MAJOR INSOLVENCY LAW REFORM: GOVERNMENT SETS SAIL TOWARDS AN INSOLVENT TRADING SAFE HARBOUR

19 May 2016 | Australia, Brisbane, Melbourne, Perth, Sydney
Legal Briefings – By **Paul Apathy**, **Siba Diqer** and **Lisa Filippin**

There has been an ongoing conversation in Australia about whether the current insolvent trading laws are stifling the turnaround of viable businesses by requiring directors to file for voluntary administration, when a better outcome could be achieved through restructuring. The Government has proposed the introduction of an insolvent trading "safe harbour" to protect directors from liability in circumstances where appropriate steps are being taken to return a company to solvency.There are two alternate safe harbour models proposed. This article explores both models in greater depth and provides comments on each model.

IN BRIEF

- There has been an ongoing conversation in Australia about whether the current insolvent trading laws are stifling the turnaround of viable businesses by requiring directors to file for voluntary administration, when a better outcome could be achieved through restructuring.
- The Australian Government, in its Improving Bankruptcy and Insolvency Laws Proposals Paper released on 29 April 2016[1] (**Proposal**), has proposed the introduction of an insolvent trading 'safe harbour' to protect directors from liability in circumstances where appropriate steps are being taken to return a company to solvency.

- There are two alternate safe harbour models proposed. Model A is a defence to the duty to prevent insolvent trading if the directors have appointed a restructuring adviser. Model B is a less prescriptive alternative that would apply when directors have taken reasonable steps to maintain or return the company to solvency.

- The Government is currently seeking the public's views about both models. Submissions are due by 27 May 2016.

- The Proposal is an encouraging step to reforming what has often been noted as a strict insolvent trading regime in Australia. It is hoped that the introduction of a safe harbour regime will bring some balance between providing greater flexibility to directors to restructure a business, and protecting creditor interests.

- There appears to be merit in both models, although greater clarity is required to enable directors and other stakeholders to ascertain when a director is acting in safe harbour. This article explores both models in greater depth and provides comments on each model.

AUSTRALIA'S INSOLVENT TRADING LAWS

Directors of Australian companies have a duty to prevent insolvent trading pursuant to section 588G of the Corporations Act 2001 (Cth) (**Act**).

Insolvent trading is said to occur if a company incurs a debt whilst it is insolvent (that is, it is unable to pay its debts as and when they fall due). Should a company subsequently enter into liquidation, a director may be personally liable for debts incurred when the company was insolvent, unless the Court relieves the director from civil liability or the director can establish one of the statutory defences set out in section 588G of the Act. A director can also be criminally liable for insolvent trading if the director's failure to prevent the company incurring the debt was dishonest.

The justification for insolvent trading laws is largely focussed on creditor protection, and is designed to encourage directors to prevent the company continuing to trade if they suspect its insolvency, so as to reduce the potential loss suffered by creditors through incurring additional credit when it may not be fully repaid.

STRIKING THE RIGHT BALANCE

Australia's insolvent trading laws are considered to be some of the strictest in the world, particularly compared to the regimes in other finance and business jurisdictions:

1. in the United States of America there is no personal liability for directors in connection

with any conceptual equivalent to insolvent trading;

2. the United Kingdom's *Insolvency Act 1986* (UK) c. 45 (**UK Insolvency Act**) provides for 'wrongful trading', where a director may be liable to make a contribution to the company's assets if the company has gone into insolvent liquidation and the director knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation. Given directors are only at risk for losses incurred once there is no longer a reasonable prospect of avoiding insolvent liquidation, in practice this provides significant space for directors to pursue restructurings while the company is insolvent;

3. Hong Kong only provides for director liability in the case of 'fraudulent trading' which requires dishonest conduct on the part of directors (albeit there has been discussion in recent years as to whether to introduce a stricter regime); and

4. directors of companies in Singapore may be liable under the wrongful trading regime, if the director knowingly or recklessly causes the company to incur debts when there is no reasonable ground of expectation of the company being able to repay those debts. In Singapore, wrongful trading is an offence; it is only upon conviction of the offence that the director may be ordered to compensate creditors who have suffered a loss as a result of being unable to recover the debt in question.

