material adverse change in the other party's financial position.

Commonwealth contracts usually contain an express right for the Commonwealth to immediately terminate the agreement if certain events occur …

The agency may reserve the right to terminate the contract if the contractor fails to adequately satisfy the agency that the contractor has remedied any financial difficulties through the contractual process.

Effective contract management

Effective management of the agreement by the agency is critical to protecting the agency's interests in the event of financial distress. If financial distress occurs, advice should be sought on how to proceed with the other party in order to limit the agency's exposure to liability.

For example, agencies may identify financial distress through:

- actively assessing the other party's performance, including whether milestones are being achieved, before authorising payment under the agreement
- scrutinising reports and financial reporting (where it is required under the agreement)
- maintaining and reviewing the register of assets purchased with money paid under an agreement (where it is required under the agreement)
- scrutinising media reports that might reveal financial difficulties.

If the agency identifies that the other party is in financial distress, it should consider what action is most appropriate having regard to insolvency law and its financial framework obligations (see the next two sections). Actions that may be available include:

Audit and access

When an agency thinks that the other party may be in financial difficulty, the agency should ascertain the facts and circumstances. Many agreements will contain provisions allowing the agency to access records, request information, obtain copies of documents and undertake audits. These provisions may be of assistance. It is important to follow the process set out in the agreement if the agency proposes to rely on these provisions. In some cases the agreement will allow the agency to engage an expert to conduct the audit.

Security
If the agency holds security, it will need to consider whether or not to enforce that security. It is prudent to obtain legal advice before doing this.

Where the agency does not hold security but the agreement allows the agency to require security to be provided in certain circumstances, the agency should consider whether to take security. It is important to act quickly.

Recovery under the agreement
Where there has been a partial or complete failure by the other party to perform the agreement due to financial distress, the agency may have a claim against the other party for damages for breach of the agreement.

Typically, where the other party suffers financial distress or comes under a form of external administration, there are other creditors, both secured and unsecured, seeking to recover from the other party. Where an agency has a right under the agreement to recover assets or money, it should seek advice to formalise its claim and act quickly to recover. Some points of note are as follows:

- If the agency does not hold security, a claim under the agreement (for example, for breach of the agreement) will be classed as an unsecured debt and rank below any claim of a secured creditor on winding-up. Therefore, there may be no assets available to meet all or part of the claim after the other party's liabilities to secured creditors have been met.
- If the agency successfully recovers a claim, it may be disputed, and potentially recovered, by an administrator or liquidator if it is paid within 6 months before the appointment of the administrator. This means agencies may need to account for recovered money as a contingent liability.
- An external administrator or liquidator may dispute a claim under the agreement. For example, a claim for breach of the agreement may be disputed on the basis that the other party has partially performed its side of the bargain, even if it has not fully performed. This may limit the amount recoverable by the agency.

Termination
The agency may consider terminating the agreement if it is entitled to do so under the terms of the agreement. Careful thought should be given to the consequences of terminating the agreement.

Summary

By assessing and planning for the risk of financial distress or collapse of a contractor, agencies will be in a stronger position to deal with the event if it occurs and will have the right to take action to limit the agency's exposure.

The strategies in this note address each stage of contracting and should be considered as potential risk mitigations to be used selectively depending on the complexity, scale and commercial profile of a contract.

INSOLVENCY LAW

In addition to understanding the agency's rights and obligations under the agreement, it is important to understand the effect of insolvency law on a Commonwealth agreement. Insolvency law will have different effects depending on what stage the other party is in the insolvency process.

Stages in this process include:

— suspicion of the other party's insolvency (before the involvement of external administrators)

— bank appointment of receivers and managers to the other party

— appointment of administrators by the directors of the other party

— court appointment of a liquidator to the other party.

Scenario 1: suspicion of contractor insolvency (before the involvement of external administrators)

The agency may have various rights under the agreement. As noted above, if the agency holds or is in a position to take security it will be a secured creditor and this will put it in a stronger position.

The agency can protect itself by becoming a secured creditor, as secured creditors sit outside most insolvency processes.

How the agency exercises its rights under the agreement and any security will depend on whether it considers that it is more appropriate having regard to its financial management accountability requirements to:

— terminate the agreement and take recovery actions

— take other actions that may assist the other party to stay afloat.

If the agency has a right to terminate the agreement where the other party is 'insolvent' it is sometimes difficult to determine at what point the other party can be regarded as being insolvent.

