

# **Safe Harbor Carve-Out for Directors for Insolvent Trading Liability in Australia and Its Implications**

*By FIREW TIBA\**

## **I. The Significance of Personal Liability and Insolvent Trading**

THE ISSUE OF PERSONAL LIABILITY for insolvent trading is important for existing and prospective company directors. Under section 588G of the *Australian Corporations Act 2001* (hereinafter “*Corporations Act 2001*”), directors of a company have the duty to prevent insolvent trading. Failure to do so will lead to the directors incurring a personal liability. “Insolvent trading involves the incurring of debts when circumstances of insolvency in relation to a company exist and the subsequent winding up in insolvency of the company.”<sup>1</sup> There are two types of debts. The first one is known as “deemed debt” and is assumed to have been incurred within the time specified under section 588G (1A) of the *Corporations Act 2001*. Under this section, deemed debts include: paying a dividend, making a reduction of share capital other than cancellation of shares for no consideration, buying back shares, redeeming preference shares that are redeemable, financially assisting a person to acquire shares in itself or in a holding company, and entering into an uncommercial transaction within the meaning of section 588FB. The second type of debt is general debt under the common law.

The duty to prevent insolvent trading is in regard to the overall financial health of the company instead of particular debt. Thus, this provision was introduced to remove “attention from the incurring of particular debt or debts and direct[s] attention to the director’s re-

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1. Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) 126, <http://www.austlii.edu.au/other/lawreform/ALRC/1988/45.html> [<https://perma.cc/NE3J-KZSS>].

sponsibility for the overall financial management of the company.”<sup>2</sup> Pursuant to section 95A of the *Corporations Act 2001*, a company is deemed insolvent if it is unable to pay all its debts, as and when they become due for payment. Personal liability is one of the considerations when weighing options as to whether or not one is prepared to assume the role of a director. The decisions directors take in response to such personal liability concerns do have a significant impact on the economy. Some directors are motivated by the fear of personal liability when they put their company into voluntary administration prematurely. Likewise, experienced directors are reluctant to take roles in promising, yet struggling early start-up companies due to personal liability concerns.

The corporate business structure is notable for its limited liability principle. Rules regarding personal liability of directors is an exception to the notion of limited liability. The protection of shareholders’ and company interests enjoy primacy for most of the company’s life. On the other hand, each corporate crisis has traditionally been accompanied by calls to strictly regulate the corporate sector for the benefit of one or more stakeholders. The law changes its protective focus to creditors when a company nears insolvency or during its twilight years.

It has been theoretically disputed whether there is a need to protect creditors by legislative means when a company nears insolvency.<sup>3</sup> Various policy justifications have been invoked for a rule against insolvent trading. Among others, it encourages directors to be aware of their company’s financial situation; it encourages directors to prevent the company from continuing trade if there are grounds for suspecting it is insolvent, for example, by relinquishing control so that the company’s creditors can determine its future; it improves the position of an insolvent company’s creditors by imposing liability for post-insolvency debts on directors who breach their duty; finally, it provides an incentive for management to obtain competent professional

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2. *Id.* at 128.

3. David Morrison, *The Australian Insolvent Trading Prohibition – Why Does It Exist?*, 11 INT’L INSOLVENCY REV. 153, 153–72 (2002). See also Andrew Keay, *Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective*, 25 LEGAL STUD. 431 (2005); DALE A. OESTERLE, *Corporate Directors’ Personal Liability for “Insolvent Trading” in Australia, “Reckless Trading” in New Zealand and “Wrongful Trading” in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders*, in COMPANY DIRECTORS’ LIABILITY FOR INSOLVENT TRADING 19 (Ian M. Ramsey ed., 2000).

advice when financial difficulties loom.<sup>4</sup> These policy justifications appear to be robust, but not without their critics. In this regard, a US academic who compared England's wrongful trading, Australia's insolvent trading, and New Zealand's reckless trading regimes to that of the US counterpart argued that these "codes are excessively protective of corporate creditors and inherently impracticable to boot. Among other ills, insolvent trading provisions, if enforced, make timid managers out of good managers and do not help to catch the crooks . . . that Australia, New Zealand and England would be well advised to repeal their provisions entirely."<sup>5</sup>

These arguments have not had much traction in shifting the policy and legislative choices drastically. That said, the practical impact of a stringent approach to insolvent trading in Australia had recently culminated in prompting the enactment of an amendment to section 588G of the *Corporations Act 2001* by providing a safe harbor to directors who take a "course of action reasonably likely to lead to a better outcome for the company" and the company's creditors.<sup>6</sup> The carve-out for directors who intend to use the safe harbour whilst not getting rid of the insolvent trading prohibition does have a significant impact for those who genuinely attempt to turn around the fortunes of their companies.

## II. Background to the Insolvent Trading Regime

States and territories in Australia first introduced criminal liability for insolvent trading in 1961 in section 303(3) of the uniform Companies Act 1961.<sup>7</sup> Intention to defraud creditors is the requisite mental element to establish criminal liability.<sup>8</sup> However, there is no need to show an intention to defraud to establish personal liability of a director in other cases. The subsequent amendment made civil liability possible, but only after a criminal conviction is obtained.<sup>9</sup> The Companies Act 1981 introduced section 556 of the Companies Code, which made directors and managers personally liable for incurring debts where there were "reasonable grounds to expect that the com-

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4. Chris Bowen, 'Insolvent trading: A safe harbour for reorganisation attempts outside of external administration' (Discussion Paper, The Treasury, January 2010) 4.

5. OESTERLE, *supra* note 3, at 20.

6. *Corporations Act 2001* (Cth) s 588GA (Austl.), as amended by *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017*.

7. PAUL JAMES, IAN RAMSAY & POLAT SIVA, INSOLVENT TRADING – AN EMPIRICAL STUDY 15 (2004).

8. *Companies Act 1961* s 303(3) (Austl.).

9. JAMES ET AL., *supra* note 7, at 16.

pany would not be able to pay all its debts when they become due.”<sup>10</sup> This took away the requirement of a criminal conviction as a prerequisite for civil liability. The subsequent national corporate law scheme that came into effect in 1992 retained the same approach in its section 592 of the Corporations Law.

It was the Harmer Report of 1988 that recommended the Australian Corporation Law’s rule on insolvent trading (section 588G).<sup>11</sup> The Corporate Law Reform Act 1992 that introduced section 588G replaced the previous provision of section 592 of the Corporation Law. A number of deficiencies of section 556 of the Companies Code (the precursor to section 592 of the Corporations Law) were criticised in the Harmer Report released by the Australian Law Reform Commission in 1988.<sup>12</sup> The 1992 Corporate Law Reform Bill sought to address these criticisms by separating civil and criminal sanctions while reserving the latter for dishonest actions.<sup>13</sup> It also imposed a positive duty on directors to ensure solvency and introduced a system whereby a liquidator will be primarily responsible for bringing an action on behalf of all creditors instead of a system where each creditor received the right to bring an action.<sup>14</sup> Furthermore, under the new reform, “the duty is expressed in such a way that the director will not be able to use lack of involvement in the company’s affairs as a basis for asserting that a particular transaction was entered into without his or her implied authority.”<sup>15</sup> The reform also introduced a number of rebuttable presumptions that “will assist the liquidator in establishing that the company was insolvent at a particular time.”<sup>16</sup>

The changes after the Harmer Report meant that the insolvent trading rule applied only to directors, unlike section 566 of the Companies Code and section 592 of the Corporations Law, which extended liability to “persons who took part in the management of the company, without necessarily being directors.”<sup>17</sup> This excluded managers. In public submissions, there were arguments that favored the

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10. *Companies Act 1981* s 556(1) (Austl.).

11. Letter from Mark Robinson, President, Insolvency Practitioners Ass’n, to Ms. Preston 18 March 2010, [http://archive.treasury.gov.au/documents/1748/PDF/Insolvency\\_Practitioners\\_Association.pdf](http://archive.treasury.gov.au/documents/1748/PDF/Insolvency_Practitioners_Association.pdf) [https://perma.cc/TG7W-LN29]; Australian Law Reform Commission, *General Insolvency Inquiry*, Summary of Report No 45 (1988).

12. Jenny Schultz, *Liability of Directors for Corporate Insolvency – The New Reforms*, 5 BOND L. REV. 191, 196–97 (1993).

13. See *id.* at 197. See also JAMES ET AL., *supra* note 7, at 16.

14. Schultz, *supra* note 12, at 197.

15. *Id.*

16. *Id.*

17. *Id.* at 198.

extension of the duty to senior managers. One of such arguments was that “senior managers are in a better position to know the affairs of the company and the directors rely heavily on them for information about those affairs.”<sup>18</sup> It was also argued that “senior managers may not be bringing matters to the attention of the board, or worse could be deliberately misleading the directors and incurring credit without having to worry about the personal liability.”<sup>19</sup> The Institute of Directors argued, in particular, that “liability for senior managers may prompt more timely reporting to the board of directors and that there should be a provision to enable liability to be apportioned between those culpable by taking into account factors such as the extent of their knowledge, the degree of responsibility for the loss and all other relevant factors.”<sup>20</sup> The Harmer Report rejected the arguments that called for personal liability of senior managers for insolvent trading.

