

SAFE HARBOUR REFORMS FOR INSOLVENT TRADING

The “safe harbour” amendments to the insolvent trading provisions of the *Corporations Act* have come into law.

The “safe harbour” provisions, in effect, provide an important new defence for directors from claims of personal liability for insolvent trading. The “safe harbour” defence applies to directors incurring debts (which might otherwise constitute insolvent trading) when the debts are connected to taking a course of action reasonably likely to lead to a better outcome for the company. These amendments are designed to allow a director to take reasonable steps to help the company recover from possible insolvency.

Consequently, these amendments are significant for all directors and companies.

Insolvency trading provisions

Under section 588G of the *Corporations Act*, directors may, subject to certain limited defences, be exposed to civil and criminal penalties if the company incurs a debt when, amongst other things:

- there were reasonable grounds for suspecting that the company was insolvent; or
- there were reasonable grounds to suspect that the debt would cause the company to become insolvent.

The new defence shields directors from these provisions when their company incurs debts in connection with a course of action reasonably likely to lead to a better outcome for the company.

Background to “safe harbour” reforms

As part of the *National Innovation and Science Agenda* the Federal Government identified that it needed to improve the country’s insolvency laws to encourage innovation. Noting that “*more often than not, entrepreneurs will fail several times before they make it*”, the Government decided to encourage Australians to “*take a risk, leave behind the fear of failure and be more innovative and ambitious.*”

The Productivity Commission in a 2015 report on “*Business Set-up, Transfer and Closure*” considered that the *Corporations Act*, previously, provided too much focus on “*penalising and stigmatising corporate failure*”. The report suggested that reforms should be made to provide incentives for directors to encourage them to take steps to improve a struggling company. The report recommended a “safe harbour” defence as a way to try and reduce the number of corporate failures in Australia.¹

¹ www.pc.gov.au/inquiries/completed/business/report/business.pdf.

In response, the Federal Government outlined a proposal to “shield” directors who were trying to restructure their companies from Australia’s corporate insolvency laws. As the explanatory memorandum indicates, traditionally the insolvent trading provisions focus on when the debts are incurred, rather than the conduct of the directors in incurring these debts.

These reforms passed parliament in September 2017, have received royal assent and are now Australian Law. They apply to debts incurred after commencement of the amendments on 19 September 2017.

New “safe harbour” defence

The new “safe harbour” defence works by providing an exception to the insolvency penalties of the *Corporations Act* if a director incurs a debt on behalf of the company (directly or indirectly) in connection with a course of action that is reasonably likely to improve the outlook of the company at a time the director suspects the company may become, or be, insolvent.

The explanatory memorandum to the reforms outlined some examples of debts that can be incurred in connection with such a course of action. The examples are a debt incurred to pay a professional turnaround adviser to provide advice on an appropriate course of action or a debt associated with the sale of assets which would help the business’s overall financial position.

The explanatory memorandum also notes that the course of action that is appropriate in the circumstances will depend on the unique factors of the relevant company. These factors include the company’s size, financial position, its nature and complexity. According to the explanatory memorandum, a director who takes a passive approach to the company’s position or allows a company to continue trading as usual during financial difficulty, or whose recovery plans are fanciful, will not be protected.

The “safe harbour” defence only operates if the debt connected with a course of action that is reasonably likely to improve the outlook of the company is incurred before:

1. the end of a reasonable amount of time to take a course of action that is likely to improve the outlook of the company; or
2. the director decides to no longer take that course of action; or
3. the course of action is no longer reasonably likely to improve the outlook of the company; or
4. the appointment of an administrator, or liquidator, of the company.

The “safe harbour” defence also does not apply in certain circumstances such as a failure to pay employee entitlements or comply with taxation obligations (without first obtaining a Court order where there are exceptional circumstances or the interests of justice require the order to be made); or if the director fails to comply with their obligations to assist an administrator, liquidator or controller of the company. The safe harbour provisions do not affect any liability for breaches of the duty of care and diligence or the duty to act in good faith.

What does this mean for directors?

To help ensure that directors are covered by the “safe harbour” defence, when incurring a debt in connection with a course of action that is reasonably likely to lead to a better outcome for the company, a director should:

- (a) properly inform themselves of the company’s financial position;
- (b) take appropriate steps to prevent any misconduct by the company’s officers or employees;
- (c) ensure that the company is keeping appropriate financial records;
- (d) obtain appropriate advice; and
- (e) develop and implement a plan for restructuring the company to improve its financial position.

***Ipsa facto* reforms**

The “safe harbour” reforms were accompanied by reforms to the operation of *ipso facto* clauses which normally give rise to a right to terminate or alter a contract due to the financial position of the company, or on the happening of a specific event, including insolvency, even if the company otherwise is meeting its obligations pursuant to the contract. These reforms have not yet commenced.

Prior to the reforms, an *ipso facto* clause could result in contracts essential to the ongoing success of the company at risk of being cancelled or significantly modified as a result of the appointment of an administrator. This can reduce the ability of that company to undertake a formal restructure, negatively impact the value of the company, or prevent the sale of the company. The reforms, when they come into effect, will provide a stay on the enforcement of such clauses.

Resolve Litigation Lawyers has extensive experience in advising directors of distressed companies, as well as former directors of companies in administration, receivership and liquidation being investigated for, amongst other things, insolvent trading. Please contact **Michael Daniel or David Hing on 02 8298 6000** to discuss assisting you in meeting your obligations.

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