Indications of insolvency

The Corporations Act defines a person to be insolvent where they are not solvent. A solvent person is a person who is able to pay all their debts as and when they become due and payable. However, insolvency is not a short-term liquidity problem; rather, it is an endemic shortage of working capital.

Some other factors that indicate insolvency include:

— a history of dishonoured cheques

— suppliers insisting on COD terms

— the issue of post-dated or 'rounded sum' cheques

— special arrangements with creditors

— inability to produce timely, audited accounts

— unpaid group tax, payroll tax, workers compensation premiums or superannuation contributions

— demands from bankers to reduce overdraft and other evidence of deteriorating relations with bankers

— receipt of letters of demand, statutory demands and court processes for debt.

The agency will usually not know if the other party is insolvent until it examines the financial records, but even this may not give certainty. It could be risky to terminate on the basis of insolvency unless insolvency is clear. If it is not clear, it is preferable for the agency to consider whether it has other grounds to terminate.

Can the contractor retreat from 'the abyss'?

The courts will determine solvency as a matter of commercial reality. This means that a court may take into account:

- the fact that creditors have agreed to give the company more time to pay debts presently due or accept payments by instalments
- the fact that a third party is willing to voluntarily provide funds or provide short-term finance to the company.

If the other party agrees informally with its creditors (including the agency) or if the agency provides additional funding or brings forward payments under the agreement, the other party may be able to trade out of insolvency.

If the agency provides additional funding or brings forward payments under the agreement, the other party may be able to trade out of insolvency.

Scenario 2: bank appointment of receivers and managers to the other party

What are receivers and managers?

Receivers and managers are registered liquidators (often accountants) usually appointed to a company by a secured creditor under a charge to protect and realise secured assets to pay out the secured creditor. This will occur by private arrangement between the other party and their bank.

What is the effect of the appointment of a receiver?

The agency

Appointment of a receiver is a private arrangement, so from a legal point of view there is very little effect on the agency.

- Under general law, the appointment of the receiver will not have the effect of terminating the agreement.
- If the agency is entitled to terminate the agreement on the appointment of a receiver and does so, there is no statutory prohibition on the agency taking action to recover amounts owing in relation to the agreement. Whether the agency is in fact able to recover will depend on the financial position of the other party.

The other party and its employees

On appointment, the receiver takes control of the company's business and its assets to the exclusion of its directors. Legally, the receiver has power to trade on the company's business and employment contracts are not automatically terminated by the appointment. However, in practice, the receiver is personally liable for the debts it incurs during their appointment. Unless the other party has enough assets to cover the costs, the receiver may dismiss the company's employees or close down all or part of the company's business. This is an important consideration if the agency considers it to be in the Commonwealth's interest to keep the other party afloat. The agency may need to negotiate with the receiver so that it does not strip all the assets and bring the other party's business to an end.

Scenario 3: directors appoint an administrator

What is administration?

In administration a registered liquidator is appointed to a company for a short period of time (usually approximately 5 weeks) to take control of the company, conduct an investigation into its affairs and, at the end of the process, hold a meeting of company creditors to determine the company's fate.

The statutory purpose of administration is:

- to maximise the company's chances, or as much of its business as possible, continuing in existence
- if this does not result in a better return for the company's creditors and members, to immediately wind up the company.

What is the effect of administration?

The agency

Under the general law the appointment of an administrator does not cause the agreement to terminate; however, an agreement may include a clause which allows the agency to terminate. If the agency does terminate, there is a statutory prohibition on the agency taking action to recover moneys paid under the agreement. The agency's rights are limited to being recognised as a creditor and participating in the meeting of creditors to determine the other party's future.

Under the general law the appointment of an administrator does not cause the agreement to terminate; however, an agreement may include such a clause.

The other party and its employees

Similarly to the appointment of receivers and managers:

- administrators take control of the company's business and assets to the exclusion of the directors
- the administrator has the power to trade on the business
- employment contracts are not terminated by the appointment.

Administrators are personally liable for the debts they incur, so they will not trade on the business and will terminate employees if there are not enough assets in the business to pay their costs. Where the company does not have enough liquidity to continue to trade, an administrator must be funded to avoid the company being shut down.

What can creditors decide at the meeting?

At the meeting of creditors, creditors have 3 options:

- return control to the directors
- wind up the company
- resolve that the company execute a deed of company arrangement.

What is a deed of company arrangement?