As per the Harmer Report:

[T]he duty focuses on preventing the company from engaging in a course of insolvent trading rather than the incurring of a particular debt. It is therefore appropriate to look to those who are entrusted with the overall management of the company rather than those who may have authority to take some part in its management. It is the directors who have a duty to oversee the whole management of the company. Only they should owe the duty to prevent insolvent trading.<sup>21</sup>

Furthermore, the report noted, the existing legislation’s definition of a director is wide enough to encompass those who act in a de facto capacity and have the same duty as those validly appointed as directors.<sup>22</sup> Thus, the current *Corporations Act 2001*, in section 9 defines a director in such a broad fashion that persons who are not appointed as directors but act in that capacity can be caught by the insolvent trading provisions.<sup>23</sup> Therefore, some senior managers who are not validly appointed as directors in a de facto capacity are considered directors. The rule that all directors, whether executive or otherwise, are equally liable has its origin in these earlier reforms. While the duty to prevent insolvent trading is targeted at directors only, other significant duties under the Corporations Act, such as the duty of care and diligence (section 180), the duty to act in good faith (section 181), the duty not to make improper use of position (section

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18. Australian Law Reform Commission, *supra* note 1, at 143.

19. *See id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. JAMES ET AL., *supra* note 7, at 5.

182), and the duty not to misuse information (section 183) extend to officers of the company, including senior managers.

The standard of duty expected of a director was also made more stringent as a result of Harmer Report's recommendations. Thus, “[u]nder section 592 [of the previous Corporations Law], for a director to be liable there needed to be reasonable grounds to *expect* that the company would not be able to pay its debts. Under section 588G(1)(c) it is sufficient if there are reasonable grounds to *suspect* insolvency.”<sup>24</sup> The operative word “grounds to *expect*” replaced “grounds to *suspect*.”

### III. How Does Australia Compare with Other Jurisdictions?

The director's obligation near the time of insolvency may generally take the form of the duty to file for insolvency or face liability for wrongful trading.<sup>25</sup> The filing duty imposes an obligation on directors of financially distressed companies to file for insolvency within a specific period after a company becomes insolvent.<sup>26</sup>

Until recently, Australia had arguably one of the most stringent insolvent trading regimes in the Common Law world. While the Australian system has an affinity to the approach taken in England and New Zealand, it sets itself apart from the other two by imposing a stricter standard. In Australia, the insolvent trading rule is invoked when there exists “reasonable grounds for suspecting that the company is insolvent, or would so become insolvent.”<sup>27</sup> In New Zealand, directors “must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.”<sup>28</sup> In England, the wrongful trading provision applies if a director “knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.”<sup>29</sup> The wrongful trading rule requires directors to take steps to minimize potential loss to company creditors either by restructuring or placing the company into liquidation.<sup>30</sup> In the United States and

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24. Schultz, *supra* note 12, at 200.

25. Robbert Goosens, *The European Initiative on the Harmonisation of Directors' Duties in the Vicinity of Insolvency*, 5 NOTTINGHAM INSOLVENCY AND BUS. E-J. 3, 6 (2017).

26. *Id.*

27. *Corporations Act 2001* (Cth) s 588G (Austl.).

28. Companies Act 1993 s 136 (N.Z.).

29. Insolvency Act 1986, c. 45, § 214(2)(b) (Eng.).

30. See *id.* § 214(3).

Canada, similar rules are lacking. In continental Europe, the duty to file for liquidation prevails.<sup>31</sup>

#### IV. The Impacts of the Insolvent Trading Prohibition

Rules have intended and unintended consequences. The intended objective of the variants of insolvent trading regulations is to put directors on notice that they will be held personally liable for debts incurred near insolvency. This rule mostly protects unsecured creditors. Various justifications have been provided for a move from “creditor beware” regimes of early corporate law history to the creditor protection regimes in the form of insolvent trading prohibition as is the case in Australia.<sup>32</sup> As pointed out earlier, there have also been arguments in favour of abandoning the rules altogether.

While the insolvent trading prohibition in Australia goes back to 1961, there have not been many court cases. An empirical study conducted in 2004 covering the period 1961–2004 showed a total of 103 cases only.<sup>33</sup> There are reasons why this has been the case. As David Morrison argued, “[t]he unintended use of the involuntary administration procedure for example, is more likely the reason for the sharp lessening in the number of insolvent trading cases, rather than the current form of the prohibition working as an effective deterrent.”<sup>34</sup>

The voluntary administration system and separate civil liability regimes for insolvent trading were both recommended by the 1988 Harmer Report. According to David Morrison, directors who fear personal liability opt for voluntary administration instead of weathering the storm and trading out of financial difficulties.<sup>35</sup> Going into voluntary administration does not guarantee a company restructure. In fact, the success rate of companies that go into voluntary insolvency coming out of this process as going business concerns has been dismally low.<sup>36</sup> The 2015 Productivity Commission Report indicated that the arrangements do not promote effective restructuring.<sup>37</sup> Failure rates

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31. See *id.* § 214(2)(b). See also Carsten Gerner-Beuerle, Philipp Paech & Edmund Philipp Schuster, *Study on Directors' Duties and Liabilities*, LONDON SCH. OF ECON. 233 (London Sch. Of Econ. 2013).

32. Gerner-Beuerle et al., *supra* note 31. See also David Morrison, *The Economic Necessity for the Australian Insolvent Trading Prohibition*, 12 INT'L INSOLVENCY REV. 171, 171–89 (2003).

33. JAMES ET AL., *supra* note 7, at 1–2.

34. Morrison, *supra* note 3, at 157.

35. *Id.*

36. Productivity Commission, *Business Set-up, Transfer and Closure*, Inquiry Report No 75 (2015) 363.

37. *Id.*

after a company enters voluntary administration are high: 37% are deregistered within two years of the commencement of a voluntary administration, 57% are deregistered within three years, 70% are deregistered within four years, and 78% are deregistered within five years.<sup>38</sup>

Yet, the objective of voluntary administration under section 435A is to maximize the company's chances of staying in existence, or if this is not possible, to produce results in a better return for the company's creditors and members than would result from an immediate winding up of the company. Regardless, it has been noted that:

Australia's use of corporate restructure processes such as voluntary administration compares poorly to Canada and the United States. Almost 60% of companies entering voluntary administration are deregistered within three years, and there are few incentives to restructure. Further, these issues disproportionately affect small companies. Relevantly, as the Productivity Commission notes, around 80% of insolvencies relate to small companies.<sup>39</sup>

It can be seen that the voluntary administration regime has not been successful in aiding restructuring of companies in Australia.

## V. Reform Measures

While the need for reforming the rule on personal liability of directors for insolvent trading has been debated for a long time, it gained the Australian Federal Government's attention only in 2007 in the wake of the Global Financial Crisis. In 2007, the then-Minister of Treasury, Honorable Peter Costello issued a paper reviewing sanctions in Corporate Law.<sup>40</sup> The paper broached the measure of general protection for directors that would relieve them of liability for decisions they made where they acted in a bona fide manner, within the scope of the corporation's business, reasonably and incidentally to the corporation's business, and for the corporation's benefit.<sup>41</sup> The proposal for a "general defence" was found necessary to alleviate concerns that some corporate law "sanctions are adversely affecting directors' willingness to engage in responsible risk taking."<sup>42</sup> This proposal paper

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38. *Id.*

39. DAVID CORNWELL, MALCOLM QUIREY & JAMES LOWREY, *Safe Harbours for Startups and Other Directors*, PIPER ALDERMAN (Dec. 16, 2015), <https://www.piperaderman.com.au/publications/corporate-commercial/article/7606> [https://perma.cc/9PGW-JC4P].

40. Corporations and Financial Services Division, The Treasury, 'Review of Sanctions in Corporate Law' (Report, 2007), [http://archive.treasury.gov.au/documents/1182/PDF/Review\\_of\\_Sanctions.pdf](http://archive.treasury.gov.au/documents/1182/PDF/Review_of_Sanctions.pdf) [https://perma.cc/SXS4-H2TS].

