

COVID-19: PRESSURE POINTS: TEMPORARY CHANGES TO INSOLVENCY LAWS - AUSTRALIAN FEDERAL GOVERNMENT ADDRESSES COVID-19 FINANCIAL DISTRESS (AUSTRALIA)

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Legal Briefings - By **Paul Apáthy, Lisa Filippin, Lauren Wright and Angus Dick**

Updated 22 September 2020: The Australian Federal Government has extended temporary amendments to insolvency and corporations laws in light of the challenges COVID-19 poses to many otherwise profitable and viable businesses.¹

IN BRIEF

In March 2020 the Australian Federal Government passed temporary amendments to insolvency and corporations laws in light of the challenges COVID-19 poses to many otherwise profitable and viable businesses.

These changes were contained in schedule 12 to the *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) (the **Act**), which came into effect on 25 March 2020 (the **Effective Date**).² Initially, the temporary relief operated for a six month period starting on the Effective Date.³

However, by way of the *Corporations and Bankruptcy Legislation Amendment (Extending Temporary Relief for Financially Distressed Businesses and Individuals Regulations 2020* (Cth) (the **Extending Regulations**) the period of relief has now been extended to apply throughout the period from the Effective Date until the end of the day on 31 December 2020 (the **Temporary Period**).

The temporary changes are intended to avoid unnecessary insolvencies and bankruptcies by providing a safety net for:

- directors and businesses to help them operate during a temporary period of illiquidity rather than enter voluntary administration or liquidation; and
- individuals to assist them with managing debt and avoiding bankruptcy.

The key reliefs contained in the Act that apply during the Temporary Period include the following:

- directors are temporarily relieved from the risk of personal liability for insolvent trading, where the debts are incurred in the ordinary course of business;
- the minimum threshold at which creditors can issue a statutory demand has increased from \$2,000 to \$20,000, and companies will have 6 months to respond to a statutory demand rather than the current 21 days;
- the minimum threshold for a creditor to initiate bankruptcy proceedings against an individual has increased from \$5,000 to \$20,000, debtors will have 6 months (rather than the current 21 days) to respond to a bankruptcy notice, and the period of protection a debtor receives after making a declaration of intention to present a debtor's petition is extended from 21 days to 6 months.

In combination with other measures introduced by the Australian Government, such as the [JobKeeper programme](#), it appears that these temporary measures have to date been quite effective in preventing a flood of formal insolvency appointments in Australia in response to the COVID-19 epidemic.

Notwithstanding the support that these measures have provided to corporate boards facing the uncertain impact of COVID-19 on their business and cashflow position, there has been a mixed reaction to the extension of the temporary protections beyond 25 September 2020 until the end of the year.

This appears to be largely due to the concern that these changes have made it more difficult for suppliers and other creditors to recover overdue payments, thereby increasing credit risk and shifting liquidity pressure from debtors to suppliers and creditors.

In addition, given there has been no change made to the laws regarding voidable transactions, there is also a risk that once the Temporary Period extends and greater numbers of companies start filing for formal insolvency many creditors will be exposed to clawback risk in respect of payments received during this time.

Suppliers and other creditors will therefore need to continue to be vigilant with their trading counterparties and consider adjusting their trading terms to address these risks.

TEMPORARY RELIEF FOR FINANCIALLY DISTRESSED BUSINESSES AND INDIVIDUALS

The temporary measures, which took effect from the Effective Date, are as follows:

INSOLVENT TRADING (COMPANIES)

The existing safe harbour provisions in the *Corporations Act 2001* (Cth) (**Corporations Act**) are supplemented by additional temporary relief for directors from personal liability for debts incurred when trading while insolvent where the debt is incurred:

- in the ordinary course of the company's business;
- during the Temporary Period;⁴ and
- before any appointment during this period of an administrator or liquidator.