The strict regime in Australia acts as an incentive to companies to only trade whilst solvent. This provides a degree of protection to creditors who might otherwise have extended credit to the company. However, by effectively requiring directors to appoint an external administrator, this can also prevent directors from taking sensible steps to achieve a better outcome for existing creditors and other stakeholders through a corporate restructuring. It has therefore been asked whether Australia's insolvent trading laws are a cure that is worse than the disease.2 Further, it has been suggested that:

1. the threat of insolvent trading claims, combined with uncertainty over the precise moment when the company is insolvent, means that often companies enter voluntary administration, sometimes prematurely;3

2. formal appointments such as that of a voluntary administrator can result in a destruction of, or diminution in, the value of a company;4 and

3. due to a fear of liability, directors are disinclined to take what may be reasonable commercial risks to restructure a company or undertake a work-out plan. A vast majority of directors agree that the risk of personal liability has caused them to take an overly cautious approach to business decision making.5

THE INTRODUCTION OF A SAFE HARBOUR

The introduction of a ‘safe harbour’ mechanism to allow some flexibility for directors to restructure a company, free from the fear of an insolvent trading claim, has long been considered. In particular, a safe harbour for directors:

1. was proposed as an option by the Australian Government in its 2010 paper ‘Insolvent Trading: A Safe harbour for reorganisation attempts outside external administration’;

2. was recommended as an area for reform in the Productivity Commission’s Business Set-up, Transfer and Closure Productivity Commission Inquiry Report in 2015 (**Report**); and

3. has now been put forward, in two different models, in the Proposal.

We explore the two models in the Proposal, Model A and Model B, below.

MODEL A

Model A is proposed as a defence to the duty to prevent insolvent trading if the directors have appointed a professional restructuring adviser:

> *Proposal 2.2*
> *It would be a defence to s588G if, at the time when the debt was incurred, a reasonable director would have an expectation, based on advice provided by an appropriately experienced, qualified and informed restructuring adviser, that the company can be returned to solvency within a reasonable period of time, and the director is taking reasonable steps to ensure it does so.*
> *The defence would apply where the company appoints a restructuring adviser who:*
> *(a) is provided with appropriate books and records within a reasonable period of their appointment to enable them to form a view as to the viability of the business; and*
> *(b) is and remains of the opinion that the company can avoid insolvent liquidation and is likely to be able to be returned to solvency within a reasonable period of time.*
> *The restructuring adviser would be required to exercise their powers and discharge their duties in good faith in the best interests of the company and to inform ASIC of any misconduct they identify.*

Our previous article provided a detailed summary of proposed Model A.6 Some aspects of the model are considered in further detail below.

WHO CAN BE A RESTRUCTURING ADVISER?

The defence will only be available to a director of a company that appoints a restructuring adviser. The Government has proposed that the restructuring adviser be a member of certain accredited organisations,7 but that the directors would need to ensure that the experience and qualifications of the restructuring adviser are appropriate for the nature and circumstances of the company.

Consideration should be given to the possible need to expand the categories of persons who may be appointed as restructuring advisers, so that those with significant international or industry experience, who are not members of an organisation approved by the Minister, can be validly appointed by the company.

We also welcome the Government's proposal that the restructuring adviser is carved out of the definition of director, and the restructuring adviser will not be civilly liable to third parties for an erroneous opinion provided that it was honestly and reasonable held. This avoids a situation where restructuring advisers may be reluctant to take an appointment if faced with the possibility of certain personal liabilities.

OPINION TO BE HELD BY THE RESTRUCTURING ADVISER

The requirement that the restructuring adviser form an opinion that the company is likely to be able to be returned to solvency suggests that a company can be insolvent at the time of appointment, an element that is different to that recommended in the Report (which recommended that a restructuring adviser certify that the company was solvent at the time of appointment).

Consideration should be given as to whether the ability to return the company to solvency is always the correct measure. Arguably, directors should be focussed on preserving viable businesses and achieving a better result for creditors than would be achieved by immediately entering into voluntary administration or liquidation. Neither of these aims necessarily require the preservation of the company itself (although returning a company to solvency would normally achieve this).

THE NATURE OF THE RESTRUCTURING ADVISER ROLE

The restructuring adviser appears to do more than simply advise the company, and in some respects is almost akin to a 'light touch' insolvency regime.

As outlined above, the proposal requires an appropriately experienced, qualified and informed adviser to be appointed who owes duties in exercising their ‘powers’, who is given the company’s books and records and who is required to report misconduct. It is also the opinion of the restructuring adviser that is critical in determining whether the company can return to solvency within a reasonable period of time.

