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Review Panel Chair
Ms Genevieve Sexton
c/- The Treasury
Langton Crescent
Parkes ACT 2600

By email: SafeHarbourReview@treasury.gov.au

Dear Ms Sexton

Submission on 'Review of the insolvent trading safe harbour'

Thank you for the opportunity to provide a submission on the operation of the permanent safe harbour for directors from liability for insolvent trading which commenced on 19 September 2017. This submission is my own (as an independent academic) and should not be attributed to UTS or UTS Law.

Credentials

I am a Senior Lecturer in Law at UTS Law (Sydney). I am a published insolvency law academic and have been a lecturer in insolvency law for eight years. Prior to academia and two years as ARITA's Legal Director, I spent 10 years as a solicitor in private practice with firms in Australia and the United Kingdom (qualified in both jurisdictions) specialising in insolvency law and commercial litigation.

In my current role at UTS Law, I am the Program Head and principal lecturer of the 'ARITA Advanced Certification', a postgraduate-level course of study the completion of which fulfils the requirements laid down by the *Insolvency Practice Rules (Corporations) 2016* (Cth) ('IPR') s 20-1(2)(b) (academic requirements of applicants for registration as a liquidator).

Overview and Executive Summary

My submission comprises two parts:

- Part A addressing the impact of the availability of the safe harbour; and
- Part B addressing the ineffectiveness of the underlying prohibition on insolvent trading.

I support the continuing availability of the safe harbour provisions for company directors – ss 588GA and 588GB of the *Corporations Act 2001* (Cth) ('the Act') – and see no compelling reason for immediate change (amendment) to the safe harbour provisions and conditions (eligibility criteria), particularly in the current uncertain economic environment. Where the conditions of safe harbour are met by diligent and professionally-advised directors, its overall impact should be positive. Some of the positive impact of safe harbour could be undermined by other current laws that provide conflicting incentives for directors contemplating a restructuring outside a formal insolvency procedure.

However, the very existence of safe harbour – and the debate surrounding its accessibility for small businesses – is partly premised on an artificial assumption that the s 588G duty operates broadly and effectively to protect the interests of creditors of financially distressed companies (indeed, there are indicators and evidence to the contrary). I submit there is a case for revisiting the terms of the s 588G statutory duty with a view to its amendment or replacing it altogether with other measures that more effectively promote and incentivise the behaviour and actions expected of company directors including their accountability for very poor 'balance sheet' outcomes for creditors in liquidations.

In some cases, a transaction which clearly constitutes egregious insolvent trading just before a liquidation will not even be caught by the prohibition because it cannot be characterised as a 'debt' (eg, customer prepayments). The prohibition should be extended to 'liabilities' incurred as well as debts. Another more substantial improvement on the present s 588G would be to replace it with a 'wrongful' trading provision that does not rely on the vexed element of 'actual insolvency' but rather, more simply, imposes personal liability on directors where a company incurs a debt *or liability* in circumstances where there is no reasonable basis to expect that the obligation will be satisfied.

The actions expected of directors of financially distressed companies and required by 'safe harbour' – ie, developing a course of action reasonably likely to lead to a better outcome for the company – could then be subsumed (perhaps expressly) into the directors' statutory duties in Part 2D.1 of the *Corporations Act*, principally s 180 and the 'business judgment rule' (instead of being tied to a separate duty of a director to prevent the incurring of debt when a company is actually insolvent).

I submit that the *extent* of balance sheet deficiencies reported by external administrators and ASIC (detailed below) – including the prevalence of abysmal returns to creditors – reflect a use of the corporate form by many directors who pay little or no regard to creditors' stake in the company's balance sheet once a company is plainly insolvent. The duty to prevent insolvent trading may not be the sole factor underlying poor creditor returns but it appears that the prohibition is ineffective in deterring many company directors from trading a corporate balance sheet far beyond the 'point of no return' into a worsening or even egregious state of insolvency.

To more effectively hold directors accountable for the state of a company's balance sheet upon the commencement of an external administration, a concept worthy of consideration is a 'minimal return' provision in the Act (similar to the present ss 206EAB and 206GAA) that either imposes personal liability upon, or *automatically* disqualifies, directors of companies that deliver less than a prescribed minimum return (eg, less than 10 cents in the dollar) to general, unsecured creditors in a winding up.

