Review of the **Insolvent Trading Safe Harbour**

REPORT

November 2021

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Report

23 November 2021

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INTRODUCTION AND OVERVIEW

Letter to the Minister from the Panel

Dear Assistant Treasurer

Review of the insolvent trading safe harbour

The Commonwealth announced in the 2021-22 Budget that it would commence an independent review into the insolvent trading safe harbour to ensure the provisions remain fit for purpose and their benefits extend to as many businesses as possible.

An independent panel was appointed to undertake the Review. The Review has involved extensive consultation with a broad range of stakeholders, including receipt of 20 written submissions, and participation in numerous round table discussions. In addition to the submissions, throughout this process we have benefited from insights from colleagues, academics, directors and insolvency advisers who have given their time generously to enrich our review of these important safe harbour provisions.

In accordance with section 588HA of the *Corporations Act 2001* (Cth), we are pleased to present you with the Review of the Insolvent Trading Safe Harbour.

We would be happy to meet with you to discuss our recommendations.

Yours sincerely,

Genevieve Sexton | Leanne Chesser | Stephen Parbery

Panel members

Ms Genevieve Sexton – Panel chairperson

Ms Sexton is a partner at Arnold Bloch Leibler. She is experienced in solvent and insolvent restructuring and workout transactions, advising distressed companies, insolvency practitioners, directors, lenders and other stakeholders in some of Australia's largest and most complex restructures. Genevieve holds a Bachelor of Arts and Bachelor of Laws (Hons), both from Monash University.

Ms Leanne Chesser – Panel member

Ms Chesser is a partner at KordaMentha and a Registered Liquidator. She is a current Australian Restructuring Insolvency & Turnaround Association (ARITA) Board Member and Chair of the ARITA Vic/Tas Committee. She holds a Bachelor of Commerce from the University of Melbourne.

Mr Stephen Parbery – Panel member

Mr Parbery is a senior adviser at Duff & Phelps-Kroll. He was previously a founder and chairman of PPB Advisory. He is a former president and life member of ARITA. He is a fellow of the Institute of Chartered Accountants. He is a member of the ministerial pool for the Insolvency Practitioner Registration and Disciplinary Committees.

1. Acknowledgements

The Panel would like to thank stakeholders who have provided their time and expertise in round table discussions and informal discussions, as well as through written submissions. We have benefited greatly from their depth of experience and insights.

The Panel would like to thank Alexandra Harrison-Ichlov and Elizabeth Kuiper for their assistance and dedication in assisting the Panel in finalising this Report and for acting as the Review secretariat.

2. Review

2.1 Purpose of the review

The safe harbour provisions contained in sections 588GA and 588GB of the *Corporations Act 2001* (Cth) (**Act**) commenced on 18 September 2017 and have now been in operation for just over 4 years.

Section 588HA of the Act provides for an independent review to be conducted for the purpose of examining and reporting on the impact of the availability of the safe harbour to directors of companies on:

- the conduct of directors; and
- the interests of creditors and employees of those companies.

The purpose of this Review is to assess whether the safe harbour is achieving its aims, including giving financially distressed but viable companies more ‘breathing space’ to restructure their affairs.

2.2 Terms of reference

The terms of reference for this Review are to:

1. examine and report on the impact of the availability of the safe harbour (provided for by sections 588GA and 588GB of the Act) on:
    a. the conduct of directors, including decisions to seek advice about the company’s financial position or to undertake a corporate restructure or turnaround plan outside a formal insolvency process
    b. the conduct of directors of small and medium-sized enterprises and any particular issues experienced by these directors when engaging with financial distress
    c. the interests of creditors and employees of those companies, including benefits gained under a successfully implemented restructure or turnaround plan or in formal insolvency processes
    d. the effectiveness of the underlying prohibition on insolvent trading and associated penalties, and
2. examine and report on the role of advisers in the safe harbour.

2.3 Methodology

The Panel received 20 written submissions from a broad range of industry participants in response to a consultation paper. A copy of the consultation paper is attached as Annexure F. A list of the public written submissions received by the Panel can be found in Annexure A.

The Panel also engaged in many round table discussions addressing the questions posed in the consultation paper, including with representatives of ASIC, employees of the Attorney-General's Department involved in administering the Fair Entitlements Guarantee (**FEG**) scheme, academics, law firms, insolvency practitioners, safe harbour specialists, industry representative organisations and the Australian Institute of Company Directors (**AICD**). A list of the formal round table discussions can be found in Annexure B. We also had numerous informal discussions with directors and advisers about their interactions with, and experiences of, the safe harbour provisions. In this Report, we refer collectively to the written submissions and the feedback received through round table discussions, as the Panel's 'consultation process'.