A deed of company arrangement is a formal workout arrangement to save the company, or at least part of its business. The content of the deed is largely up to directors and creditors; however, it usually involves a combination of:

- creditors compromising their claims
- creditors deferring time for payment
- a third party (usually directors) injecting funds into the company.

In these situations, the agency, as a creditor, will need to consider compromising its claims and deferring payments due by the other party to determine how it will vote at the meeting of creditors.

Secured creditors are not caught by any deed of company arrangement, so for any workout to succeed it is necessary to have secured creditors agree to the proposal.

Scenario 4: creditors put the company into liquidation

What is liquidation?

Liquidation is the appointment of the registered liquidator to a company to:

— conduct an orderly winding-up of the company's affairs

— distribute equitably and fairly the company's assets

— conduct an investigation into the company's affairs.

What is the effect of liquidation?

The agency

Under the general law, the appointment of a liquidator may give a right to terminate the company's agreements depending on the terms in the agreement. The agency will not need to rely on the general law if the agreement contains an express right to terminate on appointment of a liquidator. If the agency does terminate, it cannot pursue the other party to recover funds provided under the agreement. The agency's right to recover is substituted for a right to participate in the liquidation and receive any distribution to creditors from the other party's assets.

Liquidation is terminal and, at the end of the process, the company will be deregistered and cease to exist.

The other party and its employees

Unlike other external administrations, the company will usually cease to trade. A liquidator may trade the business of the company for a short period of time, but only for the purpose of selling its assets. Liquidation is terminal and at the end of the process the company will be deregistered and cease to exist.

— Employees are immediately terminated on the appointment of a liquidator. Employee entitlements are partly protected through their entitlement to be paid under the General Employee Entitlement Redundancy Scheme (GEERS) and their rights in relation to debts to employees being paid out in priority to the company's general unsecured creditors.

The only assets available for distribution to creditors will be what is left after secured creditors have been paid.

Can the agency recover in the liquidation?

What is the likelihood of the agency receiving any money?

Section 556 of the Corporations Act sets out the priority in which creditors get paid. Each class of creditor is paid in full before the next class is paid.

In summary, the order is:

1. the liquidator's costs and fees
2. employee entitlements
3. general unsecured creditors (the category that is likely to include the agency).

The only assets available for distribution to creditors will be what is left after secured creditors have been paid. In most cases, given its low priority in the list, if the agency is an unsecured creditor it would expect to get little or no return from the liquidation. If the agency is a secured creditor, it will only have to compete with other secured creditors for payment of its debts. In that case the key consideration will be what priority the agency's security has over other securities over the same property.

Other means of securing the payments under the agreement

The appointment of a liquidator does not prevent the agency from pursuing guarantors, directors or other parties (for example, the other party's accountants) if an action is available. For example, in some cases it may be possible to show a third party has been involved in the other party's misleading

and deceptive conduct. However, if the directors have any money, the liquidator may sue the directors for insolvent trading and other creditors may also pursue the directors under any personal guarantees.

Other risks to the agency

A liquidator can recover payments to creditors under the 'preference' provisions, for payments made 6 months before commencement of winding-up proceedings, if at the time of the transaction the company was insolvent. This includes the repayment of money and security taken by the agency within 6 months of commencement of winding-up.

There are some defences to this but where the agency has had access to the other party's financial records, these may not be available. The risk of having to pay back money to the liquidator could be avoided by taking security at the time of entering into the agreement, as the liquidator cannot recover payments to a secured creditor.

Insolvency in summary

Agencies should take note of the following points:

- Make business and policy decisions early to decide whether an informal arrangement is possible before the other party incurs the expense of external administration, which will make saving the other party more difficult.
- Any arrangement entered where public money might become payable will need to comply with the financial management framework (discussed below) including the requirement under s 44 for chief executives to manage the affairs of the agency in a way that promotes proper use of Commonwealth resources.
- Appointment of a receiver indicates financial difficulty of the other party; action under the agreement is likely to be needed even though this has no direct impact on the agency.
- If an administrator is appointed to the other party, the agency must determine what approach it will take to the creditors meeting and any deed of company arrangement.
- If a liquidator is appointed and the agency is an unsecured creditor, the agency is unlikely to see any return after secured assets are realised and the liquidator takes out its fees.