<u>Part A</u>: The impact of the availability of the safe harbour (provided for by sections 588GA and 588GB of the Corporations Act 2001)

On the basis of discussions with insolvency professionals, a review of academic and professional literature and attendances at professional/industry conferences, my assessment is that safe harbour engagements are having a positive and beneficial impact and effect. While it is difficult to quantify or measure the 'success' of the safe harbour provisions, I am not aware of any considered study, empirical research or anecdotal evidence suggesting that safe harbour is being misused or abused by directors at the expense of creditors' interests. The safe harbour engagements of which I am aware (though literature or conference presentations) appear to have involved and reflect the very sort of behavior, incentives and objectives that safe harbour was introduced to deliver: ie, company directors acting responsibly and diligently to obtain appropriate advice and guidance from qualified persons with a view to achieving a better outcome for the company (including its creditors as a whole).[1]

I have considered whether directors of companies that have not paid employees their entitlements as they fall due or whose tax reporting is non-compliant should continue to be denied the protection of safe harbour to pursue a course of action that is reasonably likely to lead to a better outcome than a liquidation or administration. I understand the desire to make safe harbour more accessible to 'small company' or SME directors. However, I submit that there is nothing unreasonable or unduly onerous in the current conditions or 'eligibility criteria' for the protection of safe harbour. Directors whose companies are not paying workers their due entitlements (or are not substantially compliant with tax lodgments) hardly have an economic or business case for access to safe harbour. If anything, the data and statistics referred to in Part B below suggest that the duty to prevent insolvent trading is an irrelevancy for many small company directors.

'Mixed signals' to directors from recent law reform undermines key objectives of safe harbour

Some laws – including other recent insolvency law reforms – contradict or undermine the potential effectiveness and impact of safe harbour by exposing directors to personal liability where they explore a restructuring outside a formal insolvency procedure. The very thing safe harbour was intended to promote – ie, directors exploring restructuring options *rather than prematurely appointing a Part 5.3A administrator* – has been discouraged by the introduction of new officer liability provisions that prioritise (in a public policy sense) the return to Australia's statutory safety net scheme for unpaid employee entitlements (the Fair Entitlements Guarantee or 'FEG').

Section 596AC of the Act – amended by the *Corporations Amendment (Strengthening Protections for Employee Entitlements) Act 2019* (Cth) effective 6 April 2019 – undermines the safe harbour reforms of 2017 by sending 'mixed signals' to directors of financially distressed companies and introducing disincentives to exploring a restructuring for the benefit of their company and its creditors *as a whole*.

[1] For example, see Hayes & McCabe, 'Some Practical Insights on Safe Harbour: The potential to provide the greatest good for the greatest number' (2019) 31(3) *ARITA Journal* 20.

Section 596AC(3) of the Act provides that an officer (including a director) of a company contravenes the provision if he/she causes the company to enter into an agreement or transaction and he/she knows, or a reasonable person in the position of the officer would know, that the agreement or transaction is likely to avoid/prevent the recovery of employee entitlements or significantly reduce the amount of employee entitlements that can be recovered. The objects provision in Part 5.8A of the Act – s 596AA – provides that the objects of the Part are to, inter alia, 'protect the entitlements of a company's employees from agreements, arrangements and transactions that avoid or prevent the recovery of those entitlements, or significantly reduce the amount of those entitlements that can be recovered, *in the winding up of the company*.'

Section 596AC of the Act focuses not on whether a reasonable person would enter into the transaction but rather on whether '*a reasonable person … would know that the transaction is likely to … significantly reduce the amount of entitlements of employees … that can be recovered [in a winding up]*'.

These provisions appear to call for a comparison of the return to employees (or the FEG, subrogated to those employees) between:

(i) An actual winding up that follows a restructuring agreement; and
(ii) A hypothetical winding up that would have transpired in the absence of the restructuring agreement.

An officer who contravenes s 596AC of the Act is liable to pay compensation under s 596ACA. However, s 596AC(7) applies to protect or exclude officers from such liability if the relevant agreement or transaction is, or is entered into under, a scheme of arrangement under s 411, *a deed of company arrangement* or a restructuring plan made by the company. Herein lies the contradiction between s 596AC and the s 588GA safe harbour: Safe harbour was intended to prevent directors making premature appointments under Part 5.3A, yet the appointment of an administrator with a view to promoting a deed of company arrangement is the very course of action that will protect an officer from potential liability under s 596AC of the Act.