41. *Id.*

42. *Id.* at 29.

was comprehensive as it considered the overall framework of directors' liability. The change of government soon after in 2007 meant that the proposals in this paper were not actioned and no further submissions were made.<sup>43</sup>

In 2010, the then-Minister for Human Services, Financial Services, Superannuation, and Corporate Law, the Honorable Chris Bowen Member of Parliament (MP), issued the discussion paper *Insolvent Trading: A Safe Harbour for Reorganisation attempts outside of external administration*. This focused on a single personal liability regime, unlike the previous discussion paper that addressed the broader framework of corporate law sanctions.<sup>44</sup> The discussion paper acknowledged "the laws directed at preventing businesses from trading while insolvent may negatively impact on genuine work-out attempts."<sup>45</sup> The paper put forward three possible options for reform: maintain the status quo, adopt a modified business judgement rule in respect of a director's duty to avoid insolvent trading, or adopt a mechanism for invoking a moratorium from the insolvent trading prohibition while work-outs are attempted.<sup>46</sup> There were a number of submissions made in response to the discussion paper, but no further action was taken until the change of government in 2013.<sup>47</sup>

In 2014, the new Treasurer, Honorable JB Hockey, requested the Productivity Commission to undertake "an inquiry into barriers to business entries and exits and identify options for reducing these barriers where appropriate, in order to drive efficiency and economic growth in the Australian economy."<sup>48</sup> In regard to insolvency, the Productivity Commission's term of reference included identifying "appropriate options for reducing these entry and exit barriers, including, but not limited to, advice on the potential impacts of . . . (e) The personal/corporate insolvency regimes on business exits."<sup>49</sup> Having discussed concerns relating to a director's liability for insolvent trading, the Commission's Report concluded, "[t]he current culture, incentives and legal framework around voluntary administration inhibit

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43. The discussion paper was issued by the Liberal-National Coalition Government on 5 March 2007. See also ABC Elections, Australia Votes 2007 (Election Results for 2007 Federal Election in Australia, November 2007) <https://www.abc.net.au/elections/federal/2007/> [https://perma.cc/WPD2-UADE].

44. Bowen, *supra* note 4, at 1.

45. *Id.* at v.

46. *Id.*

47. *Id.*

48. Productivity Commission Inquiry Report, *supra* note 36, at iv.

49. *Id.* at v.

its effectiveness as a genuine restructuring mechanism.<sup>50</sup> The Commission's Report also recommended the amendment of the *Corporations Act 2001* "to provide for 'safe harbor' defence to allow directors to obtain independent restructuring advice without liability for insolvent trading."<sup>51</sup> This study served as a catalyst for the reform that followed.

In April 2016, the Australian Federal Government released a discussion paper entitled *Improving Bankruptcy and Insolvency Laws* and sought feedback from stakeholders on issues addressed in the proposal paper.<sup>52</sup> The Government presented this as part of its Innovation and Science Agenda and the Productivity Commission's 2015 Inquiry Report on "Business Set Up, Transfer and Closure" formed the basis for the insolvency-related proposal.<sup>53</sup>

The proposal paper, citing the Productivity Commission's Report, asserts that the current insolvency laws "put too much focus on penalising and stigmatising corporate failure," and the proposed reform is aimed at striking a better balance between encouraging entrepreneurship and protecting creditors, and that over time these changes will help reduce the stigma associated with business failure.<sup>54</sup> Again, citing the Productivity Commission's Report, the proposal paper states that "the threat of Australia's insolvent trading laws, combined with uncertainty over the precise moment of insolvency has long been identified as a driver behind companies entering voluntary administration," even in circumstances where the company may be viable in the long term.<sup>55</sup>

Furthermore, the discussion paper notes, "concerns over inadvertent breaches of insolvent trading laws are frequently cited as a reason early stage (angel) investors and professional directors are reluctant to become involved in a startup."<sup>56</sup>

Jason Harris summarises the challenges facing directors seeking to restructure under the then-existing regime:

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50. *Id.* at 367.

51. *Id.* at 373.

52. Corporations and Schemes Unit, Financial Systems Division, The Treasury 'Improving Bankruptcy and Insolvency Laws' (Proposals Paper April 2016).

53. See generally *Business Set-up, Transfer and Closure*, *supra* note 36 (The report, among others, concluded that "[a] 'safe harbour' defence should be introduced to allow directors of a solvent company to explore, within guidelines, restructuring options without liability for insolvent trading.").

54. *Id.* at 23.

55. *Id.* at 378.

56. Proposals Paper, *supra* note 52, at 10.

There is a broad consensus that companies trying to restructure under the current legal framework face a challenging task, as directors (particularly in large companies) express concern and possibly hesitation about participating in restructuring where insolvent trading liability looms large and the appointment of a voluntary administrator can result in a destruction of value as key contracts are terminated by ‘ipso facto’ clauses included in many commercial contracts and leases. Furthermore, the public perception of formal restructuring procedures is one of failure. Voluntary administration is reported in the press as the end of a company, with corporate undertakers sent in to sell the business, often in conjunction with a receivership. The public dialogue concerning insolvency and restructuring is one of failure and determining blame for that failure.<sup>57</sup>

Likewise, in its submission to the Productivity Commission, the Australian Institute of Company Directors noted that the existing insolvent trading rule “not only encourages but effectively mandates directors to move to the external administration as soon as a company encounters financial difficulties in order to avoid personal liability and consequent reputational damage.”<sup>58</sup> This discourages directors from taking “sensible risks” towards restructuring, encourages secured creditors to sell off key secured property and terminate ongoing contractual arrangements, and causes loss of value and goodwill because of external administration.<sup>59</sup> It is also contended that the “imposition of directorial liability may contribute to increased demands for compensation by company officers in exchange for bearing risk.”<sup>60</sup> There have also been instances where directors have prematurely placed a company into administration. One example often cited is the placement of the Henry Walker Eltin Group into administration, where ultimately, all creditors were paid a hundred cents on the dollar and the destruction of enterprise value was experienced at the shareholder level.<sup>61</sup> These are legitimate concerns that have an empirical basis which will be canvassed briefly in the following section.

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57. Jason Harris, *The effect of voluntary administration on business restructuring*, 1, 2, <http://bfsla.org/wp-content/uploads/papers/2015/3A%20-%20Jason%20Harris%20-%20The%20effect%20of%20voluntary%20administration%20on%20business%20restructuring.pdf> [https://perma.cc/H9T7-HWL4].

58. John Brogden, Managing Director & Chief Executive Officer, Aust'l Inst. of Company Directors, Submission No 3, February 17, 2015.

59. *Id.*

60. Bowen, *supra* note 4, at 8.

61. Law Council of Austl., Insolvency Practitioners Ass'n of Aust'l & Turnaround Mgmt. Ass'n Aust'l, *Joint Submission In Relation to Insolvent Trading Safe Harbour Options Paper*, 7–8 (Mar. 2, 2010).

## VI. Empirical Basis

As noted above, the Australian Federal Government's discussion proposal cites the existing insolvent trading regime as an obstacle to entrepreneurship since the uncertainty surrounding the insolvent trading law had long prompted directors to submit prematurely to an involuntary administration resulting in a company losing the opportunity to restructure and survive temporary cash flow issues.<sup>62</sup> The reluctance of early stage (angel) investors, who invest in small startups, and professional directors involvement in a start-up is blamed on this strict directors' personal liability law.<sup>63</sup> The law prior to its current amendment focused on the "timing of when the debts are incurred by a company rather than the conduct of the directors in incurring that debt."<sup>64</sup>

In order to assess the empirical basis for the above conclusions as well as directors' other liability concerns, the Treasury and the Institute of Company Directors carried out a survey in 2008 that involved around 600 directors of ASX-200 companies.<sup>65</sup> ASX-200 companies are the 200 largest public companies by market capitalization listed on the Australian Securities Exchange (ASX). This survey sought to gauge the impact of these insolvency laws on the attitude of directors. The relevant questions asked in this regard were:

What degree of risk do you feel for being found personally liable (under any law) for decisions you or your board(s) of directors have made in good faith?

Has the risk of personal liability (under any law) caused you or a board of directors on which you sit to take an overly cautious approach to business decision-making?

Which specific laws caused this overly cautious approach to business decision making? Please indicate the degree to which the following laws were responsible. The law on the **duty to prevent insolvent trading** in section 588G of the *Corporations Act 2001*.<sup>66</sup>

At its highest, to what degree has this overly cautious approach inhibited an *optimal* business decision?

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62. *Id.*

63. Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017, (Austl.).

64. *Id.* at 7.

65. *Survey of Company Directors*, THE TREASURY (Dec. 18, 2008), [http://archive.treasury.gov.au/content/Company\\_Directors\\_Survey/SurveySummary.html](http://archive.treasury.gov.au/content/Company_Directors_Survey/SurveySummary.html) [https://perma.cc/W6SD-VHLJ].

66. See *id.* at question 7.

How did the risk of personal liability affect the decision-making process and the decision?

Briefly, what were the major costs to the company, shareholders and/or other stakeholders of taking an overly cautious approach to this decision?

Have you, primarily due to the risk of personal liability (under any law), ever:

- i) **Declined** an offer of a company directorship
- ii) **Retired** from a position as a company director
- iii) **Resigned** from a position as a company director.

