One Step Toward Chapter 11: Australian Safe Harbour Reform

Ben Sewell
Sewell & Kettle Lawyers; Sydney, Australia

The new safe harbour from insolvent trading is the most significant change to corporate insolvency law in Australia since the introduction of voluntary administration in 1993. Before the reform was enacted, directors of insolvent companies were effectively mandated to appoint a voluntary administrator. The new safe harbour encourages directors to attempt an informal turnaround upon insolvency rather than immediately appointing a voluntary administrator or liquidator.

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

Before the reform was enacted, directors of insolvent companies were effectively mandated to appoint a voluntary administrator. The new safe harbour encourages directors to attempt an informal turnaround upon insolvency rather than immediately appointing a voluntary administrator or liquidator.

Background: Insolvent Trading Prohibition and Voluntary Administration

Australia has developed a formal insolvency regime that is creditor-centric, and through voluntary administration the control of corporate insolvency is given to specialist insolvency practitioners. In stark contrast to a debtor-in-possession system, the voluntary administrator assumes the powers of directors and is required by statute to act in the best interests of creditors if the business cannot be salvaged[1] After five weeks of voluntary administration, the creditors decide on whether to accept a compromise offer or place the company into liquidation. Liquidation results in the termination of the business, the destruction of any remaining goodwill and a fire sale of assets.

Australia's prohibition on companies trading while insolvent[2] has had a long history of being criticized. Australia previously had the strictest insolvent trading prohibition in the developed world[3] No other developed country prohibited companies from incurring debts while insolvent, thereby mandating the commencement of formal insolvency proceedings.[4]

Under the prohibition, a director of a company may be held personally liable for debts incurred by a company while it is insolvent. Broadly, section 588G provides that a director will be found to have breached their duty if:

- the person was a director at the relevant time;
- the company was actually insolvent;
- the company incurred a debt; and
- there were reasonable grounds for the director to suspect insolvency.

The penalties for a director breaching the prohibition include:

- civil penalties of up to $200,000 (sections 1317E and 1317G);
- liability to compensate the company or relevant creditor for the amount of the debt incurred as a result of the breach (section 588M); and
- criminal prosecution in limited circumstances (section 1311, Schedule 3 Item 138).

The key issue that policy-makers sought to address was that there was no defense to insolvent trading even when a director, having recognized the financial problems faced by the company, nevertheless incurred debts during an attempt to turn around the business as an alternative to formal insolvency proceedings. The direction of policy-makers was to consider how to encourage appropriate informal workouts, and the solution was the new safe harbour protection.

One Step Toward Chapter 11: The New Safe Harbour from Insolvent Trading

In September 2017, the new safe harbour amendments to the Corporations Act were passed as law. Now, company directors in Australia can utilize the safe harbour to develop an informal workout plan when faced with insolvency.

The amendment provides that the duty to prevent insolvent trading will not apply when:

- at a particular time after the director suspects insolvency, the director starts to develop 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.

To claim the safe harbour protection, there is no specific process that is mandated for a director to undertake, and it is dependent on the size and complexity of the company's circumstances. But the new law includes indicators about what a course of action may involve, including the director (and therefore the board):

- informing themselves about the company's financial position;
- taking steps to prevent misconduct by officers and employees;
- keeping appropriate books and records;
- obtaining advice from an "appropriately qualified entity"; and
- developing or implementing a plan for restructuring the company.

The new safe harbour protection is not a defense to the insolvent-trading prohibition, but it is a carve-out that requires professional interpretation. This opens up an opportunity for lawyers to advise and evaluate any "course of action" that is developed. For example, to obtain safe harbour protection, there is no strict requirement to execute a turnaround plan but only to start to "develop" one. This means that if a prudent lawyer finds that the company is better off being liquidated, the director may claim the safe harbour while this course of action is being "developed." Lawyers should note that under section 588GA(1)(b)(i), the safe harbour protection will end if the course of action that is developed is not undertaken "within a reasonable time."

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 start to "develop" a course (or courses) of action that is "reasonably likely to lead to a better outcome for the company." The first consideration is that the onus is quite low, given that the alternative could involve the extinguishment of goodwill in a business and a fire sale of assets through a liquidation or voluntary administration. The second consideration is that it may be that ultimately the best outcome is an orderly liquidation or sale of assets, and that while this is being undertaken, a director can legitimately claim the safe harbour.

The key test to be considered is whether the course of action developed may be "reasonably likely to lead to a better outcome for the company."[5] 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.

Critically, under the new safe harbour provision there is no penalty for directors utilizing assets, while in safe harbour that would have been available to satisfy creditor claims had a liquidator or voluntary administrator been appointed. One opponent of the safe harbour has also argued that it could shield directors while they undertake phoenix activity.[6]

Qualifications of Lawyers to Be an "Appropriately Qualified Entity"

One of the indicators of whether a director has a claim for safe harbour protection is whether they have obtained advice from an "appropriately qualified entity."[7] There isn't much guidance on who this person may be, but it certainly includes lawyers. The Explanatory Memorandum (Treasury Laws Amendment 2017 Enterprise Incentives No 2 Bill) explains:

> *1.35 The factors in subsection 588GA(2) therefore provide only a guide as to the steps a director may consider or take depending on the circumstances. For example, a small business may only need to seek the advice of an accountant, lawyer or other professional, while a large listed entity might retain an entire team of turnaround specialists, insolvency practitioners, and law and accounting firms to advise on a reasonable course of action.*

The most widely read report in Australia that recommended a safe harbour from insolvent trading was the Productivity Commission's Business Set-up, Transfer and Closure[8] The Productivity Commission's recommendations, however, were not followed by the government. The Commission recommended that a registered "restructuring adviser" take carriage of the safe harbour process and that they follow a set process that included providing a certificate. Under the Productivity Commission model, the restructuring adviser was also required to have a deep knowledge of insolvency.[9] Instead, the government inserted a new section 588GA into the Corporations Act that, compared to the Productivity Commission recommendations, is vague and laissez-faire. The substantial requirements to obtain safe harbour protection include starting to "develop" a course of action for a turnaround, meeting a threshold of filing tax returns on time, and paying all employee's entitlements in full.

What Next for Australia?

The foundation of the Australian insolvency regime, in contrast to chapter 11 of the U.S. Bankruptcy Code, is that independent experts are appointed as liquidators, voluntary administrators or receivers to insolvent companies. Under chapter 11, there is a debtor-in-possession regime where, with court approval, the managers of companies remain in control of the company while having the benefit of a moratorium from creditor action. The safe harbour is a step toward chapter 11 because directors can continue to trade during insolvency while undertaking a restructuring process. However, unlike chapter 11, there is no moratorium on the enforcement of creditor claims.

The next step for Australian insolvency reform is the implementation of ipso facto reform, because in Australia, unlike the U.S., there is no protection from ipso facto termination clauses in contracts. This reform is anticipated to be undertaken sometime in 2018.

---

[1] Section 435A Corporations Act.

[2] Section 588G of the Corporations Act.

[3] Hon. Martin CJ, 2009 IPA Conference 28 May 2009.

[4] Harris, Jason "Director Liability for Insolvent Trading: Is the cure worse than the disease?" (2009) *Australian Journal of Corporate Law*, Vol. 23, No. 3.

[5] Section 588GA(1)(a).

[6] Anderson, Helen, "Shelter from the storm: Phoenix activity and the safe harbour" (2018) *Melbourne University Law Review*41(3).

[7] Section 588GA(2)(d).

[8] No 75, 30 September 2015.

[9] *See* recommendation 14.2, page 387.