A holding company may rely on the temporary safe harbour for insolvent trading by its subsidiary if:

- it takes reasonable steps to ensure the temporary safe harbour applies to each director of the subsidiary and to the debt(s) incurred; and

- the temporary safe harbour does actually apply in relation to each of the directors and to the debt.

The person or holding company seeking to rely on the temporary safe harbour relief bears the evidentiary burden in establishing they are entitled to the relief. 'Evidential burden' in the new safe harbour regime means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Although providing relief to directors for the consequences of insolvent trading, the company will continue to remain liable for debts incurred.

HERBERT SMITH FREEHILLS COMMENTARY

The Explanatory Memorandum to the Act (the **Explanatory Memorandum**) states that a debt is incurred in the ordinary course of business '*if it necessary to facilitate the continuation of the business*' during the 6 month period commencing on the Effective Date.⁵ This provides a narrower protection than that included in the existing safe harbour regime (which provides protection for debts incurred directly or indirectly with a course of action likely to lead to a better outcome for the company). The examples given as to what 'debts incurred in the ordinary course of business' are:

- taking out a loan to move some business operations online; and
- debts incurred through continuing to pay employees during the COVID-19 pandemic.

Care will need to be taken by directors to ensure a debt incurred is in the ordinary course of business. It would appear from the example given in the Explanatory Memorandum (of a loan to move business online), that the expression 'ordinary course of business' is intended to be widely interpreted, to facilitate transactions with a view to 'saving' the business, but this is an area of potential uncertainty. For example, would a debt incurred as part of a rescue financing be considered to be incurred in the ordinary course of business?

Due to this uncertainty, [the existing safe harbour regime](#) may continue to have some ongoing relevance as companies respond to the financial challenges posed by COVID-19. That is, although the debt incurred as part of the rescue financing might not be in the ordinary course of business, it may comfortably fall within the existing safe harbour protection (assuming that the other criteria are satisfied). Directors may therefore seek to rely on both safe harbour regimes during the next six months to obtain protection under both regimes for debts incurred where there might be ambiguity.

In any event, it can be expected that distressed companies should and would seek to pursue the core requirement of safe harbour: to develop and take a course of action reasonably likely to lead to a better outcome than administration or liquidation where that is practically achievable. In addition the factors that may be taken into account under the existing safe harbour regime (for example, ensuring directors are receiving proper information and keeping appropriate financial records, are properly advised and are developing a plan for restructuring the company to improve its financial position) are good practice and helpful for discharging the directors' general duties to the company.

Creditors and counterparties to transactions with stressed companies should be aware of the heightened voidable transaction risk (in particular the risk of payments received by creditors subsequently being set aside as preferences) if those companies are insolvent (i.e. unable to pay their debts) but are continuing to trade in reliance on these reforms. This could cause counterparties to more frequently require upfront payment, rather than extending customary credit terms.

It appears the Act contemplates the use of regulations to restrict certain circumstances in which a director may not be able to rely on the temporary safe harbour relief. However no such regulations have been introduced to date and therefore it appears unlikely any such restrictions will be introduced before the end of the Temporary Period.

As with the current safe harbour regime, the protections do not extend to protection from the criminal penalties associated with insolvent trading that is dishonest.

STATUTORY DEMANDS (COMPANIES)

For statutory demands served on or after the Effective Date:

- the threshold at which creditors can issue a statutory demand on a company has increased from \$2,000 to \$20,000; and
- companies will have 6 months (rather than the current 21 days) to respond to statutory demands served on them.

Following the passage of the Extending Regulations, these changes will continue in effect for all statutory demands deemed to be served during the Temporary Period.⁶ Unsurprisingly, there has been a significant reduction in the use of statutory demands by creditors to force companies to make payment since the Effective Date.

The provisions do not affect:

- other methods of winding up, including the winding up by the court where it is otherwise demonstrated that the company is unable to pay its debts, on just and equitable grounds or where winding up is sought by ASIC; or
- the ability of a creditor to sue a company to recover a debt, and once judgment is obtained, to then rely upon the enforcement regime available (i.e. attachment of debts or sale of assets by the sheriff).

