AGS Commercial notes

Number 41 | Updated 19 November 2018 (updated from **Number 35** | 31 May 2012)

Managing government contracts through financial distress

What this note covers

Government agreements

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

Insolvency law

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

The Commonwealth Resource Management Framework

- What Commonwealth accountability obligations under the Commonwealth Resource Management Framework are relevant for a Commonwealth entity official managing an agreement with an insolvent party?

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

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Government agreements

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 – the quality of the goods or services, the other party's ability to complete the project for the Commonwealth entity, the project schedule and the cost to the Commonwealth entity. 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 Grants Rules and Guidelines (CGRGs) will apply to the assessment of risk and any measures taken in response to manage this risk. The proportionality principle provides that officials should consider:

- an assessment of the capability of potential grant recipients
- the policy outcomes being sought
- the purpose, value and duration of the grant
- the nature and type of deliverables
- governance
- accountability requirements
- the nature and level of risks involved.

In addition, the CGRGs state that any reporting requirements that focus rigidly on outputs over outcomes can be overly burdensome and may stifle innovation by grant recipients. The risk mitigation and management methods outlined in this note should be viewed in light of the principle of proportionality, and decisions should be made on a case-by-case basis so that they are appropriate to the situation. For example, requiring small businesses or not-for-profit entities to report in the same manner as large corporate organisations may not be appropriate.

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, Commonwealth entities should conduct a risk assessment that includes consideration of these risks.

Potential risks include the following:

- The agreement cannot be completed.
- The goods, services or activity do not meet the required standard.
- The project is delayed.
- The Commonwealth entity is unable to recover money paid, or obtain assets to be supplied, under the agreement.
- The Commonwealth entity's reputation is damaged.

Commonwealth entities should also consider whether needing to find another party to complete the relevant activity will increase the risk of cost escalation and negative impacts on project delivery. 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 Commonwealth entity makes significant up-front instalment payments for a major capital acquisition rather than paying on completion of services)
- the strategic importance of the agreement to the Commonwealth entity (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, Commonwealth entities 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.

'In identifying and rating these risks, Commonwealth entities should think carefully about how they will mitigate and manage the risk.'

Selection process

Where financial viability is considered to be a risk that needs to be managed, 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 that the Commonwealth entity needs to assess financial viability. This may extend to a requirement for information on major sub-contractors, 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 available on the Department of Finance's website.

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

A Commonwealth entity 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. These are often referred to as 'milestone' payments. Milestone payments may be based on the value of the services, goods or activities delivered, so that the Commonwealth entity's financial exposure is limited to the value it has obtained under the agreement at the time of payment.

In some cases, Commonwealth entities 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.

Commonwealth entities should consider including clear provisions in agreements 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.

Securities

In some cases it may be prudent for the Commonwealth entity to take, or 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.

Types of securities

Title to property

The agreement should specify when the Commonwealth entity takes ownership, or 'title', over any deliverables. For example, the agreement should be clear as to whether the Commonwealth entity takes progressive ownership of deliverables or takes ownership only when the project is completed. Where the Commonwealth entity takes progressive ownership, it could be entitled to the item at any stage, in priority over other creditors, if the other party runs 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 Commonwealth entity 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 Commonwealth entity 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 a Commonwealth entity may take a security such as a mortgage over an interest in land. This will prevent other creditors from taking higher ranking security over the property and provide legal remedies to recover payments under the agreement. The Commonwealth entity would then be able to sell, enter into possession of or receive any rents and profits from the land, or appoint a receiver without a court order. The Commonwealth entity 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.

A security interest over personal property

In some cases security over personal property may be appropriate. As with land there are registration requirements, including those that apply under the *Personal Property Securities Act 2009* (Cth). See AGS Legal Briefing No 96, *Personal Property Securities Act*, for more information.

Separate accounts and proper accounting for payments of funding

In grants, where funding is to be paid to the other party for an activity, it may be appropriate in some cases to require the other party to keep separate accounts for that funding and provide the Commonwealth entity with audited financial reports so the Commonwealth entity can ensure the funding is being properly applied and managed. In some situations it may also be prudent for the Commonwealth entity to take a security interest over the account until the activity is properly completed. Whether such a measure is taken will depend on the risk profile of the activity, the amount of funding that the Commonwealth entity will provide and other considerations outlined in the CGRGs.