In your judgment, has a *board of directors on which you sit* lost a potential or suitable board member because, primarily due to the risk of personal liability (under any law), he or she:

- i) **Declined** an offer of a company directorship
- ii) **Retired** from his or her position as a company director
- iii) **Resigned** from his or her position as a company director.<sup>67</sup>

The responses to the survey confirmed the importance of personal liability as a consideration in making business decisions as well as taking or declining company director positions.<sup>68</sup> One director stated that “[t]he insolvent trading laws hang over a director like the ‘Sword of Damocles.’”<sup>69</sup> While the fear of personal liability arising from insolvent trading weighs on the minds of some directors, it is the overall director’s liability regime that is raised as most inhibitive.<sup>70</sup>

“Derivative liability laws” are at the top of the list of laws said to have caused the overly cautious approach to business decision-making and by virtue of which a director may be found liable for the misconduct of a company because of their position. For example, a director can be held liable for company violations of occupational health and safety laws, environmental laws, or building laws. 35% of those surveyed stated this law highly contributed to an overly cautious ap-

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67. See *id.* at question 15 response.

68. See *id.* at question 6 response (65% of those surveyed stated that they had occasionally taken an overly cautious approach to business decision making due to fear of personal liability).

69. See generally *Survey of Company Directors*, THE TREASURY (Dec. 18, 2008), [http://archive.treasury.gov.au/content/Company\\_Directors\\_Survey/10\\_0.html](http://archive.treasury.gov.au/content/Company_Directors_Survey/10_0.html) [<https://perma.cc/BY36-KXES>] (For this and other responses to the question “iii) How did the risk of personal liability affect the decision-making process and the decision?”).

70. See *Survey of Company Directors*, question 7 response, THE TREASURY (Dec.18, 2008), [http://archive.treasury.gov.au/content/Company\\_Directors\\_Survey/SurveySummary.html](http://archive.treasury.gov.au/content/Company_Directors_Survey/SurveySummary.html) [<https://perma.cc/W6SD-VHLJ>].

proach to business decision-making.<sup>71</sup> 11.7% of the respondents ranked the duties on preventing insolvent trading (section 588G) and the duty to ensure continuous disclosure (section 674) as high for causing an overly cautious approach to business decision making.<sup>72</sup>

The survey indicates that the issue of personal liability looms large in general, but liability for insolvent trading is not at the very top of liability concerns. This can be explained by the fact that almost all businesses surveyed are successful and established companies where insolvent trading would not be a significant issue in their day-to-day operation. Insolvent trading arises as a concern when a company nears insolvency. Thus, fear of personal liability for successful companies may not be issues of immediate concern. On the other hand, an exposure to derivative liability is a recurring issue even for solvent companies. Therefore, it is difficult to extrapolate these findings to start-up and financially-distressed companies. The survey question would need to focus on whether a director would decline a directorship in a start-up company out of concern for personal liability arising from insolvent trading.

The survey confirms that fear of personal liability has been responsible for causing suboptimal business decision-making.<sup>73</sup> The major costs to stakeholders due to suboptimal business decision-making range include increased legal and regulatory costs, loss of business opportunities or competitive edge, and loss of directors.<sup>74</sup>

The survey participants put forward wide-ranging proposals. Some of these include wider availability of global business judgement rule in personal liability cases, reversal of the burden of proof of acting in good faith under section 181, safe harbour for a director who acts diligently in good faith, and removal of personal and civil liability arising from breach of Health and Occupation Law for non-executive directors.<sup>75</sup> There have also been reform proposals such as limiting director liability to the benefit they received as a director such as a fee,

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71. See *id.* at question 7 response.

72. See *id.*

73. See generally *Survey of Company Directors*, THE TREASURY (Dec. 18, 2008), [http://archive.treasury.gov.au/content/Company\\_Directors\\_Survey/9\\_0.html](http://archive.treasury.gov.au/content/Company_Directors_Survey/9_0.html) [https://perma.cc/9HZP-2ZTP] (Response 37. “A decision to invest was deferred to a suboptimal period”).

74. See *Survey of Company Directors*, THE TREASURY (Dec. 18, 2008), [http://archive.treasury.gov.au/content/Company\\_Directors\\_Survey/11\\_0.html](http://archive.treasury.gov.au/content/Company_Directors_Survey/11_0.html) [https://perma.cc/F26R-WL5A] (For the list of costs).

75. See *Survey of Company Directors*, THE TREASURY (Dec. 18, 2008), [http://archive.treasury.gov.au/content/Company\\_Directors\\_Survey/17\\_0.html](http://archive.treasury.gov.au/content/Company_Directors_Survey/17_0.html) [https://perma.cc/MQ84-ZCBG].

public education to ensure realistic expectations, or raising the threshold for bringing legal actions.<sup>76</sup>

But the prosecution of insolvent trading is rare.<sup>77</sup> The rarity of such prosecutions is partly attributed to:

[T]he difficulty in proving an individual's intention, state of mind and personal knowledge, particularly in relation to complex financial matters. Further, pursuing such cases can be "expensive for regulators as the presence of reasonableness tests can be expensive for regulators as the presence of reasonableness tests (ss 588G(1)(c) and (2)(b)) means there is considerable scope to mount a defence based on the circumstances.<sup>78</sup>

Much of the responsibility for bringing an insolvent trading civil claim lies with liquidators. The Australian Securities and Investments Commission (ASIC) can bring civil penalty actions and criminal action via the Department of Public Prosecutions (DPP). In the UK, the equivalent wrongful trading provision (section 214) also faced analogous problems. For example, liquidators experienced difficulties in getting funds to run proceedings and determining from what date wrongful trading commenced, as well as lack of certainty in relation to the meaning of elements of the section, such as: What constitutes a director taking "every step" so as to minimise potential loss to company creditors?<sup>79</sup>

Prior to the current amendment of the insolvent trading law, there have been no defences or carve-outs, "although the courts have granted relief from liability in a small number of cases reasonable restructuring efforts were made to try and save the business."<sup>80</sup> The relief is possible via section 1317S and 1318 of the *Corporations Act 2001*. These provisions permit the court to relieve the person of a civil liability in whole or in part if a director has acted honestly.<sup>81</sup> It is notable that this relief is in regard to civil liability and does not extend to criminal liability.<sup>82</sup>

These relief provisions do not strictly provide "defences" to insolvent trading laws.<sup>83</sup> For example, they do not appear to prevent a court from making a finding that there was a breach, but instead, empower the court to relieve an officer of the civil consequences of a

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76. *Id.*

77. *Business Set-up, Transfer and Closure*, *supra* note 36, at 378–79.

78. *Id.* at 379.

79. Keay, *supra* note 3, at 434.

80. Harris, *supra* note 57, at 4.

81. *Corporations Act 2001* (Cth) s 1318 (Austl.).

82. *Id.*

83. Bowen, *supra* note 4, at 5.

breach.<sup>84</sup> While the court may relieve an officer of the civil consequences of a breach, officers are still exposed to the reputational damage of such a finding.<sup>85</sup> Consequently, the relief provisions were deemed inadequate since these relief measures are discretionary and there is lack of guidance as to the criteria that may need to be met.<sup>86</sup> In comparison, if the Business Judgement Rule defence were to be invoked, it seeks to offer directors up-front comfort or protection if they reasonably seek to restructure a business.<sup>87</sup>

Conversely, the general relief provisions operate at the end of trial and provide no guidance in regard to restructuring. On this basis, it is clear that both provisions deliver safe harbour but to different extents.

As we will see in the next section, the new regime too does not provide a defence, but a carve-out for directors who take a course of action reasonably likely to lead to a better outcome for the company.

## VII. The New Law: Safe Harbour

### A. Triggering Event

The law creating safe harbor for insolvent trading came into effect on 17 September 2017.<sup>88</sup> The amendment legislation inserted section 588GA in *Corporations Act 2001* and, among others, provides:

**588GA Safe harbour—taking course of action reasonably likely to lead to a better outcome for the company**

*Safe harbour*

Subsection 588G(2) does not apply in relation to a person and a debt if:

- (a) at a particular time after the person starts to suspect the company may become or be insolvent, the person starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company . . .<sup>89</sup>

The safe harbor carve-out is triggered by taking steps after the “person starts to suspect the company may become or be insolvent.”<sup>90</sup>

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84. *Id.*

85. *Id.*

86. Ryan Purslowe, *Decisions in the Twilight Zone of Insolvency — Should Directors be Afforded a New Safe Harbour?*, 13 U NOTRE DAME AUSTL. L. REV. 113, 147 (2011).

87. *Id.*

88. *Corporations Act 2001* (Cth) (Austl.), as amended by *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017*.