The Explanatory Memoranda to the 'safe harbour' and 'strengthening protections for employee entitlements' reform bills, examined side-by-side, highlight the mixed signals sent to directors by these new laws:

> **['Safe Harbour'] Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017, Explanatory Memorandum** ('Context of amendments'):[2]
>
> The current focus on the solvency of the company and the time at which debts are incurred leads to potentially undesirable outcomes … directors (particularly of larger companies) may have disproportionate concern as to their own personal exposure during times of financial stress and ***may potentially move to formal insolvency prematurely*** …

[2] Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017, Explanatory Memorandum at [1.7] to [1.10].

> ***The focus on personal liability may also lead to*** an absence of focus by directors on their general director's duties and ***the early appointment of an administrator with a potentially unnecessary destruction of enterprise value*** which may occur even where there are clear opportunities to adjust the company's business and continue operating for the overall benefit of the company, its shareholders, employees and creditors.
>
> Even where a company may actually be solvent or could be turned around, ***the appointment of an administrator has the potential to result in the company being liquidated*** because of the loss of confidence amongst its suppliers, credit providers, employees and the general public. ***The current insolvent trading provisions can also result in the unnecessary liquidation of companies that could otherwise be successfully restructured and continue to operate***. This is not in the interests of the company's directors, employees, creditors and the economy as a whole. (emphasis added)

Corporations Amendment (Strengthening Protections for Employee Entitlements) Bill 2018, Explanatory Memorandum:[3]

> ***The purpose of excluding compromises and DOCAs from the operation of the offence provisions is to avoid undermining these mechanisms as legitimate options to rescue, reorganise or restructure a financially distressed business*** … The provisions on DOCAs in the *Corporations Act* protect employee entitlements (see sections 444DA and 444DB). As there are already specific employee entitlement protections, the criminal offence provisions do not need to apply to DOCAs. (emphasis added)

In contrast, the new officer/advisor liability provisions for a 'creditor-defeating disposition' ('CDD') provide for the same 'safe harbour' protection from liability: see s 588GA(1) which now extends safe harbour to the potential liability for a 'CDD' (s 588GAB of the Act) but *not* to the potential liability of an officer under s 596AC in Part 5.8A of the Act.

The tension for directors in navigating these sources of potential exposure and variable protections is highlighted by a hypothetical example of a restructuring agreement involving the sale and transfer of a business from a financially distressed company to a 'white knight' purchaser on 'assumption of liability' terms. The purchaser may wish to assume a range of the vendor company's liabilities (including the entitlements of 'transferring' employees) with the consideration payable for the business comprising the assumption of those liabilities *plus* a residual cash payment. Employees who do not 'transfer' to the purchaser will be left to prove for their entitlements in the winding up of the vendor company. Such a transaction would be exposed to the 'comparison' or counterfactual imposed by s 596AC and the directors of the vendor company may be held to have contravened the provision because the ultimate money received by the vendor company under the sale transaction is less than what a liquidator may recover in a winding up (even in the event of a 'break up' or 'forced value' asset sale process). While the restructuring agreement might have been the best outcome for the company and its creditors *as a whole*, a hypothetical winding up comparison may suggest that some employees (or FEG) would have

[3] Corporations Amendment (Strengthening Protections for Employee Entitlements) Bill 2018, Explanatory Memorandum at [2.56].

received a greater return on their entitlements in a liquidation if the restructuring agreement had not been executed. The interests of *one* priority creditor may not align with the interests of the company and its creditors *as a whole*.

In short, the Government's desire to prioritise the interests of *one* stakeholder sits in tension with the underlying premise and condition of safe harbour: that directors work towards a better outcome for the company and its creditors as a whole. *Safe harbour protection should be extended to potential s 596AC liability* as currently it extends to s 588GAB liability for a CDD.

A similar example of safe harbour and another insolvency law 'pulling in different directions' is the liability of a director under s 588FGA of the Act to indemnify the ATO for any preference recovered in a winding up. If such a payment were made during a time when all the conditions of safe harbour are satisfied, surely the director should be extended the same protection from personal liability under s 588FGA in the event of a winding up?

***Part B*: The ineffectiveness of the underlying prohibition on insolvent trading and associated penalties**

Recent ASIC statistics and data: Insolvent trading is prevalent, as are negligible returns to creditors

Statistics and data published by ASIC make a strong *prima facie* case for the proposition that, for many directors, the duty to prevent insolvent trading is an irrelevant and ineffective deterrent.