Financial distress provisions

In high-value, high-risk agreements it may be prudent for the Commonwealth entity 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 sub-contractors 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 of improper accounting
- suspected fraud
- a breach of the other party's obligations to lenders
- default on a payment to a major sub-contractor
- 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.

'The Commonwealth entity may reserve the right to terminate or modify the operation of the agreement upon the occurrence of some specific event'

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

The Commonwealth entity may reserve the right to terminate or modify the operation of the agreement upon the occurrence of some specific event. Such a clause is sometimes known as an 'ipso facto' clause. The trigger for termination or modification will depend on the wording of the agreement. Commonwealth agreements have usually contained 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 Commonwealth entity 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. The Commonwealth entity may also want to reserve the right to terminate the contract if the contractor fails to adequately satisfy the Commonwealth entity that the contractor has remedied any financial difficulties through the contractual process.

However, because of amendments to the *Corporations Act 2001* (Cth) by the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth), which commenced on 1 July 2018, a Commonwealth entity may be restricted in its ability to enforce an ipso facto clause in an agreement with a contractor that is a Corporations Act company. In summary, a Commonwealth entity will not be able to exercise a right under an ipso facto clause to terminate or modify an agreement entered into after 1 July 2018 where the trigger is:

- the contractor entering into a compromise or arrangement to avoid being wound up in insolvency
- the contractor being placed into administration or a managing controller being appointed over all or substantially all of the company's property.

There are limited exceptions, including where the relevant administrator, scheme administrator or managing controller gives their consent to the proposed termination. There are several carve-outs for a range of financial and other commercial arrangements. There is also scope for a party to apply to the court for an order enabling them to exercise the right.

Importantly, these Corporations Act amendments do not operate to prohibit a right to terminate that may arise under an agreement for any other reasons. For example, a Commonwealth entity may still be able to exercise a right of termination under an agreement that arises because of the contractor's failure to deliver the relevant goods or services.

Given the complexities surrounding this issue, Commonwealth entities should get legal advice before they seek to enforce rights arising under an ipso facto clause against a Corporations Act company contractor.

Effective contract management

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

For example, Commonwealth entities 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 Commonwealth entity identifies that the other party is in financial distress, it should consider what action is most appropriate having regard to insolvency law and its obligations under the Commonwealth Resource Management Framework.

Actions that may be available

Audit and access

When a Commonwealth entity thinks that the other party may be in financial difficulty, the Commonwealth entity should ascertain the facts and circumstances. Many agreements will contain provisions allowing the Commonwealth entity 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 Commonwealth entity proposes to rely on these provisions. In some cases the agreement will allow the Commonwealth entity to engage an expert to conduct the audit.

Security

If the Commonwealth entity holds security, it will need to consider whether to enforce that security. It is prudent to obtain legal advice before doing this.

Where the Commonwealth entity does not hold security but the agreement allows the Commonwealth entity to require security to be provided in certain circumstances, the Commonwealth entity 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 Commonwealth entity 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 a Commonwealth entity has a right under the agreement to recover assets or money, it should seek advice to formalise its claim and act quickly to recover:

- If the Commonwealth entity 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 Commonwealth entity successfully recovers a claim, an administrator or liquidator may dispute, and potentially recover, that claim if it is paid within 6 months before the appointment of the administrator. This means Commonwealth entities 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 that the Commonwealth entity may recover.

Termination

The Commonwealth entity may consider terminating the agreement if it is entitled to do so under the terms of the agreement. Before steps are taken, careful thought should be given to the consequences of terminating the agreement and whether, if the contractor is a Corporations Act company, termination is possible because of the operation of that Act.

Summary

By assessing and planning for the risk of financial distress or collapse of a contractor, and effectively managing the agreement, Commonwealth entities will be in a stronger position to deal with an event if it occurs and will have the right to take action to limit the Commonwealth entity'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 Commonwealth entity'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 the other party's circumstances and the terms of any agreement with the Commonwealth.