89. See *id.* s 588GA.

90. See *id.* s 588GA(1)a.

This amendment does not do away with the prohibition of insolvent trading, but provides a targeted carve-out for a director who can demonstrate that they have started developing one or more courses of action that are *reasonably likely to lead to a better outcome for the company*.<sup>91</sup> Just as the previous law, the trigger remains a suspicion, not an expectation, that a company may become insolvent.<sup>92</sup> There is, of course, the obvious fact of insolvency itself when the person is unable to pay all the person's debts, as and when they become due and payable.<sup>93</sup> Solvency is primarily dependent on the company's cash flows, although the balance sheet test also needs to be taken into account.<sup>94</sup> In *Sutherland v Hanson Construction Materials Pty Ltd*, the New South Wales Supreme Court held that "solvency is to be determined primarily according to the company's cash flows . . . It is important to note, however, that the state of the balance sheet, although not the primary test, remains relevant to the [issue of solvency]."<sup>95</sup> Suspicion of possible insolvency happens well before the materialization of insolvency. Reason to suspect insolvency means they must have a "positive feeling of actual apprehension" that there is insolvency.<sup>96</sup>

The legislation does not shed a new light on what constitutes solvency or insolvency. Given that a company's solvency is believed to be a critical triggering event, the need to address this issue remains significant. In their joint submissions, the Law Council of Australia, Insolvency Practitioners Association of Australia, and Turnaround Management Association Australia rightly point out that "the company's state of solvency is frequently not black and white."<sup>97</sup> They raise a number of practical complexities.<sup>98</sup> For instance, when a company undergoes a "mere temporary lack of liquidity" and has assets to sell, it is not clear what assumption the director can make as to how quickly the assets can be sold and how much can be realized for these assets.<sup>99</sup> They ask whether directors can assume solvency where a company has a letter of comfort from its parent company that is not legally binding, but which has always been supported in the past.<sup>100</sup> They also raise the

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91. *Id.*

92. *Id.*

93. *Corporations Act 2001* (Cth) s 95A (Austl.).

94. *Sutherland v. Hanson Constr. Materials Pty Ltd*, (2009) 254 ALR 650, 652 (Austl.).

95. *Id.*

96. *Queensland Bacon Pty Ltd v. Rees* (1966) 115 CLR 266, 303 (Austl.).

97. Law Council of Austl., *supra* note 61.

98. *Id.*

99. *Id.*

100. *Id.*

question of whether directors can continue to rely on the shareholder continuing to support the business where a company that previously traded unprofitably but has always met creditor demands through financial support of its major shareholder who continues to informally give its support but declines a legally binding guarantee.<sup>101</sup> It may also happen that a solvent subsidiary in Australia is owed a significant sum by its parent undergoing formal insolvency proceedings overseas and the liquidator refuses to give a commitment that it will not call upon the intercompany debt but to date has not done so.<sup>102</sup> These practical complexities cited in joint submissions indicate that the assumption of solvency or insolvency is not always easy to determine. How courts address these practical issues in the future is a matter to be seen.

### B. Duration

According to section 588GA (1)(b), the duration of the action begins with the start of taking the action and ends with any of the following times:

[I]f the person fails to take any such course of action within a reasonable period after that time—the end of that reasonable period; when the person ceases to take any such course of action; when any such course of action ceases to be reasonably likely to lead to a better outcome for the company; the appointment of an administrator, or liquidator, of the company.<sup>103</sup>

This indicates that there is no set time period for safe harbour, unlike voluntary administration or liquidation. However, it is reasonable to assume that a course of action to be pursued for small and big companies will be different, and these will require varying timeframes for implementation. The reasonableness is to be determined on a case-by-case basis after the facts. Until this area of the law settles there is bound to be some confusion.

### C. The Nature of the Debt

The debt must be incurred directly or indirectly in connection with the course of action reasonably likely to lead to a better outcome.<sup>104</sup> From the creditor's perspective, the course of action is one that is reasonably likely to offer a better return on the dollar. Thus,

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101. *Id.*

102. *Id.*

103. *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017* (Cth) s 588GA(1)(b) (Austl.).

104. *Id.*

not all types of debts can pass this test and all debts assumed post the entrance of safe harbour need to be assessed in light of this requirement. The safe harbour legislation does not shed additional light on the nature of the debt. However, the Explanatory Memorandum does give some examples. These include, “debts taken on for the specific purpose of affecting a restructure as part of that course (for example paying a professional turnaround adviser to provide advice on the course of action).”<sup>105</sup>

Needless to say, the usual debts incurred in relation to the day-to-day operation of a business can be regarded as debts incurred in order to achieve a better outcome.<sup>106</sup> However, it can also be said that continuing to throw good money after bad will not bring a better outcome especially when it has been shown to be unsuccessful. The debt could be a new type of debt altogether, provided the debt is reasonably likely to result in a better outcome. This may be a case where a company may be onto a lucrative business deal that may change its fortunes. But new debts not of a type previously incurred may be incurred in an attempt to turn around the business of the company.

#### **D. A Course of Action Reasonably Likely to Lead to a Better Outcome for the Company**

A “better outcome” is defined as a better outcome for the company and the company’s creditors as a whole, rather than the outcome of the company becoming a Chapter 5 body corporate.<sup>107</sup> This is a comparative exercise. The burden is on the directors to demonstrate that the company and its creditors are better off by the option taken compared to the company going into administration or liquidation.<sup>108</sup> According to section 1.52 of the Explanatory Memorandum:

The phrase “reasonably likely” does not require a better than 50 percent chance of a better outcome than the immediate appointment of an administrator or liquidator. “Reasonably likely” here requires that there is a chance of achieving a better outcome that is not fanciful or remote, but is “fair”, “sufficient” or “worth noting.”<sup>109</sup>

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105. Explanatory Memorandum, Treasure Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) 13 (Austl.).

106. *Id.*

107. *Corporations Act 2001* (Cth) s 588GA(7) (Austl.), as amended by *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act (2017)*.

108. See *id.* s 588GA(1).

109. Explanatory Memorandum, *supra* note 63, at 14.

This standard does not contemplate a difficult threshold. The requirement that a course of action is reasonably likely to lead to a better outcome is assessed based on demonstrable evidence.<sup>110</sup> Safe harbour may extend to the period prior to taking the course of action during which deliberations and preparations for the course of action are occurring, if the director can demonstrate he or she is taking reasonable steps toward the course of action.<sup>111</sup> This assumes that any plan goes through a preparation phase before it is rolled out.

While the Explanatory Memorandum acknowledges that there is no “one size fits all” prescription of what kind of course of action is reasonably likely to lead to a better outcome for the company and its creditors, the law does not give a specific guideline to a distressed company wishing to seek shelter in safe harbour. Hope as a strategy is clearly ruled out.<sup>112</sup> Thus, “directors who merely take a passive approach to the business’s position or allow a company to continue trading as usual during severe financial difficulty, or whose recovery plans are fanciful, will fall outside the bounds of the safe harbour.”<sup>113</sup> The Legislature provides a non-exhaustive list of considerations to be taken into account in determining whether a person is taking a course of action reasonably likely to lead to a better outcome for the company under section 588GA(2):

- (a) is properly informing himself or herself of the company’s financial position; or
- (b) is taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company’s ability to pay all its debts; or
- (c) is taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company; or
- (d) is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or<sup>114</sup>

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110. *See generally id.* (Thus, “company directors relying on safe harbour will be required to point to evidence that suggests that they started to develop a course of action reasonably likely to lead to a better outcome for the company after starting to suspect the company was insolvent.”).

111. *Id.* at 11.

112. *Id.* at 14.

113. *Id.* at 7.

114. *See TMA Best Practice Guidelines – Navigating Safe Harbour*, TURNAROUND MGMT. Ass’n OF AUSTL., (June 16, 2017), [http://www.turnaround.org.au/documents/TMA\\_Best\\_Practice\\_Guidelines\\_16.6.2017.pdf](http://www.turnaround.org.au/documents/TMA_Best_Practice_Guidelines_16.6.2017.pdf) [https://perma.cc/28GE-99AQ] (The legislation does not define who the appropriately qualified entity could be. One take pursuant to Australia’s Turnaround Management Association is that the entity needs to have expertise in the operational, management, financial and legal aspects of a restructuring; tertiary

- (e) is developing or implementing a plan for restructuring the company to improve its financial position.<sup>115</sup>

These requirements are alternative requirements. While one does not discount the importance of each of these requirements, it is not clear how courts would decide if any of the courses of action that go to the heart of a restructuring effort are missing. The Explanatory Memorandum states, “these indicia are not prescriptive and it is not necessary for all of these factors to apply for directors to have the protection of safe harbor.”<sup>116</sup> Thus, “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, and also to the factors a Court may consider in any subsequent proceedings where the safe harbour is at issue.”<sup>117</sup> This leaves the door wide open for consideration of an array of factors in determining the suitability of a course of action reasonably likely to lead to a better outcome for the company and its creditors. This may create a lot of uncertainty until this area of law is well established through court decisions.

Whether a course of action is reasonably likely to lead to a better outcome for the company is to be assessed neither in hindsight nor based on whether the course of action actually resulted in a better outcome.<sup>118</sup> However, this does not mean that a director should stay the course in the face of changed circumstances that warrants a change of plan to meet the better outcome requirement.<sup>119</sup> In other words, the director needs to adjust the plan to changed circumstances even if the original plan was believed to lead to a better outcome if it were not for the changed circumstance.