The consultations provided the opportunity for interested members of the community to share their experiences under the current law and regulatory settings and to discuss any potential reforms.

2.4 Timing

The Panel was given 3 months to undertake a consultation process with stakeholders and deliver its Report to the Assistant Treasurer. Pursuant to section 588HA(4) of the Act, the Minister will then table this Report in Parliament.

3. Executive Summary

For some time, company directors in Australia have been subject to a strict duty to prevent a company from engaging in insolvent trading. Directors who breach this duty may be held personally liable for those debts. This threat of personal liability has been described as a ‘sword of Damocles’, hanging over the head of directors of financially distressed companies and distorting the lens through which they contemplate potential turnaround options.

The safe harbour reforms were intended to shift directors’ focus from personal liability for insolvent trading, and encourage them to engage in greater innovation and entrepreneurship when pursuing turnaround options for their companies.

Although just over four years have passed since the safe harbour provisions were introduced, the COVID-19 pandemic and its unprecedented impact on all aspects of Australian life over the past 18 months has hampered the assessment of the efficacy of the provisions as they would apply under more conventional circumstances. Businesses and corporations have been greatly affected by COVID-19 restrictions, lockdowns, and the prevailing uncertainty brought about by the pandemic. The mix of public capital stimulus (including JobKeeper and JobSeeker payment schemes, rent abatements and the COVID-19 insolvent trading moratorium), together with the low cost of private capital, has led to an environment where – at least anecdotally – many companies appear to be treading water, but relatively few formal insolvency appointments have been made.

Safe harbour is also not a public process. It relates to confidential board decisions and does not usually become public unless the company enters a formal insolvency process (and even then, there is little public data available). There are good reasons for this: publicising a company’s financial distress during a period of safe harbour can have dire consequences for its liquidity and ongoing ability to trade.

Accordingly, when conducting this review, the Panel has relied almost entirely on input received from advisers, directors and other stakeholders as to their experiences of the safe harbour provisions.

3.1 Stakeholder submissions

Throughout the Panel’s extensive consultation process, two main issues emerged:

- the appropriateness and efficacy of the safe harbour provisions and whether improvements or amendments are required; and
- the appropriateness and efficacy of the insolvent trading prohibition more generally and whether there should be a holistic reconsideration of the framework of directors’ duties as they intersect with corporate distress and/or failure.

In addition, stakeholders referred to:

- the lack of awareness and understanding of a director’s duty to prevent insolvent trading (and the related safe harbour carve-out) with many stakeholders noting that this was a key factor which has prevented directors from more readily engaging with the safe harbour provisions; and
- the difficulties faced by having a single insolvency law framework that applies to all sizes and types of companies. In this respect, there was clear consensus between stakeholders that the safe harbour protections and the prohibition on insolvent trading have greater resonance with, and application to, larger companies and/or more sophisticated boards.

When considering how these issues could be addressed, the Panel had regard to the following proposals, which received almost unanimous support among stakeholders:

- increasing awareness and education of the safe harbour provisions, the related duty to prevent insolvent trading and general directors' duties; and
- conducting a broad review of Australia's insolvency laws.

3.2 Recommendations

The Panel's recommendations are set out in Part VI. Whilst the focus of those recommendations is on the wording of the safe harbour provisions themselves, the Panel has also endorsed the need for ongoing education and guidance to support the operation of the legislative provisions and promote awareness of them amongst stakeholders. The Panel is keenly aware that there is currently no ASIC guide or industry-endorsed best practice guide as to how the safe harbour provisions operate in practice. Therefore, a number of the Panel's recommendations are aimed at simplifying the provisions or clarifying their meaning, so that they can be readily understood and applied.

Overall, the Panel considers that within the construct of a regime which imposes strict liability for insolvent trading, the safe harbour protections offer considerable assistance in encouraging an active turnaround market, particularly for larger companies. The case studies submitted by stakeholders demonstrate many examples where stakeholders, including creditors and employees, have benefited from the increased runway provided to directors (through the safe harbour provisions) to achieve operational restructures. However, the Panel holds concerns as to the relevance and applicability of the safe harbour (and, indeed, the underlying prohibition on insolvent trading) to the SME market.