THE FINANCIAL MANAGEMENT FRAMEWORK

Applying the financial management framework

The financial management framework is underpinned by the *Financial Management and Accountability Act 1997* (Cth) (FMA Act), the *Financial Management and Accountability Regulations 1997* (Cth) (FMA Regulations) and the Finance Minister's Orders.

FMA Regulations

The Finance Minister may issue guidelines (Commonwealth Procurement Guidelines (CPGs) or Commonwealth Grant Guidelines (CGGs)) on procurement and grant activity. An official performing duties in relation to those activities must act in accordance with the CPGs or CGGs, as the case requires (regs 7 and 7A).

A person must not enter into an arrangement unless a spending proposal has been approved under reg 9 and, if required, written agreement has been given under reg 10 (reg 8). An 'arrangement' refers to contracts, agreements or arrangements under which public money is, or may become, payable.[3] An approver must not approve a spending proposal unless they are satisfied, after making reasonable inquiries, that it would be a proper use of Commonwealth resources (reg 9).

If a person proposes to enter into an arrangement and the relevant agency has an insufficient appropriation of money under the provisions of an existing law or a proposed law that is before the Parliament to meet expenditure that might be payable under the arrangement, the person must not enter into the arrangement unless the Finance Minister has agreed, in writing, to the expenditure that might become payable. If an agency gives an indemnity, payments that might be made under that indemnity are 'expenditure that might be payable under the arrangement'. An obligation to pay money under an indemnity is a contingent liability.

An approver must not approve a spending proposal unless they are satisfied, after making reasonable inquiries, that it would be a proper use of Commonwealth resources …

Approvals of expenditure (whether they be for grants or for procurements) need to be recorded in writing, if not at the time then as soon as practicable thereafter (reg 12). The approver must record the basis on which he or she is satisfied the spending proposal complies with reg 9.

Existing rights and obligations under an agreement

Once an agreement has been entered into, the agency has a contractual obligation to comply with its obligations under that agreement, including its obligations to make progress payments in accordance with the terms of the agreement.

Payment of progress payments required under an agreement does not require a further approval process under the FMA Regulations, although the CPGs, CGGs and agency chief executive instructions may provide guidance on managing an agreement and what is required before a progress payment is made. Additional payments such as out of scope work and variations to provide additional funding will usually require approvals. See Finance Circular 2011/01 – Commitments to spend public money (FMA Regulations 7–12).

When difficulties arise under an agreement

When a relationship created under an agreement encounters difficulties, the primary focus will remain on what the agency's legal obligations and options are in the circumstances. In considering any options available to the agency, regard must be had to the FMA Act. The FMA Act does not have the effect of directing that one or another option must be chosen in specific situations. However, it does set out the principles that must be applied, which in turn informs what the appropriate options are.

When a contractual relationship encounters difficulties, the primary focus will remain on what the Commonwealth's legal obligations and options are in the circumstances.

The most relevant provision will usually be s 44, which requires the chief executive of an agency to manage the affairs of the agency in a way that promotes proper use of Commonwealth resources. Depending upon the available options, other relevant provisions will be ss 34 (waiver) and 47 (recovery). Consideration may need to be given to any fraudulent or unethical behaviour (so the agency's fraud control and audit committee processes under ss 45 and 46, and the probity and transparency requirements in the CPGs and CGGs may also be relevant).

Section 44 of the FMA Act

Promoting efficient, effective, economical and ethical use

Section 44 of the FMA Act states that the chief executive of an agency must manage the affairs of the agency in a way that promotes 'proper use' of Commonwealth resources. 'Proper use' means efficient, effective, economical and ethical use that is not inconsistent with the policies of the Commonwealth. This responsibility to promote proper use also involves the appropriate exercise of rights and obligations under agreements. For example, where the agency has negotiated an option to take a charge (as a form of security for debt) over certain property then failure to exercise that option might not, in the circumstances, amount to proper use of Commonwealth resources. However, it may be that the option to take a charge has disappeared or, given its relative priority in relation to other secured creditors, may now be virtually worthless.

What is proper use in the present context requires consideration of the circumstances, including:

- the use of Commonwealth resources and the level of risk associated with this
- the relevant rights and obligations of the agency under the agreement
- the extent of the financial difficulties facing the other party
- the consequences of the other party going into some form of external administration
- the desirability that the work of the other party be continued.