The question remains as to whether Model A can be used ‘in hindsight’; that is, that directors can rely on the defence if they satisfy its requirements, even if the restructuring adviser was not appointed with the expectation that such appointment would be relied upon in any liquidation. Whilst it may have been the Government’s intention that the defence would operate in this manner, certain obligations (such as the provision of books and records, reporting of misconduct and the exercise of powers and discharge of duties in good faith in the best interests of the company) means that directors and restructuring advisers are likely to take a prudent approach at the outset and document the appointment to ensure that they have the benefit of the defence. It will be important that any draft legislation does not cut across that approach.

There is potentially some tension between the concept of an adviser and that of an officeholder. That is, would the restructuring adviser be required to provide advice to the company consistent with the objective of returning the company to solvency, or would the scope of the role of the restructuring adviser be set by the company? Further, what would the position of the restructuring adviser be where the board of the company chose not to adopt (or otherwise departed from) the recommendations of the restructuring adviser?

There also remains an overarching question as to whether requiring the formal appointment of a restructuring adviser to undertake a particular role may be overly prescriptive and inflexible in practice, particularly having regard to the different context and circumstances in which companies operate.

DISCLOSURE OBLIGATIONS

The Proposal provides that companies will not be required to disclose whether they are operating in safe harbour, but there will be no relaxation of a company’s continuous disclosure obligations. Whether the appointment of a restructuring adviser triggers a continuous disclosure obligation will depend on the final drafting of any legislation.

VOIDABLE TRANSACTIONS

Although the Proposal provides that the period during which the safe harbour defence applies should be disregarded for the purposes of calculating any reach-back period for director related transactions, it is silent as to what impact, if any, the safe harbour has on all other voidable transactions. For example, a payment received by a creditor within 6 months prior to the appointment of a voluntary administrator, at a time when the company was insolvent, or became insolvent as a result of the transaction, may be characterised as an unfair preference subject to claw-back by a liquidator. The risk that a creditor dealing with a company during the safe harbour period may be forced to return payments it received during this period if the restructuring ultimately fails has not been dealt with in the Proposal. Once the Proposal is implemented into draft legislation, there may be greater clarity on the impact of the reforms in respect of other voidable transactions.

IPSO FACTO REFORMS

The appointment of a restructuring adviser also needs to be considered in light of theipso facto reforms set out in the Proposal. Parties may incorporate the appointment of a restructuring adviser as an event of default in their agreements, thereby possibly diminishing the company's value and ability to restructure.

EARLY STAGES

The Proposal is not in the form of draft legislation and is drafted in general terms. If the Government adopts Model A, there will need to be some certainty about what is meant by 'reasonable period' and 'viability of the business', though we note that the Government is seeking views on the meaning of the latter.

Consideration will also need to be given as to how the appointment of a restructuring adviser will be effected in a large group of companies where each of the directors of those companies may wish to have the benefit of the defence.

Whilst still in early stages, there are some clear benefits for directors if Model A is implemented, particularly around the certainty of steps a director must take to rely on the defence and clarity of a director's and restructuring adviser's obligations whilst operating in safe harbour. In addition, we note that there is merit in encouraging financially distressed companies to seek advice from suitably qualified specialists.

MODEL B

Model B is a less prescriptive alternative to Model A and acts as a carve-out to section 588G of the Act, rather than a defence. The onus would be on the liquidator to show that a director has breached any one of the three limbs of the proposed provision:

Proposal 2.3
Section 588 does not apply:
(a) if the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and
(b) the person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole; and
(c) incurring the debt does not materially increase the risk of serious loss to creditors.

Our previous article provided a detailed summary of proposed Model B. Some aspects of the model are explored further below.

FLEXIBILITY

Model B aims to provide directors who are acting in the best interests of the company and its creditors as a whole with a safe harbour within which they may attempt to return the company to profitability. It aims to provide directors with the flexibility of taking reasonable steps to maintain or return the company to solvency, so long as they hold an honest and reasonable belief that doing so will benefit the company and its creditors. An advantage of Model B is that it does not prescribe a particular process and unlike Model A, there is no requirement to appoint an external adviser (although the appointment of a restructuring adviser would assist a director in establishing that 'reasonable steps to maintain or return the company to solvency' were taken). There are some similarities between Model B and section 180 of the Act (being the business judgment rule), as well as the model adopted in the UK Insolvency Act, which allows a director to defend a wrongful trading claim if they take every step with a view to minimising the potential loss to the company's creditors.