It is also timely for serious consideration to be given to a holistic review of Australia's insolvency regime. More than 30 years have passed since the release of the last comprehensive review of Australia's insolvency laws; the Harmer Report.[1] The Harmer Report acknowledged that economic and social changes had given rise to a need for a review of insolvency law and procedure.[2] We find ourselves in a similar position today. The last 30 years have seen unprecedented globalisation, and immense changes to the ways in which Australia's capital markets operate. During that period, Australia has also adopted the UNCITRAL Model Law on Cross-Border Insolvency,[3] to assist in addressing complexities in cross-border insolvencies, and in recognition of the global environment in which many Australian companies operate.

To state the obvious, it is important that Australia's insolvency laws remain fit-for-purpose and consistent with community expectations about how a company is to be governed and managed at each stage of its life cycle. A comprehensive review that not only considers the past 30 years of jurisprudence on our current insolvency regime, but also assesses the impact of our insolvency laws on our trading partners, on domestic and international capital markets and other economic and social factors, would be a significant and invaluable development.

1 Australian Law Reform Commission, General Insolvency Inquiry [1988] ALRC 45.
2 Australian Law Reform Commission, General Insolvency Inquiry [1988] ALRC 45, p 1.
3 Enacted by the *Cross-Border Insolvency Act 2008* (Cth).

4. Introduction

This Report considers the operation of the safe harbour provisions contained in sections 588GA and 588GB of the Act together with relevant ancillary provisions. All references in this Report to the Act are, unless otherwise noted, references to the *Corporations Act 2001* (Cth), and all references to safe harbour, unless otherwise noted, are references to sections 588GA and 588GB of the Act. The Panel recognises that the safe harbour is a legislative carve-out to the underlying prohibition on insolvent trading in the Act and has provided analysis on this basis. However, the safe harbour is also a concept that needs to be readily understood by directors. The Panel notes that the idea of the safe harbour as a 'defence' or a 'harbour' in which to moor appears to resonate with many directors who may need to rely on it. We do not feel it necessary to get stuck on semantics. Therefore, any references in this Report to the safe harbour 'defence', 'being in' and/or 'entering into' safe harbour should be understood as a director seeking to rely on the safe harbour legislative carve-out to the prohibition on insolvent trading.

Throughout this Report, reference is made to small and medium-sized enterprises (**SMEs**), 'SME companies' and the 'SME market'. However, from the Panel's consultation process, it is clear there is no uniform view of what constitutes a SME.[4] The Australian Bureau of Statistics (**ABS**) defines small businesses as employing 0-19 employees and medium businesses as employing 20-199 people.[5] While this serves as a general guide to defining a SME company, there are many who would not consider a company that employs close to 200 people as an SME. As a result, when referring to SMEs, the Panel has also had regard to other factors associated with SMEs including that they usually have common owners and management, minimal internal accounting resources and thin levels of capital.

Our references to medium or mid-market companies are those whose enterprise value may not be considered large, but which fall in between SMEs and large corporates. They typically have more disperse owners and managers, and greater levels of capital than an SME.

When considering the discussion points and recommendations received as part of the Panel's consultation process, it became clear that the content of most submissions fell into 2 broad categories. First, many submissions considered the terminology of the safe harbour provisions and how they should be interpreted. In this Report, we refer to these considerations as the **Legislative Considerations**. Second, many submissions considered the broader framework within which the prohibition on insolvent trading sits, including how it interacts with other directors' duties and unfair preferences. In this Report, we refer to these considerations as **Other Considerations**.

The Report is divided into 5 parts:

- First, we outline the prohibition on insolvent trading and the context in which the safe harbour provisions were introduced.
- Second, we consider the impact of the introduction of the safe harbour provisions and how they operate in practice.

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4 By way of example, some parties consider 'micro' businesses as those with a turnover of up to $1 million per annum, while others consider micro businesses as having a turnover of up to $5 million per annum. Similarly, some parties consider the 'small' companies in the SME market to have an enterprise value of between $10 million and $50 million (with an even greater enterprise value for 'medium' companies in the SME market), whereas other parties view SMEs as having an annual revenue of between $1 million and $10 million.

5 Australian Bureau of Statistics website: <https://www.aph.gov.au/about_parliament/parliamentary_departments/parliamentary_library/pubs/rp/rp1516/quick_guides/data>.