ASIC Report 645 '*Insolvency statistics: External administrators' reports (July 2018 to June 2019)*' (December 2019) details the following from lodged initial external administrators' reports for 2018/19 (most of which were 6,932 reports lodged by liquidators under s 533 of the Act):[4]

- 71% of these reports disclosed alleged possible breaches of the duty to prevent insolvent trading under ss 588G(1) – (2). (This follows results of 69% and 63% for 2017/18 and 2016/17 respectively);
- 88.2% of reports alleging a civil breach of the s 588G duty to prevent insolvent trading advised there was evidence to support the allegation;
- 'Where external administrators advised that evidence existed for an alleged civil breach, most of these reports (3,818 or 80.9%) estimated that the debt incurred when the company was insolvent was less than $1 million (10.5% of these reports estimated $1 million to $5 million debt incurred);
- Where a civil breach was alleged, the external administrator reported that evidence existed and the estimated debt incurred was between $250,000 and $1 million, the estimated

[4] ASIC Report 645 is stated to present 'an overview of total lodgements of statutory reports lodged by liquidators, receivers and voluntary administrators (external administrators) from 1 July 2018 to 30 June 2019, as well as our statistical findings from external administrators' reports lodged electronically when a company enters external administration (EXAD) status (initial external administrators' reports).' 2018-19 is the most recent period reported; ASIC's website states: 'ASIC discontinued Form EX01 on 27 March 2020 and replaced it with the Initial statutory report (ISR). The reporting format of these statistics is currently under review. We plan to provide this information in a different format in FY22.'

assets available were less than $1 in 29% of cases and $250,000 or less in 90% of cases;

- Where a civil breach was alleged, the external administrator reported that evidence existed and the estimated debt incurred was between $1 million and $5 million, the estimated assets available were $250,000 or less in 78% of cases;
- Where a civil breach was alleged and the external administrator reported that evidence existed, 58.2% of reports alleged that the company became insolvent more than 15 months prior to the appointment;
- 38% of reports estimated an asset deficiency (ie, shortfall between estimated assets and estimated liabilities) of more than $500,000; 22% of reports estimated a deficiency of more than $1 million;
- 96.4% of reports estimated a dividend payable to unsecured creditors of less than 11 cents in the dollar; 92.1% of reports estimated no (zero cents) dividend payable to unsecured creditors.

Whilst acknowledging that external administrators' reports disclose *allegations* of breaches and not concluded findings of a contravention, I submit that the above statistics and data (albeit imperfect) sustain two observations:

- Breaches of the duty to prevent insolvent trading are prevalent even though courts have delivered a modest number of insolvent trading judgements;[5]
- The abysmal 'balance sheet' outcomes for unsecured creditors in liquidations (ie, negligible or no dividend return in most cases) suggest that our current laws are *not* striking a good balance between affording directors reasonable commercial latitude (risk-taking) and preventing the abuse of use of the corporate form at the expense of creditors.

Revisiting the settings and elements of the present s 588G duty to prevent insolvent trading

While the ineffectiveness of s 588G can probably be explained by a number of legal and commercial factors operating in combination (including the practical realities of enforcement), I contend that the following deficiencies detract from the application of s 588G and its impact.

<u>The element of actual 'insolvency'</u>: Recent case law demonstrates the unsatisfactory complexity and difficulty in establishing 'insolvency' under s 95A of the Act. This complexity and uncertainty has been demonstrated in a number of cases – the latest being the very recent *Arrium* judgment[6] – and works against the interests of both creditors *and* directors. Liquidators face a burdensome (sometimes impossible) challenge in proving insolvency as an element of any insolvent trading claim, while diligent directors face difficulty in assessing the financial position (solvency) of their

[5] See Steele and Ramsay, 'Insolvent Trading in Australia: A Study of Court Judgments from 2004 to 2017' (2019) 27 *Insolv LJ* 156 at 162 who stated that 'the 39 judgments identified … suggest that there have only ever been a few judgments each year' although '[t]here is also evidence from the judgments that there is more activity in relation to insolvent trading not captured … [such as] private negotiations as between liquidators and directors which may, for example, lead to contributions under deeds of company arrangement.'