SATISFYING THE THREE LIMBS

The hurdles for a director to satisfy Model B seem to be significant. In particular:

1. it requires the directors to seek to return the company to solvency within a reasonable period of time. We note that this may not be achievable, but it may still be worthwhile continuing to pursue an outcome that results in a better outcome for creditors than an immediate formal insolvency;

2. whilst the directors may be of the view that continuing to pursue a restructuring is in the best interests of the company and the creditors as a whole, it may be difficult for directors to form that view in respect of every debt being incurred during that period. As a practical matter, it is possible that the directors of a large company do not know of many of the debts being incurred; and

3. incurring a new debt is likely to materially increase the risk for that particular creditor,

which would contravene limb (c) of the proposed Model B. We presume the creditor in question is not included in the analysis, though this will need to be clear in any legislation.

The requirement that the debt does not materially increase the serious loss to creditors is significant (which is not currently an element of the proposed Model A defence). We note that this information may not be available to the director at the time the debt is incurred, particularly if the debt is incurred as part of a series of steps undertaken by the company in a restructure, and is likely to be the subject of expert evidence at any trial at which insolvent trading claims are made.

EARLY STAGES

As discussed above, the Proposal is not in the form of draft legislation at this stage. The draft legislation ought provide greater certainty around:

what would be considered ‘reasonable steps’ and ‘reasonable time’. The Government intends that the indicia of both these terms will be discussed more fully in the Explanatory Memorandum; and
whether the carve-out still applies if the director took reasonable steps when the company was already insolvent.

BEYOND THE MODELS

Both models proposed by the Government merit consideration and will benefit from further refinement.

However, it is also worth considering further reform. As noted at the outset of this article, Australia’s insolvent trading laws are particularly strict. The safe harbour concept begs the question whether the insolvent trading rules should:

1. be fundamentally reworked (for example by moving to a concept more akin to the ‘wrongful trading’ approach used in the United Kingdom); or

2. be abolished entirely, with more reliance placed on directors’ general duties (similarly to the approach in the United States of America).

This approach would place more responsibility in the hands of counterparties and creditors to determine for themselves whether they are prepared to take the risk of extending further credit to a distressed company. However it would also allow directors to focus more clearly on what is in the best interests of the company as a whole including, where the company is insolvent, the position of its existing creditors.

This article is one of a series that Herbert Smith Freehills is publishing on the Government's insolvency and bankruptcy law reform proposals. More information can be found on the Herbert Smith Freehills website.

ENDNOTES

1. Improving Bankruptcy and Insolvency Laws Proposal Paper.

2. Jason Harris, 'Director liability for insolvent trading: Is the cure worse than the disease?' (2009) 23(3) Australian Journal of Corporate Law 266.

3. Business Set-up, Transfer and Closure Productivity Commission Inquiry Report, page 378.

4. Joint Submission made by the Law Council of Australia, Insolvent Practitioners Association of Australia (now Australian Restructuring Insolvency and Turnaround Association) and the Turnaround Management Association of Australia dated 2 March 2010 in relation to the Australian Government's Insolvent Trading Safe Harbour Options Paper.

5. Australian Institute of Company Directors, Director Sentiment Index: Research Findings Second Half 2015 (2015).

6. Australian Government forges ahead with major insolvency law reform.

7. The Proposals Paper seeks the public's views on what qualifications and experience a restructuring adviser must have, but the Government has suggested that accredited members of organisations such as the Law Society, CPA Australia, Chartered Accountants Australia and New Zealand, the Australian Restructuring, Insolvency and Turnaround Association and the Turnaround Management Association would be approved to act as restructuring advisers.

The views expressed in this publication are the authors' personal views and do not necessarily represent the views of Herbert Smith Freehills or any of its clients.

This article is one of a series that Herbert Smith Freehills is publishing on the Government's insolvency and bankruptcy law reform proposals.

KEY CONTACTS

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

PAUL APÁTHY
PARTNER, SYDNEY

+61 2 9225 5097
paul.apathy@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2021

SUBSCRIBE TO STAY UP-TO-DATE WITH INSIGHTS, LEGAL UPDATES, EVENTS, AND MORE
Close

© HERBERT SMITH FREEHILLS LLP 2021