- Third, we outline the main Legislative Considerations, discuss the issues raised and consider whether improvements are necessary or desirable.
- Fourth, we examine the issues raised as Other Considerations, notably the overwhelming feedback for a holistic review of Australia's insolvency laws.
- Fifth, and finally, we include a list of recommendations.

This Report also refers to the recently introduced provisions aimed at combatting illegal phoenixing,[6] and those implementing the Small Business Restructuring (**SBR**) framework.[7] The Panel did not receive any detailed submissions that considered the application of the safe harbour vis-à-vis these provisions. Given this, and the recency of their enactment, this Report touches on them only briefly.

Finally, we note that the views of the Panel members expressed in this report are expressed in their personal capacity and are not to be viewed as representative of their places of work, or any industry bodies of which they are members.

6 *Corporations Act 2001* (Cth) ss 588FDB and 588FE(6A).
7 *Corporations Act 2001* (Cth) s 588GAAB.

5. Context of Safe Harbour

5.1 Insolvent trading: what is it?

To understand what is meant by 'safe harbour', it is necessary to consider what safe harbour offers protection from.

In Australia, directors have a strict duty under section 588G of the Act to prevent insolvent trading by a company. A director can be held personally liable for debts incurred by a company while it is insolvent, if at the time the debt was incurred, the director was aware there were reasonable grounds to suspect that the company was insolvent (or would become insolvent by incurring that debt), or if a reasonable person in a like position in a company in the company's circumstances would be so aware.[8] Section 588G is a civil penalty provision,[9] meaning a director's contravention of the duty may result in a court making orders including a pecuniary penalty order, or disqualifying the director from managing corporations.[10] Criminal sanctions may also apply where the failure to prevent the company incurring the debt was dishonest.[11]

The party seeking to establish that a breach of the duty has occurred bears the burden of proving its elements. Those elements are as follows.

a) Debts

The company must have incurred a debt.[12] Section 588G is concerned with *debts* as opposed to all *liabilities*. The term 'debt' is not defined in the Act. However, it is accepted that a debt constitutes a liability to pay a liquidated amount, even if the liability to pay is contingent.[13] Accordingly, unliquidated or 'unascertained' claims, such as a liability to pay an unliquidated amount of damages for breach of contract, are not regarded as debts for the purpose of section 588G.[14] Section 588G(1A) also contains a list of actions which may be taken by a company which result in a debt being incurred, such as the payment of a dividend or the company's entry into a buy-back agreement for shares.[15] Determining when a debt is incurred otherwise turns on when the company is exposed to the

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8 *Corporations Act 2001* (Cth) ss 588G and 588J. See also s 1317H.

9 *Corporations Act 2001* (Cth) s 1317E.

10 *Corporations Act 2001* (Cth) ss 1317G and 206C.

11 *Corporations Act 2001* (Cth) s 588G(3).

12 *Corporations Act 2001* (Cth) s 588G.

13 See *Hawkins v Bank of China* (1992) 26 NSWLR 562, 572 (Gleeson CJ). In the recent case of *Quin v Vlahos* [2021] VSCA 205, the Victorian Court of Appeal stated, with respect to the meaning of 'debt' in section 588G, that '[a] useful starting point is the ordinary legal meaning of a debt, being 'a sum of money which is now payable or will become payable in future by reason of a present obligation' (at [250], citations omitted).

14 *Shephard v Australia & New Zealand Banking Corp Ltd* (1996) 41 NSWLR 431; see also *Re Simmoll Pty Ltd* [2021] VSC 693, [45] (Hetyey AsJ). Although, the law in relation to the status of unliquidated claims in the assessment of a company's solvency is unsettled: see, for example, L Powers, 'The Impact of Unliquidated Claims When Assessing Solvency: A Director's Dilemma' (2017) 32 Aust Jnl of Corp Law 368.

15 *Corporations Act 2001* (Cth) s 588G(1A).

relevant liability as a matter of commercial reality.[16] There must be no other action that the company can take to avoid the obligation to pay.[17]

Submissions received by the Panel queried why section 588G should be limited to only 'debts'. As an example, 2 submissions queried why the issuance of a gift card the day before an appointment of an administrator should not also constitute a debt within the meaning of section 588G.[18] The Panel has not formed a view as to the merits of the present construction of a debt for the purpose of the insolvent trading prohibition, and believes it is outside the ambit of this Review to consider whether the underlying prohibition should extend to a broader definition of liabilities (and if so, what those additional liabilities should be). The concept of a debt as interpreted in the insolvent trading context has application in other contexts, including statutory demands.[19] Accordingly, any reconsideration of debts and liabilities should be done as part of a holistic review of Australia's insolvency laws.

