Review of the insolvent trading safe harbour

KPMG Submission

KPMG Australia

October 2021

KPMG.com.au

Contents

Executive summary

Background

Section 1: Recommendations

Section 2: KPMG Insights

Key Authors

Executive Summary

As a leading professional services firm, KPMG Australia (KPMG) is committed to meeting the requirements of all our stakeholders – not only the organisations we audit and advise, but also employees, governments, regulators and the wider community. We strive to contribute to the debate that is shaping the Australian economy and welcome the opportunity to provide a response to the insolvent trading 'Safe Harbour' review (the review).

The Safe Harbour legislation (section 588GA of the Corporations Act) protects company directors from personal liability for insolvent trading if the company is undertaking a legitimate restructure which is likely to result in a better outcome for the company. KPMG has advised a number of its clients on navigating the requirements of Safe Harbour and has developed a *KPMG Framework for Safe Harbour* to ensure directors have a better understanding of the steps involved[1].

While the use of Safe Harbour was expected to increase due to the COVID-19 pandemic, the insolvent trading moratorium enacted in response to the pandemic[2] meant that Safe Harbour protection was not required. Additionally, a lack of data makes it difficult to understand how many directors are currently relying upon the Safe Harbour provisions.

We note that the insolvent trading moratorium ended on 1 January 2021 and did not result in any spike in insolvencies or Safe Harbour advice. Our view is that other government support measures were the key to avoiding large scale insolvencies during the COVID-19 pandemic, and not the insolvent trading moratorium or Safe Harbour provisions. However, the insolvent trading moratorium may have increased awareness of the Safe Harbour provisions for directors.

A solvent restructure is a much-preferred outcome to an insolvent restructuring mechanism such as voluntary administration. Safe Harbour extends the timeframe for directors to implement a solvent restructure without the risk of being personally liable for debts if the restructure fails. However, Safe Harbour is only available to directors who act quickly when facing into financial decline. Directors who act too late face falling foul of the qualifying criteria for Safe Harbour, meaning that voluntary administration or liquidation may be their only options.

To successfully qualify for Safe Harbour protection, directors and the company must also meet the various qualifying criteria. The most significant of which is that one or more courses of action needs to be reasonably likely to lead to a better outcome for the company (than the appointment of an administrator or liquidator to the company). The interpretation of 'reasonably likely' and 'better outcome' can be hard to determine and subject to individual opinion.

Furthermore, the Safe Harbour is only open to directors who are acting honestly and diligently and who have taken appropriate steps to ensure the company has:

- Paid entitlements of its employees by the time they fall due; and

[1] *Safe Harbour – Protecting businesses through the COVID-19 crisis (assets.kpmg)*

[2] *Section 5885AAA of the Corporations Act*

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

- Given returns, notices, statements, applications or other documents as required by taxation laws.

The preconditions above may preclude a significant number of directors from being able to qualify for Safe Harbour due to both employee entitlements (usually superannuation) and tax lodgements rarely being up to date for distressed businesses. However, we believe the preconditions are appropriate, and that improvements need to be made around awareness of the preconditions and director behaviours to allow greater use of the Safe Harbour provisions.

Whilst entering Safe Harbour is a question of adherence to s588GA of the Corporations Act, undertaking a turnaround can be hard to do. For example, the construction of a sufficiently robust and detailed restructuring plan requires expert knowledge and experience, as well as technical proficiency in the application of Australia's corporate turnaround and insolvency laws. This can act as a barrier to businesses entering Safe Harbour in some circumstances.

KPMG's submission addresses the consultation questions outlined as part of the review and makes several recommendations that could be considered to improve take-up and awareness of Safe Harbour.

We would welcome further discussion with Treasury and the expert panel on this important topic as the review progresses.

Yours sincerely,

James Stewart

National Leader, Restructuring Services

KPMG Australia

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Background

About KPMG

KPMG is a global organisation of independent professional firms, providing a full range of services to organisations across a wide range of industries, governments and not-for-profit sectors. We operate in 146 countries and territories and have more than 227,000 people working in member firms around the world. In Australia, KPMG has a long tradition of professionalism and integrity combined with our dynamic approach to advising clients in a digital-driven world.

KPMG Restructuring Services

KPMG has one of the largest restructuring services practices in Australia and around the world. We provide restructuring, turnaround and insolvency services to a wide range of clients from small and medium businesses to large institutional and multi-national organisations. We strive to contribute to the development of reliable and practical insolvency and restructuring procedures to assist Australian businesses facing financial difficulty so that they may contribute to a strong and prosperous economy.

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Section 1: KPMG recommendations

Recommendation 1: The Safe Harbour provisions should be amended to clarify the advice directors are required to obtain to satisfy the requirement that the course of action is reasonably likely to lead to a better outcome which would provide directors with greater certainty, making the provisions more effective.