The provisions do, however, impact on creditors who may rely on the statutory demand process as a reasonably cheap and simple way to pressure debtors to pay outstanding debts.

BANKRUPTCY PROCEEDINGS (INDIVIDUALS)

For bankruptcy notices and declarations served during the Temporary Period:⁷

- the threshold for a creditor to initiate bankruptcy proceedings against an individual has increased from \$5,000 to \$20,000;
- debtors will have 6 months (rather than the current 21 days) to respond to a bankruptcy notice;
- the period of protection a debtor receives after making a declaration of intention to present a debtor's petition is extended from 21 days to 6 months.

TEMPORARY POWERS GIVEN TO THE TREASURER

Section 1362A of the Corporations Act enables the Treasurer to provide short-term regulatory relief to classes of persons that are unable to meet their obligations under the Corporations Act or the *Corporations Regulations 2001* (Cth) (the **Corporations Regulations**) by:

- determining that specified classes of persons are exempt from specified obligations; or
- modifying specified obligations to enable specified classes or persons to comply with their obligations during the COVID-19 crisis.

This mechanism commences on the Effective Date for 6 months, and the power has not to date been extended beyond this initial period (and is therefore scheduled to expire on 25 September 2020). It is only available where a class of companies is unable to comply with their obligations – either because it would not be reasonable to expect them to comply with the provisions, or because the exemption or modification is otherwise necessary or appropriate to facilitate the continuation of business or mitigate economic impacts of COVID-19. We expect this power to be used to provide relief to directors from complying with statutory obligations which are impracticable in the current situation, such as requirements to hold meetings in person.

OTHER MEASURES

TAX PAYMENTS AND ENFORCEMENT

On 22 March 2020, the Australian Federal Government also announced that the ATO will tailor solutions for businesses struggling due to COVID-19, including temporary reduction of payments or deferrals, and withholding enforcement actions including Director Penalty Notices and wind-ups. See the [Greenwoods + Herbert Smith Freehills COVID-19 Hub](#) for more details on tax, fiscal and administrative measures designed to help taxpayers deal with the impacts of COVID-19.

Herbert Smith Freehills' dedicated restructuring, turnaround and insolvency team is continuing to review the Australian Federal Government's response to COVID-19 and provide further updates as additional information becomes available.

Please contact any of the Herbert Smith Freehills' [Restructuring Turnaround and Insolvency team](#) below for further details on these changes, or to discuss your specific circumstances.

For further details regarding the temporary changes to insolvency laws, refer to the Treasurer's [media release](#), the [Act](#), and the [Explanatory Memorandum](#).

For details regarding the recent extension to these laws, see the [Extension Regulation](#), [Explanatory Memorandum](#) and the associated [Media Release](#).

ENDNOTES

1. This article was originally dated 25 March 2020 when the Act came into effect, but has been updated to reflect the extension affected by the *Corporations and Bankruptcy Legislation Amendment (Extending Temporary Relief for Financially Distressed Businesses and Individuals Regulations 2020* (Cth) ('Extension Regulations').
2. The Act passed both Houses of Parliament on 23 March 2020, and received Royal Assent on 24 March 2020.

3. The changes took effect on the Effective Date, with no retrospective application.
4. *Extension Regulations* (n 1) Sch 1 item 4; *Corporations Regulations 2001* (Cth) sub-reg 5.7B.01.
5. Now extended to 31 December 2020.
6. *Extension Regulations* (n 1) sch 1 item 3; *Corporations Regulations 2001* (Cth) sub-reg 5.4.01AA(3); *Sunstate Land Pty Ltd v Hiview Design & Construction Pty Ltd* [2020] QSC 181.
7. *Extension Regulations* (n 1) sch 1 items 1-2; *Bankruptcy Regulations 1996* (Cth) sub regs 4.02AA(3), 4.10A(2).

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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