While courts are yet to apply these rules to actual cases, there are already some guidelines being developed by professional associations. For example, the Australian Turnaround Management Association has issued a guideline of best practices for its members.<sup>120</sup> The best practice guide includes things to do during the various phases of safe harbour. Each phase’s objectives include conducting an initial assessment of financial position, assessing the availability of safe harbour

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qualifications (or their equivalent) in turnaround; demonstrable turnaround/ restructuring experience; and compliance with the code of ethics and professional development requirements of the person’s relevant accrediting organisation.).

115. *Treasury Laws Amendment Act 2017*, *supra* note 107, at s 588GA(2)(e).

116. Explanatory Memorandum, *supra* note 63, at 16.

117. *Id.*

118. *Id.* at 14–15.

119. *Id.* at 15.

120. *TMA Best Practice Guidelines*, *supra* note 114.

and resolving to enter, developing and approving a turnaround plan, and implementing a turnaround plan and monitoring performance regularly.<sup>121</sup> For each objective, the guide provides corresponding available steps, evidence outputs, and timing.<sup>122</sup>

Obviously, a struggling company would most likely need an input from appropriately qualified experts from outside the company. The safe harbour law does not make use of an appropriately qualified entity mandatory, but courts will be positively disposed towards directors who obtain advice from an appropriately qualified entity who was given sufficient information to give appropriate advice.<sup>123</sup> In fact, it would be counter-intuitive for a business to continue to do the same thing and use the same in-house expertise to turn its business around without seeking external specialist help.

The legislation does not define an “appropriately qualified entity.” The Australian Turnaround Management Association guide indicates that an appropriately qualified entity needs to hold the following qualifications: expertise in the operational, management, financial, and legal aspects of a restructuring, tertiary qualifications (or their equivalent) in turnaround, demonstrable turnaround or restructuring experience, and compliance with the code of ethics and professional development requirements of the person’s relevant accrediting organisation.<sup>124</sup> While this is a matter to be determined by the courts in the future, it is clear that the Legislature has intentionally left the definition open to limit an appropriately qualified entity to registered liquidators or turnaround professionals.

There is no doubt that complex restructuring would call for diverse professional expertise with varied skill sets. This, however, does not come cheap. For instance, “a typical voluntary administration of a small to medium-sized company will cost around \$60,000 in professional fees.”<sup>125</sup> Thus, the expenses must be weighed against the likelihood of success.

On the other hand, the lower end of the pre-insolvency advisor sector may be affected by unscrupulous advisors who, among others, encourage illegal phoenix activity. Illegal phoenix activity occurs

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121. *Id.*

122. *Id.*

123. *Corporations Act 2001* (Cth) s 588GA(2)(d) (Austl.).

124. *TMA Best Practice Guidelines*, *supra* note 114, at 3.

125. *Using a voluntary administration to save a company - the statistics are against you*, SMARTCOMPANY (Nov. 25, 2014), <https://www.smartcompany.com.au/finance/cashflow/using-a-voluntary-administration-to-save-a-company-the-statistics-are-against-you/> [https://perma.cc/9W86-DF3Z].

when “a new company is created to continue the business of a company that has been deliberately liquidated to avoid paying its debts, including taxes, creditors and employee entitlements.”<sup>126</sup> Therefore, the independence of advisors is critical. In view of this, some legislative guidelines on required qualifications and code of conduct would have been helpful.<sup>127</sup> It may well be that rules applying to registered liquidators and insolvency practitioners could apply, but the reference to appropriately qualified entity is not limited to liquidators and insolvency practitioners. In view of this, it appears that the matter has been left to registering and accrediting professional and regulatory organs.

According to the joint submission of Law Council of Australia, Insolvency Practitioners Association of Australia, and Turnaround Management Association Australia:

One safeguard against abuse of the safe harbour is that the directors not be able to rely on practitioners who may be sought out and engaged not for their professional skills, but for their preparedness to provide unrealistic or inappropriate advice tailored exclusively to enable the directors to continue to trade with the benefit of this defence. (It is not being suggested that this is currently occurring, only that it would be prudent to ensure that any legislative amendment does not create the opportunity for such conduct to occur in the future). By ensuring that the engagement is by the company, the professional advisers will owe their duty of care and diligence to the company, and be accountable should they fail to properly discharge their duty.<sup>128</sup>

Likewise, section 1.68 of the Explanatory Memorandum provides:<sup>129</sup>

In selecting an adviser, directors, in keeping with their duties to the company, should be wary of advisers who target company directors whose businesses may be in financial difficulty and suggest that they take actions which could be illegal, such as transferring assets to another person or company without that person or company paying for them. Such advice, if followed, may bring the existence of safe harbour into question and could potentially expose directors to other actions.

Furthermore, section 1.69 states:<sup>130</sup>

“Appropriately qualified” in this context is used in the sense of “fit for purpose” and is not limited merely to the possession of particu-

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126. *Illegal phoenix activity*, AUSTRALIAN TAXATION OFFICE, (Jul. 24, 2018), <https://www.ato.gov.au/General/The-fight-against-tax-crime/Our-focus/Illegal-phoenix-activity/> [https://perma.cc/84YW-P76L].

127. See generally, ‘Registered liquidators: Registration, disciplinary actions and insurance requirements’ (Regulatory Guide No 258, Australian Securities & Investments Commission March 2017).

128. Law Council of Austl., *supra* note 61, at 16.

129. Explanatory Memorandum, *supra* note 63, at 16.

130. *Id.* at 16–17.

lar qualifications. It is for the person who appoints the adviser to determine whether the adviser is appropriate in the context, having regard to issues such as:

- the nature, size, complexity and financial position of the business to be restructured;
- the adviser's independence, professional qualifications, good standing and membership of appropriate professional bodies (or in the case of an advising entity, those of its people);
- the adviser's experience; and
- whether the adviser has adequate levels of professional indemnity insurance to cover the advice being given.

Section 1.70 further provides that “[t]he particular qualifications needed by the adviser will vary on a case-by-case basis.”<sup>131</sup>

There is the question of whether an advisor so appointed may end up being regarded as a shadow director for the purposes of the *Corporations Act 2001*. This possibility was foreseen during the submissions where it was submitted that “the legislative amendments should not have the unintended consequence of making any such adviser to the company a shadow director.”<sup>132</sup> This concern was predicated on the possible requirement of appointment of a Chief Restructuring Officer (“CRO”), a common feature of some overseas insolvency jurisdictions.<sup>133</sup> Now that the appointment of CRO has not been made mandatory by the safe harbour legislation, appropriately qualified entities that act as advisors will not be automatically regarded as shadow directors and assume directorial duties and liabilities. According to section 9 of the *Corporations Act 2001*, the finding of a shadow director does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person’s professional capacity. So long as the qualified entities act in a professional advisory capacity, the advisors will not automatically be considered shadow directors. However, as professional advisors, they will owe a duty of care to the directors who are the recipients of such advice.

Finally, in regard to the evidentiary burden of proof, the legislation requires that a person who wishes to rely on safe harbour “in a proceeding for, or relating to, a contravention of section 588G(2) bears the evidential burden of proof in relation to that matter.”<sup>134</sup> Once the initial low evidential burden is provided, “it is the party

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131. *Id.* at 17.

132. Law Council of Austl., *supra* note 61, at 16.

133. *Id.* at 9.

134. *Corporations Act 2001* (Cth) s 588GA(3) (Austl.).

bringing a proceeding for the purposes of section 588G(2) who will bear the legal burden to show to the balance of probabilities that the course of action being taken was one not reasonably likely to lead to a better outcome for the company.”<sup>135</sup>

#### E. Exclusions: Threshold Issues

Companies that are not in a position to comply with certain specified obligations cannot invoke safe harbour. These are companies that fail to provide for the entitlement of their employees and those that fail to give returns, notices, statements, applications, or other documents required by taxation laws.<sup>136</sup> However, the court may excuse these failures if “the Court is satisfied that the failures were due to exceptional circumstances, or that it is otherwise in the interests of justice to make the order, and an application for the order is made by the person.”<sup>137</sup>

The requirement that the company needs to make a provision for its employees to be able to invoke safe harbour raises some interesting issues in relation to small companies, including one-man companies where the directors also act as employees of the company. It would be interesting to find out if directors of a small company who have not been able to pay themselves a salary or forwarding superannuation contribution in their capacity as employees would be excluded from relying on safe harbor.

#### F. Restrictions

The use of materials or evidence for the safe harbour defence is restricted if the director does not provide the administrator or liquidator access to these materials or evidence upon request.<sup>138</sup> These restrictions are in place to ensure that “directors do not withhold books or information about the company in an attempt to prevent a liquidator or administrator from investigating the company’s activities and taking appropriate action.”<sup>139</sup> Further, “the restriction ensures that books and information that were not available at the time a liquidator or administrator is appointed are not later prepared in a way to make it retrospectively appear that a director would have fallen within the

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135. Explanatory Memorandum, *supra* note 63, at 20.

136. *Corporations Act 2001* (Cth) s 588GA(4) (Austl.).