[6] *Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* [2021] NSWSC 1025.

company to determine whether s 588G will apply. I submit that serious consideration should be given to replacing the existing s 588G with a provision that does not require the proof or establishment of actual insolvency for its application and enforcement. I commend an earlier submission in 2016 by King & Wood Mallesons which stated that:[7]

> *Much if not all of the difficult dilemma faced by Australian directors would be resolved if the primary offence of "insolvent trading" was limited to the incurring of a debt in circumstances where the directors have no reasonable basis to expect that debt to be repaid in accordance with its terms. In other words, if the primary offence were detached from the concept of "insolvency". This would avoid the unnecessary complexity of establishing an exception to this provision.*
>
> *The primary … [contravention] could be redrafted to establish that a director will be liable when they have reasonable grounds to expect that the company will be unable to fulfil those obligations, rather than when they have reasonable grounds to suspect insolvency. Adopting such a provision in Australia would require redrafting of section 588G, but would render much of section 588H (the current defences) unnecessary.*
>
> *This approach was taken in New Zealand in 1993 and has worked well there since then. It provides greater certainty for directors, as compared with the current Australian regime, because directors of distressed companies are able to avoid potential liability for the offence by carefully managing their company's cash flow to ensure that there is sufficient cash to pay each debt which is incurred while the directors develop and pursue a turnaround strategy or a restructure. This approach also protects creditors in that it should ensure that debts incurred by a distressed company in the "twilight zone" are generally repaid.*

Section 588G only applies to '*debts*' incurred: The central focus of s 588G on the incurring of 'debts' when a company is insolvent leaves many other types of liabilities and obligations – that may be incurred just prior to a liquidation – beyond the reach of the duty and prohibition. For example, a director of a corporate retailer that knows a liquidation is inevitable but continues to approve the sale of gift cards or the acceptance of prepayments and deposits for good and services will not breach s 588G because these types of obligations are not 'debts'; rather, they are contingent, unliquidated *damages* claims.[8] Similarly, damages claims have been excluded from the s 95A test for solvency because they are not 'debts', even where a company's financial position is 'commercially untenable'.[9] A cash flow test of insolvency which ignores onerous liabilities that do not meet the technical description of a 'debt' does not always accord with 'commercial reality'.

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[7] KWM's submission on 'Improving bankruptcy and insolvency laws – Proposals Paper' released by the Commonwealth Government on 29 April 2016 – '*Let's Optimise the Opportunity for Reform*' is accessible here.
[8] *Shephard v ANZ Banking Corporation Ltd* (1996) 41 NSWLR 431 in which the NSW Court of Appeal held that, where pre-payments and deposits are accepted by a company which then fails to supply the goods or services, any restitutionary obligation of the company is only 'incurred' at the time the contract is discharged by election, which usually will not occur prior to the liquidation. See also Wellard, 'Debts "incurred" by receivers, administrators and liquidators' (2013) 21 *Insolv LJ* 60 at 68 – 70.
[9] *Box Valley Pty Ltd v Kidd* (2006) 24 ACLC 471 [2006] NSWCA 26, [61]. See Powers, 'The impact of unliquidated claims when assessing solvency: A director's dilemma' (2017) 32 *Aust Jnl of Corp Law* 368 and Stucken, 'A Blind Spot in the Test for Solvency? Reconsidering the Exclusion of Unliquidated Damages Claims from s 95A' (2018) 26 *Insolv LJ* 73.

It is noteworthy that in 2013 Singapore opted to introduce a wrongful trading provision that extends to *liabilities* as well as debts incurred (although the provision, unhelpfully in my view, retains a necessary element of 'actual insolvency'). Section 239 of Singapore's *Insolvency, Restructuring and Dissolution Act 2018* commenced operation on 30 July 2020 and provides that:

> *[A] company trades wrongfully if —*
> *(a) the company, when insolvent, incurs* ***debts or other liabilities*** *without reasonable prospect of meeting them in full; or*
> *(b) the company incurs* ***debts or other liabilities*** *—*
> *(i) that it has no reasonable prospect of meeting in full; and*
> *(ii) that result in the company becoming insolvent.* (emphasis added)

The Final Report of Singapore's Insolvency Law Review Committee ('ILRC') recommended this form of provision for wrongful trading after considering and rejecting both the present UK s 214 *Insolvency Act* provision for wrongful trading and Australia's s 588G *Corporations Act*. At p 207 of its Final Report the Committee stated:[10]