Scenarios in the insolvency 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
- creditors putting the company into liquidation.

Suspicion of contractor insolvency (before the involvement of external administrators)

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

How the Commonwealth entity exercises its rights under the agreement and any security will depend on whether it considers that it is more appropriate, when considering 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 Commonwealth entity 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.

> *'…insolvency is not a short-term liquidity problem; rather, it is an endemic shortage of working capital.'*

Indications of insolvency

The Corporations Act deems 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.

Factors that indicate insolvency include:

- a history of dishonoured cheques
- suppliers insisting on cash-on-delivery 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 Commonwealth entity 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 Commonwealth entity to consider whether it has other grounds to terminate.

Determination of insolvency by courts

Under s 459B of the Corporations Act, if a court is satisfied that a company is insolvent, it may order that the company be wound-up in insolvency.

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

- that creditors have agreed to give the company more time to pay debts presently due or accept payments by instalments
- 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 Commonwealth entity) or if the Commonwealth entity provides additional funding or brings forward payments under the agreement, the other party may be able to trade out of insolvency.

Safe harbours for insolvent trading

The *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* amended the Corporations Act to give directors safe harbour from the civil insolvent trading provisions of s 588G(2) in specified circumstances. The aim of the amendments is to facilitate more successful company restructures outside of a formal insolvency process. The key features of the amendments are as follows:

- The safe harbour provisions will protect directors from personal liability for debts incurred by an insolvent company in certain circumstances.
- Directors will only be able to rely on the safe harbour provisions if it can be shown that they were developing or taking a course of action that at the time was reasonably likely to lead to a better outcome for the company than proceeding to immediate administration or liquidation.
- The safe harbour is only open to directors who have been ensuring that the company complies with its obligation to pay its employees (including superannuation) and meet its tax reporting obligations.
- There are restrictions on the use of safe harbours to ensure that, where a company eventually enters administration or is wound up, directors do not withhold books or information about the company.

These amendments do not affect whether a company is insolvent, but they do encourage directors to develop or take action that may be likely to lead to a better outcome for the company.

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 or security interest 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 Commonwealth entity

- The appointment of a receiver is a private arrangement, and the Commonwealth entity will generally not be involved in the appointment.

- Under general law the appointment of the receiver will not have the effect of terminating the agreement between the Commonwealth entity and the other party.
- If the agreement includes an entitlement for the Commonwealth entity to terminate the agreement on the appointment of a receiver, s 434J of the Corporations Act (see discussion of the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* above) may impose a stay on the exercise of the termination right (although other termination rights may still be available). Legal advice should be obtained before relying on a termination right in these circumstances.

> *'The Commonwealth entity 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.'*

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's power to trade on the company's business and employment contracts is not automatically terminated by the appointment. However, in practice, the receiver is personally liable for the debts the company 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 Commonwealth entity considers it to be in the Commonwealth's interest to keep the other party afloat. The Commonwealth entity 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.

Appointment of administrators by the directors of the other party

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, investigate 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 Commonwealth entity

Under the general law the appointment of an administrator does not cause the termination of the agreement. However, an agreement may include a clause which allows the Commonwealth entity to terminate. Due to the amendments introduced by the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* discussed above, the Corporations Act may impose a stay on the exercise of these termination rights when a company is undertaking a formal restructure.

If the Commonwealth entity does terminate the agreement (for example, under a different termination right), there is a statutory prohibition on the Commonwealth entity taking action to recover moneys paid under the agreement. The Commonwealth entity's rights are limited to being recognised as a creditor and participating in the meeting of creditors to determine the other party's future.

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:

- end the voluntary administration and return the company to the directors' control
- wind-up the company and appoint a liquidator
- resolve that the company execute a deed of company arrangement through which the company will pay all or part of its debts and then be free of those.

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 Commonwealth entity, 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.

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 the company's assets equitably and fairly
- investigate the company's affairs.

What is the effect of liquidation?