137. *See id.* s 588GA (6).

138. *See id.* s 588GB.

139. Explanatory Memorandum, *supra* note 63, at 8.

safe harbour provisions.”<sup>140</sup> This enables the administrator or the liquidator to determine if there has been an abuse of the safe harbour and other directorial duties.

There is an exemption from being restricted from using the documents in two scenarios. The first scenario is where the person did not possess the book or information at any relevant time and that there were no reasonable steps the person could have taken to obtain the book or information.<sup>141</sup> This suggests that such document may have come to the director’s attention later than when the request was made by the administrator or liquidator. Otherwise, it is superfluous to carve out an exemption when the document does not exist altogether. The second scenario is where the directors were not given notice that failing to provide the book or information would restrict their ability to rely on those documents if and when action is initiated against them down the line.<sup>142</sup> However, liquidators seeking information pursuant to section 530A(1) are not required to notify a director that their failure to provide books or information about the company would prevent them from later using those books for their safe harbour defence.<sup>143</sup>

### VIII. Safe Harbour and Continuous Disclosure Requirements

The financial reporting obligation of a company depends on whether a company is a disclosing entity or not. A disclosing entity is an entity that issues an Enhanced Disclosure Securities (“EDS”). EDS are defined as shares or other securities where a disclosure document in relation to securities in that class is lodged with ASIC, securities in that class are issued pursuant to that disclosure, and 100 or more persons held security of that class or continue to hold those securities at all times.<sup>144</sup>

A disclosing entity is subject to biannual, annual, and continuous disclosure requirements under sections 674 and 675.<sup>145</sup> The disclosing entity may be a listed or an unlisted company. Section 675(2) requires a disclosing entity to have a continuous disclosure obligation if it becomes aware of information that is not generally available publicly and that a reasonable person would expect it to have a material effect

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140. *Id.*

141. *Corporations Act 2001* (Cth) s 588GB(3)(a) (Austl.).

142. Explanatory Memorandum, *supra* note 63, at 22.

143. *Id.* at 15.

144. *Corporations Act 2011* (Cth) s 111AF(1) (Austl.).

145. *See id.* s 111AP.

on the price or value of EDS of the entity. Information is presumed to have a material effect on price or value if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of the EDS.<sup>146</sup>

In view of this, it is difficult to imagine scenarios where the mere fact of a company entering a safe harbor would not be considered to have a material effect on the price of EDS, thereby influencing persons who commonly invest in those securities.<sup>147</sup> The section 1.15 of the Explanatory Memorandum in relation to the continuation of the disclosure requirement provides that “[s]afe harbour does not affect any obligation of a company (or any of its officers) to comply with any continuous disclosure obligations under the law, including section 674 of the Act, or any continuous disclosure rules imposed by a market operator which apply.”<sup>148</sup>

This, of course, may cause some confusion in the short run. Given that the disclosure brings to light the financial struggles of a company, it would put the company under more pressure from creditors and suppliers. As one of the directors who participated in the joint survey by the Treasury and Australian Institute of Company Directors pointed out, “the costs and reputational impacts of having actions or investigations commenced will sink you well before any final determination is made in a case.”<sup>149</sup> The prohibition of enforcement of *ipso facto* clauses in the recent amendment may give some reprieve to companies seeking to utilize the safe harbour.<sup>150</sup> However, as Kerr argues:

[T]he reforms do not go far enough, because the right of a secured creditor with a security interest over the whole – or substantially the whole – of the company’s property to appoint a receiver in the decision period will still exist. That right was removed in the

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146. See *id.* s 677.

147. See generally ‘Unlisted disclosing entities: Continuous disclosure obligations’ (Regulatory Guide No 198, Australian Securities & Investments Commission June 2009) (For examples of information to be disclosed by unlisted companies).

148. Explanatory Memorandum, *supra* note 63 at 7.

149. See Survey of Company Directors, *supra* note 75 (For list of responses to “Do you have any specific suggestions for reforming the directors’ duties, defences and/or ‘safe harbours’ in the Corporations Act 2001?”).

150. Explanatory Memorandum, *supra* note 63 at 3 (Ipsa facto clause is “a provision that allows one party to terminate or modify the operation of a contract upon the occurrence of some specific event, regardless of otherwise continued performance of the counterparty. The operation of these clauses can reduce the scope for a successful restructure or prevent the sale of the business as a going concern.”).

UK in 2002 to encourage the development of a turnaround culture.<sup>151</sup>

Furthermore, a moratorium on enforcement of *ipso facto* clauses does not provide relief to a company whose suppliers and creditors are not willing to extend it a fresh line of credit.

One of the outstanding questions with the amendment is whether listed companies seeking the benefit of safe harbour are required to continue to adhere to their continuous disclosure obligations. As noted earlier, the Explanatory Memorandum had stated that the safe harbour “does not affect any obligation of a company (or any of its officers) to comply with any continuous disclosure obligations under the law, including section 674 of the Act, or any continuous disclosure rules imposed by a market operator which apply.”<sup>152</sup>

The ASX recently clarified this position in its Guidance Note Number 8 dated 9 March 2018.<sup>153</sup> ASX resolved to maintain the status quo stating that section 588GA (safe harbour) “is a conditional carve-out from a director’s potential liability for insolvent trading that does not affect an entity’s continuous disclosure obligations or reduce the entity’s obligation to disclose the extent of its financial difficulties.”<sup>154</sup> However, ASX also noted:

The fact that an entity’s directors are relying on the insolvent trading safe harbour to develop a course of action that may lead to a better outcome for the entity than an insolvent administration, in and of itself, is not something that ASX would generally require an entity to disclose under Listing Rule 3.1. Most investors would expect directors of an entity in financial difficulty to be considering whether there is a better alternative for the entity and its stakeholders than an insolvent administration. The fact that they are doing so is not likely to require disclosure unless it ceases to be confidential or a definitive course of action has been determined.<sup>155</sup>

In other words, while the fact of an entity entering a safe harbour in and of itself need not be disclosed, the fact of a company experiencing financial difficulty must be disclosed. But it is not in the inter-

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151. James Dunn, *The Safe Harbour*, Australian Institute of Company Directors (Jul. 1, 2017), <http://aicd.companydirectors.com.au/membership/company-director-magazine/2017-back-editions/july/safe-harbour> [https://perma.cc/4DMY-5E2Z].

152. Explanatory Memorandum, *supra* note 63, at 7.

153. See generally ASX LISTING RULES, GUIDANCE NOTE 8: CONTINUOUS DISCLOSURE: LISTING RULES 3.1-3.1B (March 9, 2018), [https://www.asx.com.au/documents/rules/gn08\\_continuous\\_disclosure.pdf](https://www.asx.com.au/documents/rules/gn08_continuous_disclosure.pdf) [https://perma.cc/2JE4-8MQ6] (The purpose of the Guidance Note is to assist listed entities to understand and comply with their continuous disclosure obligations under Listing Rules 3.1, 3.1A and 3.1B in light of the amendments to the insolvent trading provision.).

154. *Id.* at 40.

155. *Id.* at 40–41.

est of an entity to merely disclose its financial difficulty whilst not disclosing a safe harbor. This is because knowing that something is being done about the financial struggles of a company would have a soothing effect as opposed to simply disclosing the financial state of the company.

Perhaps as Jason Harris observes, some of the negotiations may not need to be disclosed. Accordingly:

It is likely however that the restructuring proposal will involve confidential negotiations and will fall within the carve outs to continuous disclosure under the ASX Listing Rules (ASX LR 3.1A) as the restructuring negotiations are an incomplete proposal and a reasonable person would not expect them to be publicly disclosed. If the carve out applies then there is no liability under s 674. However, if the restructuring is leaked to the media then the carve-out will be lost.<sup>156</sup>

All is not lost, however. ASX leaves a door ajar to provide an entity with leeway when it states:

ASX recognises that for an entity in financial difficulties, the requirement to disclose materially negative market sensitive information immediately can be a significant impediment to completing a financial restructure or reorganisation necessary for its survival. However, the proper course for the entity in such a situation is not to disregard its continuous disclosure obligations but instead to approach ASX to discuss the possibility of a voluntary suspension to manage its disclosure obligations while it completes the transaction in question.<sup>157</sup>

Suspension of quotation of an entity's security may be granted where ASX is satisfied that the "entity is in genuine financial difficulties and continued trading in its securities is likely to be materially prejudicial to its ability to complete a transaction critical to its continued financial viability."<sup>158</sup> To gain the suspension the entity must make a written request for the suspension that includes:

[I]nformation required under Listing Rule 17.2, including the reasons for the suspension (or continued suspension) and a proposed timetable for trading in its securities to resume, for release to the market. The stated reason for the suspension must include a forthright account of the entity's current financial situation, details of the transaction that the entity says is critical to its continued financial viability, and an affirmation that, in the entity's opinion, continued trading of its securities is likely to be materially prejudicial to its ability to complete that transaction.<sup>159</sup>

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156. Harris, *supra* note 57, at 4–5.