> '*The Committee is of the view that such a framework strikes the best balance between promoting responsible entrepreneurship and preventing abuse of the corporate form by those who manage companies. It puts in place a fairer and more updated and comprehensive legal regime to regulate insolvent trading.* ***For instance, the framework would apply to the "incurring of debts or other liabilities" instead of only to the "contracting of a debt"*** *as currently provided*'. (emphasis added)

The model provision endorsed by the Singapore ILRC is that which was recommended by the UK's Cork Report in 1982[11] but which the UK Parliament rejected in favour of the present s 214 *Insolvency Act 1986* (UK). The Cork Report's Ch 44 'Wrongful Trading' expressly referred to instances of insolvent or wrongful trading that may involve the incurring of obligations beyond mere 'debts':[12]

> '*The essence of wrongful trading is the incurring of liabilities with no reasonable prospect of meeting them;* ***whether by incurring debts*** *with no reasonable prospect of paying them,* ***or by taking payment in advance for goods to be supplied with no reasonable prospect of being open to supply them or return the money in default****.*
>
> *Trading when a business is heavily under-capitalised will often come within the concept of 'wrongful trading'. Those responsible for carrying on trading with insufficient share capital and reserves may well find themselves guilty of wrongful trading and accordingly subject to a personal civil liability in this respect.* ***We believe that our proposals will encourage directors to satisfy themselves that their companies are adequately capitalised when regard is had to the scale of the operations***

[10] The Singapore Insolvency Law Review Committee's Final Report of 4 October 2013 is accessible here. See also Steele, Ramsay and Webster, 'Insolvency law reform in Australia and Singapore: Directors' liability for insolvent trading and wrongful trading' (2019) 28(3) *International Insolvency Review* 363.
[11] *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558 ('the Cork Report').
[12] *Report of the Review Committee on Insolvency Law and Practice* (1982) Cmnd 8558 ('the Cork Report'), Ch 44 'Wrongful Trading', [1784] – [1785].

> ***and the level of the commitments into which they are proposing to enter****; and that the new concept of wrongful trading will go a long way to meet the criticisms of those who complained of the absence of a statutory minimum paid-up share capital for all trading companies*'. (emphasis added)

The above statements of the Cork Report support the view that the effectiveness of any prohibition against insolvent trading needs to be assessed (at least in part) against the 'balance sheet outcomes' (dividend returns) delivered for creditors in liquidations.

Rethinking how to hold directors accountable for 'worsening' or egregious insolvency

The estimated asset deficiencies and dividend returns reported by external administrators (detailed above) reflect a prevalence of abysmal outcomes for creditors in liquidations. The *extent* of the deficiency of most company balance sheets estimated and reported by external administrators does *not* reflect a scenario of diligent directors struggling in the 'twilight zone' of apprehended insolvency according to the s 95A 'cash flow' test. Rather, the estimates provided by external administrators – even acknowledging the 'forced sale' asset values that apply in a formal insolvency procedure – indicate that extreme, negligent and/or reckless leverage is commonplace, with many directors paying little or no regard to situations of 'worsening' insolvency. Creditors are plainly paying a high price for this dynamic through derisory or negligible returns in most liquidations.

A 'cash flow' test of insolvency (with its focus on the company's resources) applies under ss 95A and 588G (among other provisions in the Act) in the months or years leading up to the appointment of an external administrator. However, in a liquidation, it is the balance sheet that primarily determines the scale of the ultimate dividend return to creditors. Whilst a variety of factors can explain low returns in liquidations, the present prohibition on insolvent trading appears to be ineffective in that it is having little effect in providing the necessary incentives for directors to either cease trading or obtain appropriate advice when their company is in a state of impending or actual insolvency.

I submit that consideration be given to amending s 588G and/or replacing it with an alternative regime for director accountability or liability that more effectively incentivises and promotes the behaviour we expect of directors of financially distressed companies, including a greater focus by directors on *the extent* of a company's leverage and *the extent* of the deficiency of its balance sheet (should a liquidation eventuate).

In my view, lawmakers need to reconsider and reformulate the legislative settings that will, quoting the Cork Report, 'encourage directors to satisfy themselves that their companies are adequately capitalised when regard is had to *the scale* of the operations and *the level* of the commitments into which they are proposing to enter.'

'Minimal return' provisions: an alternative way of holding directors accountable for the extent of insolvency?