The Commonwealth entity

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 Commonwealth entity will not need to rely on the general law for termination if the agreement contains an express right to terminate on appointment of a liquidator. The Commonwealth cannot pursue the other party to recover funds provided under the agreement. The Commonwealth entity'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.

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 to sell its assets. Liquidation is terminal: 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 that debts to employees are paid out in priority to the company's general unsecured creditors.

What is the likelihood of the Commonwealth entity receiving any money?

Section 556 of the Corporations Act sets out the priority in which unsecured creditors get paid from any assets available for distribution. 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. payments to general unsecured creditors (the category that is likely to include the Commonwealth entity).

The only assets available for distribution to unsecured creditors will be those that remain after secured creditors' claims are satisfied. In most cases, if the Commonwealth entity is an unsecured creditor, it would expect to get little or no return from the liquidation. If the Commonwealth entity 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 Commonwealth entity'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 Commonwealth entity 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 that 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 (subject to the safe harbour provisions introduced by the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017*), and other creditors may also pursue the directors under any personal guarantees.

Other risks to the Commonwealth entity

A liquidator can recover payments that the company has made to creditors under the 'preference' provisions, for payments made 6 months before commencement of winding-up proceedings, if the company was insolvent at the time it made the transaction. This includes the possibility of the liquidator recovering money and security that the Commonwealth entity has taken within 6 months of commencement of winding-up.

There are some defences to recovery of preference payments. However, where the Commonwealth entity has had access to the other party's financial records and subject to the safe harbour provisions, these defences may not be available. The risk of having to pay back money to the liquidator can 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

Commonwealth entities 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 Resource Management Framework (discussed below), including the requirement that Commonwealth officials promote the proper use of Commonwealth money – that is, the efficient, effective, economical and ethical use of the money.
- Appointment of a receiver indicates financial difficulty of the other party; action under the agreement is likely to be needed even though this does not necessarily directly impact on the Commonwealth entity.
- If an administrator is appointed to the other party, the Commonwealth entity must determine what approach it will take to the creditors meeting and any deed of company arrangement. Early consideration of the Commonwealth's position is essential.
- It may not be possible to exercise an express termination right in an agreement if the right arises because of the appointment to a company of a managing controller or administrator. Other termination rights may remain available.
- If a liquidator is appointed and the Commonwealth entity is an unsecured creditor, the Commonwealth entity is unlikely to see any return after secured assets are realised and the liquidator takes out its fees. The Commonwealth may also be exposed to claw-back by the liquidator of preferential payments.

The resource management framework

Applying the Resource Management Framework

The *Public Governance, Performance and Accountability Act 2013* (PGPA Act) is the cornerstone of the Resource Management Framework. Under ss 105B and 105C, the Finance Minister may issue guidelines on procurement and grant administration. The Commonwealth Procurement Rules (CPRs) and CGRGs have been made under these powers. An official performing duties as part of those activities must act in accordance with the CPRs or CGRGs, as the case requires.

Existing rights and obligations under an agreement

Once an agreement has been entered into, the Commonwealth entity has a contractual obligation to comply with its obligations under that agreement, including any obligations to make progress payments in accordance with the terms of the agreement. Under the PGPA Act, no further approval process is required for payment of progress payments under an agreement, although the CPRs, CGRGs and Commonwealth entity's accountable authority 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.

When difficulties arise under an agreement

When a relationship created under an agreement encounters difficulties, the primary focus will remain on what the Commonwealth entity's legal obligations and options are in the circumstances. In considering any options available to the Commonwealth entity, the provisions of the PGPA Act will need to be considered. The PGPA 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.

The most relevant provision will usually be s 15 of the PGPA Act, which requires that the accountable authority of a Commonwealth entity govern the entity in a way that promotes proper use of Commonwealth resources. Depending upon the available options, s 63 may also be a relevant provision. Section 63 allows the Finance Minister, on behalf of the Commonwealth, to authorise the waiver of an amount owing to the Commonwealth or modification of the terms and conditions on which an amount owing to the Commonwealth is to be paid to the Commonwealth.