Recommendation 2: The Safe Harbour provisions should prescribe who is qualified to provide advice on whether a course of action is reasonably likely to lead to a 'better outcome'. The Commonwealth should consider limiting the provision of advice to an appropriately qualified and regulated advisor, such as Registered Liquidators or a new designation of Registered Liquidators such as occurred with Small Business Restructuring.

Recommendation 3: Director awareness of the Safe Harbour provisions (and director duties more generally) must be improved. Consideration should be given to how this information can be provided to company directors, potentially through the introduction of Director Identification Numbers.

Recommendation 4: The Australian Securities and Investment Commission should start collecting data on Safe Harbour engagements so an assessment can be made on the uptake and usefulness of the Safe Harbour provisions. This could include collection through Registered Liquidator annual returns, statutory reports lodged during the liquidation of companies and annual returns filed by corporations.

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Section 2: KPMG Insights

KPMG Insights

Defining 'reasonably likely' and 'better outcome'

The Corporations Act does not define what is "reasonably likely" and in our view, reasonably likely reflects an objective assessment of whether there is more than a fanciful chance that one or more courses of action will lead to a better outcome than the immediate appointment of an administrator, or liquidator, of the company. Whether the courses of action are reasonably likely to lead to a better outcome is assessed as at the time the decision is made, not with the benefit of hindsight.

The Corporations Act has defined 'better outcome' as an outcome that is better for the company (and its creditors) than the immediate appointment of an administrator, or liquidator. The Safe Harbour protection applies from the time the director starts to develop the courses of action that are reasonably likely to provide a better outcome for the company than an immediate liquidation or administration. Safe Harbour is not intended to be a mechanism for a company to trade past the point it is viable. Once the directors conclude that the course of action is no longer reasonably likely and therefore is not likely to deliver a better outcome than insolvency, the 'better outcome' test will no longer be satisfied and the protection of the Safe Harbour ceases.

If eligible for Safe Harbour, directors must continue to take an early and proactive approach to ensure that the courses of action are reasonably likely to lead to a better outcome including:

- Obtaining proper information on the financial position of the company;
- Obtaining appropriate advice;
- Developing or implementing a plan for restructuring;
- Assessing whether each debt is incurred directly or indirectly "in connection with the courses of action";
- Determining whether a standstill period can be agreed between internal and external stakeholders; and
- Taking steps to maintain appropriate financial records.

Given the uncertainly around what constitutes 'better outcome' and 'reasonably likely', the Safe Harbour provisions may need to be amended to clarify the advice directors are required to obtain to satisfy the requirement that the course of action is reasonably likely to lead to a better outcome.

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Response to consultation questions

1 Are the safe harbour provisions working effectively?

In our experience, Safe Harbour has been used effectively by directors to achieve outcomes that were superior when compared to the likely outcome if the directors had placed the company into voluntary administration.

Our experience has generally been limited to particular circumstances, such as where Safe Harbour provided directors with the necessary comfort to bridge a short-term funding issue. These typically involve listed companies or sophisticated directors. We have seen very limited utilisation of Safe Harbour by directors of small and medium enterprises (SMEs).

There are a number of reasons why Safe Harbour may not be widely adopted. These include directors not engaging early enough, the cost of obtaining advice, the qualifying criteria and Safe Harbour not providing any protection for directors with personal guarantees.

Additionally, the nature of the Safe Harbour provisions mean there is no reliable data collected to determine how widely or appropriately the provisions are being used. Given this we suggest that the government review potential options for data collection, these could include:

- Liquidators disclosing the number of engagements through the annual return process;
- Liquidators of insolvent companies disclosing if directors have indicated they have relied on Safe Harbour through their confidential statutory lodgements; and/or
- Disclosure through a company annual return process.

The above would not be in the public domain which is important to ensure directors continue to utilise Safe Harbour without the fear of creditor retribution. However, the first two options rely on the Safe Harbour adviser being a Registered Liquidator, rather than a lawyer or other expert.

KPMG is not aware of any insolvent trading litigation which has tested the Safe Harbour defence. The ultimate effectiveness of the legislation is unlikely to be known until it is tested in Court. One option to resolve the ambiguity is for a non-adversarial case to be taken to Court in order to create a precedent that helps improve certainty.

2 What impact has the availability of the safe harbour had on the conduct of directors?

KPMG has not experienced any real changes in the conduct of directors due to the availability of Safe Harbour.

Generally, we have seen a slight increase in directors seeking to engage restructuring advisors earlier. However, this has not been a transformational change to the Australian

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

business culture, which typically does not engage advisors until the financial distress is beyond the point where Safe Harbour is useful.

