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

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Snapshot

- 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.

Australia'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 (Hon Martin CJ, opening address to the 16th National Conference of the Insolvency Practitioners' Association of Australia, 28 May 2009). No other developed country prohibited companies from incurring debts whilst insolvent, thereby mandating commencement of formal insolvency proceedings (Harris, Jason 'Director Liability for Insolvent Trading: Is the cure worse than the disease?' (2009) *Australian Journal of Corporate Law,* Vol 23, No 3).

Background: watering down of the insolvent trading prohibition

Under the existing insolvent trading prohibition, a director of a company may be held personally liable for debts incurred by a company whilst 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 following penalties apply to a director found to be in breach:

- Civil penalties of up to $200,000 (ss 1317E and 1317G);
- Liability to compensate the company or relevant creditor for the amount of the debt incurred as a result of the breach (s 588M); and
- Criminal prosecution in limited circumstances (s 1311, sch 3, item 138).

The key issue that policy-makers sought to address was that there was no defence to insolvent trading even when a director, having recognised the financial problems faced by their company, nevertheless incurred debts during an attempt to turnaround the business as an alternative to formal insolvency proceedings. In response, policy makers considered how to encourage appropriate informal work-outs. The solution was the new safe harbour protection.

An important report from the Productivity Commission, *Business Set-up, Transfer and Closure* (No 75, 30 September 2015), 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 this model, the Restructuring Adviser was also required to have a deep knowledge of insolvency (see recommendation 14.2, p 387). However, the government rejected these recommendations and instead inserted a new section 588GA into the *Corporations Act* which, in this author's view, is vague and laissez-faire in comparison. The substantial requirements to obtain safe harbour protection include starting to 'develop' a course of action for a turnaround and meeting a threshold of filing tax returns on time and paying all employee's entitlements in full.

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:

- Inform 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 key 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 to insolvent 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 from creditor action. The new safe harbour is a step towards Chapter 11 because the directors can continue to trade during insolvency while undertaking a restructure 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)).

Same law, different behaviour: large corporates v SMEs

One criticism of corporate insolvency law in Australia is that the same law applies to large corporates (greater than 200 employees) and to small- to medium-sized enterprises ('**SMEs**') (less than 200 employees) while the problems they face and their responses to insolvency are significantly different. Large corporates 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, SMEs 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 than likely that 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 of SMEs may be tempted to breach their duties when facing insolvency by undertaking phoenix activity (see *ASIC v Somerville & Ors* [2009] NSWSC 934 for an example of a solicitor being found to have accessorial 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 being done or be done'. Further, if a company goes into liquidation after a safe harbour period 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. Section 588GB applies if directors fail to meet their obligations to supply books and records to liquidators.

Is a solicitor 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' (s 588GA(2)(d)). There isn't much guidance on who this person may be but it certainly includes solicitors, at least so far as SMEs are concerned. 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.'

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 if 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 should note that the safe harbour protection will end however if the course of action that is developed is not undertaken 'within a reasonable time' (s 588GA(1)(b)(i)).

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, strategy 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 ultimately, the best outcome may be an orderly liquidation or sale of assets during which time a director can legitimately claim the safe harbour. **LSJ**