Section 15 of the PGPA Act

Promoting efficient, effective, economical and ethical use

Section 15 of the PGPA Act states that the accountable authority of a Commonwealth entity must manage the affairs of the Commonwealth entity in a way that promotes 'proper use' of Commonwealth resources. 'Proper use' means efficient, effective, economical and ethical use. This responsibility to promote proper use also involves the appropriate exercise of rights and obligations under agreements.

For example, where the Commonwealth entity has negotiated an option to take a security interest (as a form of security for debt) over certain property, failure to exercise that option might not, in the circumstances, amount to proper use of Commonwealth resources. However, the option to take a security interest may have disappeared or, given its priority relative to other secured creditors, may now be virtually worthless.

Proper use of Commonwealth resources

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 Commonwealth entity 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 continue.

As discussed above, the Commonwealth entity 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 Commonwealth entity. Where there is additional financial commitment by the Commonwealth entity then, apart from the requirements of s 15 of the PGPA Act, a further spending proposal will need to be approved and the CPRs (or the CGRGs) and the Commonwealth entity's policies will need to be considered.

If the Commonwealth entity instead decides to pursue recovery of amounts owed under the agreement as a debt, s 11 of the PGPA Rule will be relevant.

Recovery of debts and waiver of debts

Recovery of debts

The general duties of an accountable authority to govern a Commonwealth entity in a way that promotes the proper use and management of public resources and promotes the financial sustainability of the entity should guide decision-making about debt management.

Section 11 of the PGPA Rule provides that an accountable authority of a Commonwealth entity must pursue recovery of each debt for which it is responsible unless:

- the accountable authority considers that it is not economical to pursue recovery of the debt
- the accountable authority is satisfied that the debt is not legally recoverable or
- the debt has been written-off as authorised by legislation.

Not pursuing recovery of a debt is different from legally extinguishing a debt. The debt can be pursued in the future (subject to the debt becoming not legally recoverable because of a limitation period) if it has not been formally extinguished and the debtor's circumstances change. The only way for a Commonwealth entity to legally extinguish a debt is for the Finance Minister to waive the amount under s 63 of the PGPA Act.

Finance Minister may waive debts

Under s 63 of the PGPA Act, the Finance Minister has the power to waive an amount owing (or a debt owed) to the Commonwealth or modify the terms and conditions on which an amount owing to the Commonwealth is to be paid to the Commonwealth.

> *'The Finance Minister has not generally delegated the power to waive debts... '*

In contrast to deciding not to pursue a debt, decisions made under s 63 affect the legal relationship between the Commonwealth entity and the person owing the money. An amount which has been waived ceases to be a debt.

Where the agreement provides for the Commonwealth entity to recover an amount from the other party, there is an 'amount owing' to the Commonwealth entity (and these circumstances could arise where the Commonwealth entity is not otherwise proposing to financially support the business). On the other hand, if the Commonwealth entity 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 under s 63. The Finance Minister has not generally delegated the power to waive debts under s 63 outside of the Department of Finance; therefore, Commonwealth entities must consult with the Department of Finance where there is a possibility that s 63 might apply. Commonwealth entities should also consider Resource Management Guide 401: *Requests for discretionary financial assistance under the PGPA Act*.

If the Commonwealth entity negotiated a compromise with the other party to provide additional support to permit it to continue to trade then that may involve an agreement to alter the arrangements under the agreement (applicable where there is no actual waiver by the Commonwealth entity). The Finance Minister has delegated power under s 63 to authorise payment by instalments or defer the time for payment of an amount owing to the Commonwealth. Such negotiations would occur in the context of the accountable authority's overarching duty under s 15 of the PGPA Act and should have regard to the directions to delegates set out in the relevant instrument of delegation from the Finance Minister.

Key issues

Commonwealth entities 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 Commonwealth entity and competing creditors and how these affect the Commonwealth entity's rights to recover money paid under the grant agreement.
- Decisions need to be made having regard to the Resource Management Framework.

This publication was prepared by Mark Molloy, Jane Supit and Zita Rowling.

It is an update of Commercial notes 35.

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ISSN 1443-9549 (Print)
ISSN 2204-6550 (Online)
Approved Postage PP 233744/00042

Client Services 221–2018 10/18