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The new safe harbour for directors will change the insolvency culture in Australia.

New Safe Harbour for Directors

But how? In this episode we will ask Ben Sewell of Sewell & Kettle to give you an answer to this question. Here are some notes from that interview.

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Until Now

Until now Australia had one of the strictest insolvent trading prohibition in the developed world. Its prohibition on trading whilst insolvent (Corporations Act, s 588G) had often been the subject of criticism. It meant pushing companies much earlier into formal insolvency proceedings.

Until now a director of a company may be personally liable for debts incurred by a company while insolvent.

Broadly, section 588G provides that a director will breach their duty if:

- the person was director at the relevant time
- the company was actually insolvent
- there were reasonable grounds for the director to suspect insolvency

The following penalties apply to a director 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)

Key Issue

There was no defence to insolvent trading even when a director, having recognised the financial problems faced by their company, incurred debts to try and turn the business around. There was no alternative to formal insolvency proceedings.

This is the issue policy makers tried to address. How to encourage appropriate informal work-outs? The solution is the new safe harbour for directors.
Recommendations

A report by the Productivity Commission, *Business Set-up, Transfer and Closure* (No 75, 30 September 2015) recommended that a registered ‘Restructuring Adviser’ with a deep knowledge of insolvency takes control of the safe harbour process. And that they follow a set process that included providing a certificate.

However, the government rejected these recommendations. Instead, to obtain safe harbour protection directors need to ‘develop’ a course of action for a turnaround, file tax returns and pay employee’s entitlements in full and on time.

The New Rules

In September 2017, the new safe harbour amendments to the *Corporations Act* received royal assent and they have now come into effect. The amendments saw a new section inserted into the Corporation Act – section 588GA.

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 do a better outcome for the company and the company debt is incurred in connection with the course of action.

It doesn’t require a registered adviser or a set process.

The safe harbour is not a defence but is a carve-out from the principal cause of action.

No Specific Process

Directors don’t have to follow a specific process in order to claim the safe harbour protection. Rather, the protection depends on the size and complexity of the company’s circumstances.

The new law does, however, include indicators about the need for the director (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

Better Outcome

The key test 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.

Not a Chapter 11

In contrast to Chapter 11 of the United States Bankruptcy Code, the Australian insolvency regime requires the appointment of independent experts 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 the 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.

While a director is in safe harbour under the new rules in Australia, there is no penalty for the director utilising assets that would have been available to satisfy creditor claims upon appointment of a liquidator or voluntary administrator.

**One Size Does Not Fit All**

The same law applies to large corporates as to small – to – medium-sized enterprises (‘SMEs’) (less than 200 employees). However, they face different problems and respond differently to these.

Large corporates have independent directors who don’t have their assets tied up in the business. Their directors have access to sophisticated professional advisers.

On the other hand, SME directors are often the sole shareholders of SME companies. And are unlikely to have ready access to sophisticated professional advisers. SME directors often have personal guarantees linking their personal assets to the fate of the company. They have ‘skin in the game’.

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.

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’.

If directors don’t cooperate with the liquidator in a subsequent liquidation, they will retrospectively lose the safe harbour 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.

** 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. 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 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 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**
The new safe harbour protection is not a defence but rather a carve-out that requires professional interpretation. This creates an opportunity for accountants to advise clients and evaluate “any course of action”.

There is no requirement to execute a turnaround plan. But only to start to develop one.

The safe harbour protection will end when directors don’t undertake the course of action ‘within reasonable time’. See s588GA(1)(b)(i)) for more details.

Turnaround Plan

To claim protection under the safe harbour there is no requirement that a director actually execute a turnaround plan. The director just has to develop a course of action.

And that course of action must be ‘reasonably likely to lead to a better outcome for the company’. A better outcome for the company. Not necessarily a better outcome for creditors.

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