Navigating the safe harbour for small- to medium-sized enterprises

BY BEN SEWELL

A ustrialia’s prohibition on companies trading whilst insolvent (Corporations Act, s 588G) has often been the subject of criticism. Until recently, Australia was said to have the strictest insolvent trading prohibition in the developed world (Harris, Jason ‘Director Liability for Insolvent Trading: Is the cure worse than the disease?’ (2009) Australian Journal of Corporate Law, Vol 23, No 3).

Nevertheless incurred debts during an attempt to turnaround the business as an alternative to formal insolvency proceedings. In particular, in September 2017, the new safe harbour amendments to the Corporations Act in Australia is that the same laws apply to large corporations (greater than 200 employees) and to small- to medium-sized enterprises (‘SME’s’) (less than 200 employees) while the problems they face and their responses to company insolvency are significantly different. Large corporations have independent directors who don’t have their assets substantially tied up in the business and they have access to sophisticated professional advisers. On the other hand, SME’s are owned by their directors and are unlikely to have ready access to sophisticated professional advisers. SME directors have ‘skin in the game’ and it is more likely than their personal asset position is intrinsically linked to their company through personal guarantees.

The result is that SME directors are more likely than directors from large corporates to take risk (both good and bad) when their company is facing insolvency. This is an important consideration for solicitors advising directors facing insolvency because a careful reading of s 588GA should be undertaken before advising a client about whether they have the right to claim the safe harbour. Directors must be careful to breach the statutory duties when facing insolvency by undertaking phoenix activity (see ASIC’s Somerville & Ors (No 2) [2009] NSWSC 354 for an example of a solicitor’s potential liability for phoenix activity).

Tax returns and employee entitlements

Phoenix activity is a concern for regulators and so lodging tax returns and paying employee entitlements is a threshold requirement for the new safe harbour. The specific requirements are set out in s 588GA(4) under the heading ‘Matters that must be done or be done’. Further, if a company goes into liquidation after safe harbour protection and the directors do not cooperate with the liquidator, they will retrospectively lose the protection. Books and records that the director relies upon may not be admissible to support a claim for safe harbour protection.

The new safe harbour from insolvent trading: one step towards Chapter 11

In September 2017, the new safe harbour amendments to the Corporations Act received royal assent and they have now come into effect. The amendments provide that the duty to prevent insolvent trading will not apply if:

• at a particular time after the director suspects insolvency, the director develops a course of action that is reasonably likely to lead to a better outcome for the company; and
• the company debt is incurred in connection with the course of action.

It must be remembered that the safe harbour is not a defence but is a carve-out from the principal cause of action. It must, therefore, be considered by liquidators before they undertake a claim for insolvent trading.

It is not mandated that directors follow a specific process in order to claim the safe harbour protection, rather, the protection is dependent on the size and complexity of the company’s circumstances. The new law does, however, include indicators about the need for the director (and therefore the board) to do the following:

• Informs themselves about the company’s financial position; • Take steps to prevent misconduct by officers and employees; • Keep appropriate books and records; • Obtain advice from an ‘appropriately qualified entity’; and • Develop or implement a plan for restructuring the company. The test to be considered is whether the course of action may be ‘reasonably likely to lead to a better outcome for the company’ (s 588GA(1)(a)). A ‘better outcome’ is compared to what would occur if there was to be an immediate appointment of a voluntary administrator or liquidator over the company.

In contrast to Chapter 11 of the United States Bankruptcy Code, the Australian insolvency regime requires independent experts to be appointed as liquidators, voluntary administrators, or receivers over companies. Under Chapter 11 there is a debtor-in-possession regime where, with court approval, the directors of companies remain in control of the company while having the benefit of a moratorium on action by creditors. The new safe harbour is a step towards Chapter 11 because the directors can continue to trade during insolvency while undertaking a restructuring process. Critically, under the new amendments, while a director is in safe harbour, there is no penalty for the director utilising assets that would have been available to satisfy creditor claims had a liquidator or voluntary administrator been appointed. One opponent of the safe harbour has argued that it could also shield directors whilst they undertake phoenix activity (Anderson, Helen ‘Shelter from the storm: Phoenix activity and the safe harbour’ (2018) Melbourne University Law Review 41(3)).

Elements of the solicitor’s potential role

As the new safe harbour protection is not a defence but rather a carve-out that requires professional interpretation, this creates an opportunity for solicitors to advise clients and evaluate any ‘course of action’ that is developed. For example, to obtain protection there is no strict requirement to execute a turnaround plan but only to start to develop one. This means that a prudent solicitor finds that the company is better off being liquidated, the director may claim the safe harbour whilst this course of action is being ‘developed’. Solicitors will need to consider the potential for safe harbour protection will end if however the course of action that is developed is not undertaken ‘within a reasonable time’ (s 588GA(1)(b)). The take-away for solicitors should be to apply common sense and provide advice and support for clients which is within their set of skills and experience. The elements of work that a solicitor may provide could include: due diligence, financial analysis, project management, strategic development, legal research, template selection and bespoke drafting, negotiation, document management, legal advice, and risk assessment.

Helping directors develop a turnaround plan

To claim protection under the safe harbour there is no requirement that a director actually execute a turnaround plan. The obligation upon a director is to ‘develop’ a ‘course or courses’, of action that is ‘reasonably likely to lead to a better outcome for the company’. The onus on the director is quite low when one considers that the alternative could involve the extinguishment of goodwill in a business and a fire sale of assets through a liquidation or voluntary administration. That said, it is also worth considering that the ultimate best outcome may be an orderly liquidation or sale of assets during which time a director can legitimately claim the safe harbour.

The new safe harbour from insolvent trading is the most significant change to corporate insolvency law since the introduction of voluntary administration in 1993.

• Helping directors of small- to medium-sized enterprises obtain safe harbour protection represents an exciting opportunity for solicitors when, previously, insolvent companies were mandated to commence external administration.

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