There has been even less impact for the directors of small and medium enterprises, particularly in circumstances where they are also shareholders. These directors are likely to have provided personal guarantees and have little concern for personal liability from insolvent trading.

We have observed that support from financiers, and more recently the Federal Government, has likely done more to prevent directors appointing voluntary administrators than the Safe Harbour provisions.

3 What impact has the availability of the safe harbour had on the interests of creditors and employees?

In circumstances where Safe Harbour has avoided voluntary administration, the interests of creditors and employees have been improved through either higher returns or continued employment.

However, where the plan has failed, it is possible that an erosion in assets has occurred that ultimately results in a lower return to creditors compared to if the directors appointed a voluntary administrator at an earlier point in time.

Generally, creditors are not aware when directors are relying on the Safe Harbour provisions to continue incurring debts. We expect that if this was public knowledge, the creditors would respond through curtailing the credit available to the detriment of the company.

4 How has the safe harbour impacted on, or interacted with, the underlying prohibition on insolvent trading?

We have experienced very few examples of the Safe Harbour provisions being relied upon by directors in a formal insolvency appointment. Due to our limited experience, we have not been able to conclude any position on how the provisions are interacting with the insolvent trading prohibition.

We note that the Safe Harbour provisions do not release directors from the common law obligation to not cause the company to incur credit that it cannot repay. However, the statutory relief from insolvent trading is important in the psychology of the board of directors when considering the best course of action.

In our experience, SME directors will not seek advice early as they're already liable for any number of personal guarantees and many civil proceedings aren’t commercially viable, meaning that there hasn’t been a noticeable impact on the underlying prohibition on insolvent trading in this category.

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

5 What was your experience with the COVID-19 insolvent trading moratorium, and has that impacted your view or experience of the safe harbour provisions?

The insolvent trading moratorium effectively provided an automatic Safe Harbour for directors. This reduced to almost nil the requirement for directors to seek Safe Harbour advice.

The insolvent trading moratorium ended on 1 January 2021 and did not result in any spike in insolvencies or Safe Harbour advice. Our view is that other government support measures were the key to avoiding large scale insolvencies during the COVID-19 pandemic, and not the insolvent trading moratorium or Safe Harbour provisions.

We note the insolvent trading moratorium may have increased awareness of the Safe Harbour provisions for directors.

6 Are you aware of any instances where safe harbour has been misused?

KPMG is not aware of any instances or circumstances where the Safe Harbour provisions have been misused.

7 Are the pre-conditions to accessing safe harbour appropriate?

In our view, the preconditions preclude a significant number of directors from being able to qualify for Safe Harbour. This is due to both employee entitlements (usually superannuation) and tax lodgements (BAS and income tax) rarely being up to date for distressed businesses. This is particularly the case in small and medium enterprises.

However, we believe the preconditions are appropriate, and that improvements need to be made around awareness of the preconditions and director behaviours to allow greater use of the Safe Harbour provisions.

The reason these conditions are usually not met is because many directors of distressed companies are aware the ATO is not always timely in seeking to recover these debts or following up lodgements compared to how trade creditors engage with distressed businesses. This allows directors to defer ATO related payments or activities to redeploy that working capital to meet essential trade creditor claims. If directors had greater awareness that this compromises their ability to rely on Safe Harbour, it may lead to better director behaviour and earlier engagement with restructuring advisors.

8 Does the law provide sufficient certainty to enable its effective use?

Our experience through engaging with directors is the Safe Harbour provisions and the process required to meet directors' Safe Harbour obligations are opaque and do not provide directors with the necessary confidence to invest in an appropriate Safe Harbour process at an early stage.

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

A key issue is that there is no certainty that the defence will be valid in hindsight. While the *better outcome* test is necessarily subjective, the lack of legislative or case law guidance around a proper process as a defence to an insolvent trading claim made with hindsight is an impediment to its wider adoption by directors of distressed companies.

We suggest more specific legislation or case law is needed to provide directors with certainty on what actions need to be taken to qualify for and meet the Safe Harbour protection provisions.

9 Is clarification required around the role of advisers, including who qualifies as advisers, and what is required of them?

In our view, clarification is required for directors to understand the requirement to obtain advice, which we note is *only a consideration* for determining whether a course of action is likely to lead to a better outcome and is not a strict pre-condition to accessing Safe Harbour.

There are different types of advice that directors generally require in relation to Safe Harbour, both legal and financial. We have considered the role of the advisors as contemplated in the legislation[3], which is in relation to whether the course of action being taken is reasonably likely to lead to a better outcome.