Ultimately, insolvent trading laws are a matter of promoting behavior that balances the privilege of the use of limited liability (for reasonable risk-taking or productive entrepreneurship) with checks and balances to guard against the potential abuse of the corporate form. A provision that may serve as an exemplar for an alternative approach is s 206GAA of the Act (introduced in 2019) which provides ASIC a power to disqualify a person from managing corporations if a person has been an officer of two corporations that have been wound up and delivered a 'minimal return' to FEG on account of advances for the payment of employee entitlements (and ASIC has reason to believe a contravention of the Act has been committed).[13]

I submit that further consideration be given to similar 'minimal return' provisions which could apply in the event of low returns to general, unsecured creditors. The calibration of the 'minimal return' would be a matter for debate – eg, 25 cents in the dollar or 10 cents in the dollar to general, unsecured creditors. Such a provision (or set of provisions) could either impose personal liability on directors for a minimal return and/or *automatically* disqualify directors in the event of one or two failures to generate a minimal return in a liquidation. As with current laws, provision could be made for relief to directors who can demonstrate honesty and that reasonable steps or conduct were taken to address the worsening insolvency of the company.[14]

A 'minimal return' provision could either operate in lieu of the present insolvent trading provision or operate in conjunction with an amended (overhauled) s 588G that imposes personal liability on directors where a company incurs a debt or obligation in circumstances where there is no reasonable basis to expect that debt will be repaid (ie, removing the current provision's connection to the vexed element of 'actual insolvency'). The actions expected of directors of financially distressed companies and currently required by 'safe harbour' – ie, developing a course of action reasonably likely to lead to a better outcome for the company – could then be subsumed (perhaps expressly) into the directors' statutory duties in Part 2D.1 of the Act, principally s 180 and the 'business judgment rule' (instead of being tied to a separate duty of a director to prevent the incurring of debt when a company is actually insolvent).

Low number of director disqualifications: One reason I support the introduction of an *automatic* disqualification of directors whose companies fail to deliver a 'minimal return' to unsecured creditors is the continuing low number of disqualifications.

As the law presently stands, a director of two companies that have delivered less than 50 cents in the dollar to unsecured creditors in a liquidation is exposed to ASIC's power of disqualification under s 206F of the Act. However, ASIC's *Enforcement Update* for January to June 2021 (Report 699, September 2021) reported only '19 individuals disqualified or removed from directing

[13] Section 206EAB provides a similar Court power of disqualification. In both ss 206EAB and 206GAA, a 'minimal return' is 10 cents in the dollar or less.
[14] See ss 206EAB(4), 206GAA(4) and 1318 of the Act.

companies'. ASIC's Annual Reports for the last five years disclose an average of around 50 director disqualifications each year which appears a very low number in the context of the egregious balance sheet deficiencies and number of insolvent trading allegations reported by external administrators.[15]

Australia needs a 'root and branch' review of its insolvency law regime for a 21st century economy including expert economic perspectives

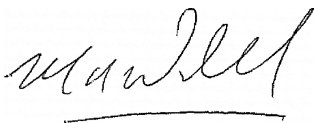
Finally, I commend and renew ARITA's call for a 'root and branch' review of Australia's personal and corporate insolvency laws. Whilst concepts and proposals such as 'minimal return' provisions are worthy of consideration as part of an alternative, simpler regime to existing director liability provisions, I acknowledge that our present corporate and insolvency laws present a complex system of interrelated 'moving parts'.

In my view, such a review must incorporate input from economic experts on the role and expectations of our insolvency laws in the context of Australia's economy today (a very different economy to that of 1988 when the Harmer Report[16] was delivered). 'Promoting a culture of entrepreneurship and innovation' (stated in the Consultation Paper) are worthy goals, but I remain sceptical as to what impact our insolvency laws have in the broader context of contemporary economic conditions, settings and incentives that are 'front of mind' for genuine entrepreneurs and innovators. What national 'economic dividend' can and should we expect from our insolvency regime today?

A considered 'root and branch' review of our insolvency regime will produce better law making and outcomes than the reactive, disjointed law reform measures of the last five years which have, in my view, added a great deal of complexity to our insolvency regime but for questionable benefit.

I am more than happy to speak to any of the above points (or my submission generally) and can be contacted by email or via UTS Law.

Yours sincerely,



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[15] ASIC Annual Reports from 2015-16 through to 2019-20 disclose around 39 to 59 director disqualifications per year.
[16] General Insolvency Inquiry (ALRC Report 45), tabled 13 December 1988.