As discussed above, the agency may have the choice of terminating the agreement (and seeking a repayment of amounts already paid) or coming to some arrangement that may enable the other party to continue trading. Such an arrangement might involve an additional financial commitment by the agency. Where there is additional financial commitment by the agency then, apart from the requirements of s 44 of the FMA Act, a (further) spending proposal will need to be approved under the FMA Regulations and the CPGs (or the CGGs) and the agency's policies will need to be considered.

If the agency instead decides to pursue recovery of amounts owed in relation to the agreement as a debt s 47 of the FMA Act will be relevant.

Section 47 of the FMA Act

Recovery of debts

A chief executive of an agency must pursue recovery of a debt owed to the agency unless: (i) the debt has been written off as authorised by an Act; (ii) he or she considers it is not legally recoverable; or (iii) he or she considers it is not economical. 'Debt' for the purposes of the FMA Act is an amount which is ascertainable and certain (ie known or able to be determined objectively), due for payment now, and capable of being recovered in a court action for debt. For the purposes of the present discussion, it is likely to be the third of these exceptions that would be relevant. If such an exception applies, s 47 relieves a chief executive from the obligation to pursue the debt. In these circumstances the debt is not extinguished but might be regarded as 'written off' for accounting purposes. In other words, the debt still exists in terms of the legal relationship of the agency and the other party. Whether a debt has arisen will also depend on the terms of the agreement, and what action the agency might take in response.

It may be that the most cost-effective way to pursue a debt owing to the agency would be to do so in liquidation by the agency lining up with the

other creditors to get back what it can. If the agency has a charge over certain assets of the other party then it will be in a stronger position to recover the amounts owing. In some circumstances, as suggested above, permitting the other party to continue to trade under a deed of company arrangement might offer a preferable alternative to pursuing a debt owed to the agency. Such arrangements often involve a compromise on the amount of a debt as between a company and its creditors and s 34 of the FMA Act may become relevant.

Finance Minister may waive debts

The Finance Minister has the power under s 34 of the FMA Act to waive an amount owing (or a debt owed) to the Commonwealth. In contrast to s 47, decisions made under s 34(1) affect the legal relationship between the agency and the person owing the money. An amount which has been waived ceases to be a debt.

Where the agreement provides for the agency to recover an amount from the other party, there is an 'amount owing' to the agency (and these circumstances could arise where the agency is not otherwise proposing to financially support the business). On the other hand, if the agency voted in favour of a deed of arrangement under which it was to receive a lesser sum (because it thought that held greater prospects than liquidation) then that action might amount to a waiver of an amount owing for the purposes of s 34. The Finance Minister has not generally delegated the power to waive debts under the s 34; therefore, there must be consultation with the Department of Finance and Deregulation where there is a possibility that s 34 might apply.

If the agency negotiated a compromise with the other party to provide additional support to permit it to continue to trade then that would most likely be where the agency was not making a 'formal' claim for any 'amount owing' but, rather, where there is an agreement to alter the arrangements under the agreement (applicable where there is no actual waiver by the agency). Such negotiations would occur in the context of the chief executive's overarching duty under s 44 of the FMA Act.

The Finance Minister has not generally delegated the power to waive debts …

KEY ISSUES

Agencies must proactively manage agreements through financial difficulty.

- Where financial distress is considered a risk that should be managed, this should be taken into account in developing the selection process and the terms of the agreement as well as in contract management.
- If financial distress occurs, it is important to understand the impact of insolvency law, particularly the legal rights of the agency and competing creditors and how these affect the agency's rights to recover money paid under the grant agreement.
- Decisions need to be made having regard to the Financial Management and Accountability Framework.

__Mark Molloy__ is a specialist government lawyer with broad experience in commercial law and procurement frameworks, administrative and public law, statutory interpretation, foreign investment, trade practices and migration law. He also has extensive experience in the policy development process and has advised on the development of legislative frameworks, implementation of enacted legislative schemes, public sector employment issues, departmental salary packaging arrangements and individual employment issues.

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Notes

1. *The Liability Risk Assessment Guide for FMA Act Agencies*, published by the Department of Innovation, Industry, Science and Research, provides guidance to procurement officers on conducting a liability risk assessment when planning to enter into a Commonwealth contract.
2. For more information on taking securities over real property and personal property, see AGS Commercial Notes 33 *Securities: ensuring payment of debts to the Commonwealth*, 9 November 2009.
3. Circumstances excluded from the definition of 'arrangement' are the engagement of an employee or an appointment to a statutory office (or the provision of associated statutory or employment entitlements) as well as any agreement governed by international law.

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