157. ASX LISTING RULES, *supra* note 152, at 41.

158. *Id.*

159. *Id.*

This stopgap measure of suspension of trading for a period of time may stop the company from further hemorrhaging. It is not clear if ASIC would take equivalent reprieve measures for unlisted companies.

Obviously, a company will not always be able to keep its ongoing financial struggles confidential even if its disclosure obligations are waived. For instance, a company may opt to rely on the suspension of *ipso facto* contractual clauses pursuant to the recent amendment, which applies to contracts entered into after 1 July 2018. There is no doubt that a company seeking the non-enforcement of *ipso facto* clauses will need to inform its creditor that it is relying on safe harbour.

However, there is a possible counter-argument that financial disclosure is in the best interest of the struggling company given that “the disclosure of accurate financial information on the debtor is crucial to the success of a workout, as creditors must be able to evaluate the debtor’s financial situation as well as any proposals made as part of the restructuring.”<sup>160</sup>

## IX. Would Safe Harbour Increase Informal Workouts?

There is an understanding that previous insolvency regimes did not encourage the restructuring of companies that had a fighting chance of survival. The next alternative, which is the appointment of an administrator, is deemed “almost always value destructive, making it harder for the company to restructure and increasing the likelihood of its eventual liquidation.”<sup>161</sup> This is due to loss of confidence amongst its suppliers, credit provider, employees, and the general public even if the company is solvent or could be turned around.<sup>162</sup>

The introduction of the safe harbour for insolvent trading is intended to “allow companies to be restructured outside of a formal insolvency process” where “doing so would achieve a better outcome for the company and its creditors as a whole.”<sup>163</sup> In the Australian context, the various regimes of external administration (voluntary administration and liquidation) have not been conducive to the restructuring of struggling companies. Whether the intended objective of

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160. Jose M. Garrido, *Out-of-Court Debt Restructuring*, THE WORLD BANK 18 (2012), <http://documents.worldbank.org/curated/en/417551468159322109/pdf/662320PUB0EPI00turing09780821389836.pdf> [https://perma.cc/TP2K-9L2Z].

161. Explanatory Memorandum, *supra* note 63, at 6.

162. *Id.*

163. Explanatory Memorandum, *supra* note 63, at 7–8.

spurring informal workouts will be achieved is a matter to be seen, but some tentative observations can be made.

The term informal work out covers:

[A] range of private arrangements between a company and one or more creditors. They are flexible and varied, with their only defining feature being the privacy of the agreement, with no involvement of outside parties such as small creditors and courts. Workouts can include agreements that renegotiate, reduce, delay or waive preexisting debts or terms of trade. The goal of such agreements is for the company to ‘workout’ of financial trouble and continue trading, with creditors benefiting from a continued stream of payments.<sup>164</sup>

Such an arrangement is likely to fulfil the requirements of “taking reasonable steps” for safe harbour purposes. The informal nature and flexibility of the mechanism are less risky than external administrations. As the Productivity Commission Inquiry Report notes:

The benefits and disadvantages of these workouts both stem from their informality. As private agreements they are flexible and importantly, usually do not become public knowledge. This means that a company’s reputation remains intact and is not affected by any of the stigmas of entering administration, liquidation or receivership. However, as private transactions they are usually limited to the options available in dealing with a particular creditor or group of creditors, rather than creditors as a whole, and can lead to complications (such as voidable transactions or directors being liable for breach of insolvent trading rules) should a liquidation end up occurring despite the efforts to renegotiate with creditors.<sup>165</sup>

However, this process includes the following disadvantages:

There is a lack of transparency and accountability due to the absence of a mandated disclosure and supervisory regime, such as that which applies in respect of external administration. This can give rise to the risk of misconduct, or result in arrangements that, while they fall short of misconduct, may unfairly advantage influential stakeholders. Even in the absence of actual misconduct or unfair arrangements, a lack of transparency and accountability can still diminish market confidence.<sup>166</sup>

This alludes to the lack of a legal framework for the regulation of informal workouts. It is therefore important that there exists an enabling framework for the success of informal workouts. At the same time, it has to be noted that:

In the absence of an independent and impartial investigation of the affairs of the company and with ultimate control of the process by company management there may be a failure to address any

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164. Productivity Commission Inquiry Report, *supra* note 36, at 354.

165. *Id.*

166. Bowen, *supra* note 4, at 12.

underlying governance concerns. Any breaches of the Corporations Act that might be identified will probably not be referred to the relevant regulator, in particular because any work-out specialist will have no statutory duty or authority to refer such matters or any protections from potential actions for defamation or breach of confidence.<sup>167</sup>

Given the absence of rules regulating informal workouts, “there are no formal steps for commencing an informal work-out, which can result in it being unclear to persons dealing with the company whether such a process has commenced or ended.”<sup>168</sup> There is a lack of information about the length of the completion of informal workout processes and how often companies are put into external administration while informal workouts might have been more appropriate.<sup>169</sup> The existence of an enabling legislative framework for the success of informal workouts is critical. For instance, adequate consideration needs to be given to the issue of whether debt-restructuring transactions are tax-exempt in order to encourage informal workouts.

The World Bank’s Principles (Principle B3) that require an enabling legislative framework for optimum workouts including informal workouts calls for inclusion of the following elements:

- The availability of accurate and reliable information;
- Incentives to invest in or recapitalize viable, financially distressed enterprises;
- A range of restructuring tools that the stakeholders can use to achieve their goals;
- Appropriate tax treatment in associated laws that enable debt restructurings;
- Effective debt enforcement and insolvency procedures;
- In addition, regulatory impediments in associated laws should be removed.<sup>170</sup>

In view of this, there is a need to re-examine the friendliness of the existing legal framework for the facilitation of informal workout – a policy goal the safe harbour law intended to achieve directly or indirectly.

## Conclusion

Australia’s amendment of its insolvent trading law is a welcome development. While this may arguably take the bite out of the previ-

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167. *Id.*

168. *Id.* at 13.

169. *Id.*

170. *A Toolkit For Out-of-Court Workouts*, THE WORLD BANK 7 (2016), <http://documents.worldbank.org/curated/en/851561511964075432/pdf/121753-WP-PUBLIC-OCWToolkitFINALENGLISHWEB.pdf> [https://perma.cc/6FN9-KVMY].

ously stringent law, the exercise is a missed opportunity in addressing directorial liability defence regime comprehensively and the laying of a regulatory framework for informal workouts. While it is shown that fear of personal liability is just one of the factors prompting directors to prematurely take their companies into voluntary administration, there have been no studies showing the existence of an enabling environment facilitating informal restructuring.

The fact that “suspicion” of insolvency instead of “expectation” of insolvency remains the basis for finding civil liability means that the strict approach to insolvent trading still characterises the Australian approach. The change of standard would have blunted the harsh impact of insolvent trading laws in Australia.

This brief amendment legislation leaves a number of key issues to courts. These include the duration of safe harbour (unlike external administration whose duration is regulated), the nature of the debt to qualify as one incurred in order to bring about a better outcome, and the qualifications of appropriately qualified entities for the purpose of giving advice. In regard to the last point, in the absence of a legislative definition of “qualified entities,” it is not clear as to how a safeguard against abuse such as phoenix activity can be put in place. It is hoped that some of these gaps will be filled by courts in the future. It is also hoped that the independent review to be carried out two years after this amendment pursuant to section 588HA will address practical problems observed since the amendment. The review is expected to focus on the impact of the availability of the safe harbour to directors of companies on the conduct of directors, the interests of creditors and employees of those companies, and any other matters the Minister considers relevant.

The safe harbour law does not affect the company’s compliance with its continuous disclosure obligations. This obligation does not afford companies the opportunity to make restructuring attempts on a confidential basis. While knowledge of the actual financial position of the company is good for a creditor to be able to make an informed decision, the impact the disclosure could have on the perception of reliability among consumers is huge. Without consumer confidence, a company will not be able to survive for long even if better credit facilities are negotiated.

As for listed companies, the only reprieve the ASX is prepared to grant companies relying on the safe harbour is a suspension of quotation of an entity’s security on a stock exchange provided that a financially struggling company could use the suspension period to

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complete a transaction critical to its continued financial viability. This is not a blanket suspension of trading but a stopgap measure to enable the company to complete a pending critical transaction. It is not clear if ASIC would take equivalent reprieve measures, such as suspension of disclosure, for unlisted companies.

The desired policy of spurring informal workouts for struggling companies requires more than providing a carve-out of liability for insolvent trading. The existence of an enabling legislative framework for the success of informal workouts is critical. For instance, adequate consideration needs to be given to the issue of whether debt-restructuring transactions are tax-exempt in order to encourage informal workouts. There are no laws stopping secured creditors from exercising their rights, let alone a law granting priority to a new lender. Therefore, given that not enough attention was given to informal workouts in the past due to harsh insolvent trading laws, it is now imperative to further facilitate the creation of a suitable enabling legal framework for their development.