Providing advice in relation to a course of action compared to a counter-factual voluntary administration or liquidation is advice that should only be provided by a qualified advisor. All restructuring and insolvency regimes within Chapter 5 of the Corporations Act require a Registered Liquidator to undertake this work. Registered Liquidators are regulated by the Australian Securities and Investment Commission, which ensures they are suitably qualified and comply with a higher benchmark of standards than unregulated advisors.

We recommend that the Safe Harbour provisions be amended to ensure that directors seek advice in relation to whether the course of action is likely to lead to a better outcome from a Registered Liquidator or equivalently regulated person. This review should consider whether a new designation for Registered Liquidators is established for Safe Harbour advice, similar to Registered Liquidators who are only able to perform Small Business Restructures under Part 5.3B.

10 Is there sufficient awareness of the safe harbour, including among small and medium enterprises?

In our experience, there is limited awareness of the Safe Harbour provisions. This is less so for large or sophisticated boards, which are typically well advised.

In relation to small and medium enterprises, there is minimal awareness or knowledge of the Safe Harbour provisions. Our experience is that most directors of small and

[3] *Section 588GA(2)(d)*

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

medium enterprises only a have rudimentary understanding of their duties and obligations in their role as a director. Therefore, it is not surprising that there is a lack of awareness of Safe Harbour, given there is limited awareness of the duty to prevent insolvent trading.

We also note that directors of small and medium enterprises are often intertwined with their companies through personal guarantees which are provided to creditors, often with their homes offered as collateral to financial lenders. This makes them less likely to interact with the Safe Harbour provisions, which offers no protections for their already significant personal exposure.

11 In relation to potential qualified advisors, what barriers or conflicts (if any) limit your engagement with companies seeking safe harbour advice?

KPMG has limited examples where barriers or conflicts have existed which prevented our engagement as a Safe Harbour advisor. However, certain friction points exist which could limit the ability of directors to obtain suitable advice.

The first is the cost of advice, which is often considerably different from the expectations of directors, particularly for small and medium enterprises. The opaque nature of the Safe Harbour legislation necessitates directors to seek advice from appropriate advisors to undertake thorough analysis and provide carefully considered advice. This can include, but is not limited to:

- Detailed review of current and forecast financial information;
- Preparation or review of detailed restructuring plans;
- Development of counter-factual scenarios and the likely outcome for stakeholders;
- Assessing whether debts are incurred directly or indirectly "in connection with the courses of action"; and
- Ensuring that a company maintains appropriate financial records.

The uncertainty around the liability for the advisors providing Safe Harbour advice means these services need to be detailed and thorough, which is not always the expectation of directors.

The second friction point is often directors engage too late, at a stage where Safe Harbour advice would be relatively meaningless. In these circumstances, advisors often resist providing the Safe Harbour advice because that role will conflict the advisor from working on the more substantial formal insolvency / restructuring role that may follow.

12 Are there any other accessibility issues impacting its use?

Given the relatively limited use of the Safe Harbour provisions since their introduction, KPMG is not aware of any other major accessibility issues that have not already been addressed in this submission.

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

13 Are there any improvements or qualifications you would like to see made to the safe harbour provisions and/or the underlying prohibition on insolvent trading?

Due to the low use of the Safe Harbour provisions, we have limited our recommendations to providing certainty about the advice directors are required to obtain and who should be providing that advice.

Some other points we raise for consideration are:

- Amending s588GA(1)(a) to alter the test to "a better outcome for the company and all classes of creditors".
- Including a provision stipulating maximum time limits upon which Safe Harbour can be relied to prevent potential abuses. These time limits could be capable of extension with court approval on an ex parte basis.
- Other reasonable measures to provide directors with more certainty as to the appropriate process and effectiveness of the defence where there no case law or precedents to guide directors and how to ensure they comply with the legislation.

©2021 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Key authors and contacts

James Stewart – Partner, National Leader Restructuring Services

Liam Creedon – Director, Restructuring Services

Robyn Duggan – Director, Restructuring Services, National Head of Technical and Professional Development

Sophie Finemore – Associate Director, Regulatory Affairs

Olivia Spurio – Senior Consultant, Government & Regulatory Affairs

KPMG.com.au

The information contained in this document is of a general nature and is not intended to address the objectives, financial situation or needs of any particular individual or entity. It is provided for information purposes only and does not constitute, nor should it be regarded in any manner whatsoever, as advice and is not intended to influence a person in making a decision, including, if applicable, in relation to any financial product or an interest in a financial product. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the situation.
To the extent permissible by law, KPMG and its associated entities shall not be liable for any errors, omissions, defects or misrepresentations in the information or for any loss or damage suffered by persons who use or rely on such information (including for reasons of negligence, negligent misstatement or otherwise).
©2020 KPMG, an Australian partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

Liability limited by a scheme approved under Professional Standards Legislation.

Document Classification: KPMG Public