b) Insolvency

The company must have been insolvent at the time the debt was incurred or it must have become insolvent as a result of incurring debts which include the relevant debt.[20] The focus of section 588G is, therefore, insolvency; either the existence of insolvency at the time the debt was incurred or the consequence of insolvency from the debt being incurred. It requires directors to comprehend the nuanced distinction between financial distress and insolvency. It also requires directors to, prima facie, bear the risk of a company trading while insolvent. For that reason, prior to the introduction of the safe harbour provisions, the Australian corporate regulatory framework was described as the strictest in the world.[21] Some say it remains so.[22]

The concepts of solvency and insolvency are defined in section 95A of the Act, which states that:

- a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable, and
- a person who is not solvent is insolvent.[23]

Section 95A adopts a cashflow test of insolvency which turns upon the cash sources available to the company and the expenditure obligations that it has to meet. An alternative balance sheet test, which examines whether a company's liabilities exceed the value of its assets, can provide context for the application of the cashflow test.[24] The cashflow test provides only a starting point for the analysis: the statutory emphasis is on solvency and not liquidity.[25] Solvency is a question of fact to be determined by reference to the company's financial position taken as a whole, viewed in light of commercial realities.[26] This requires a court to consider the nature of the company's business, its recent trading history, its current assets, its ability to realise other assets, its ability to borrow money

16 *Australian Securities and Investments Commission v Plymin* (No 1) (2003) 175 FLR 124, [516] (Mandie J); *Re Overgold Pty Ltd* [2019] VSC 624, [9]-[19] (Gardiner AsJ).
17 *Hawkins v Bank of China* (1992) 26 NSWLR 562.
18 ARITA submission, p 23 of Appendix B; Wellard submission, p 8.
19 *Re Simmoll Pty Ltd* [2021] VSC 693, [45]-[51] (Hetyey AsJ).
20 *Corporations Act 2001* (Cth) s 588G.
21 Chief Justice Wayne Martin, 'Official Opening Address' (Speech delivered at Insolvency Practitioners' Association of Australia Conference, Burswood Entertainment Complex, 28 May 2009).
22 For example, the AICD/BCA noted that 'Australia's insolvent trading rules remain among the strictest in the world.' (AICD/BCA submission, p 3).
23 *Corporations Act 2001* (Cth) s 95A.
24 *Re Swan Services Pty Ltd (in liq)* [2016] NSWSC 1724, [136] (Black J).
25 N F Coburn, *Coburn's Insolvent Trading* (Lawbook Co, 2nd ed, 2003), p. 66, as cited in *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1, [1073] (Owen J).
26 *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213, 224 [54] (citations omitted) (Palmer J); *Sandell v Porter* (1966) 115 CLR 666, 670 (Barwick CJ).

(with or without security) in time to meet its debts and its overall asset and liability position.[27] The courts have recognised a number of indicators, or common features, of insolvency,[28] although their significance will vary from case to case.[29]

Solvency under section 95A is to be assessed by reference to those circumstances that were known or knowable at the relevant time.[30] The test, however, calls for a 'degree of forward-looking'.[31] That is, it is relevant to consider a company's ability to pay future debts. The company's circumstances dictate how far into the future that assessment must extend.[32] However, insolvency on the basis of a company's inability to pay long-term debts, being those debts that are not payable immediately or in the near future, is difficult to establish. This is because it is difficult to show to a sufficient degree of likelihood that, as at the date of alleged insolvency, the company would not be able to repay its debts when they fall due in the future.[33]

c) Reasonable grounds to suspect insolvency

The director must have failed to prevent the company from incurring a debt in circumstances where the director was either objectively aware, or where a reasonable person would have been so aware,[34] that there were reasonable grounds to suspect that the company was insolvent or would become insolvent when the debt was incurred.[35]

The prohibition on insolvent trading is concerned with 'the timing of when debts are incurred by a company rather than the conduct of the directors in incurring that debt'.[36] Personal culpability is, therefore, less relevant to the prohibition on insolvent trading under section 588G when compared with other directors' duties. This is because section 588G does not require that a director's actions are dishonest or fraudulent, nor does it require that a director subjectively knew that their company was insolvent when they incurred the debts.[37] That being said, the director's state of mind *is* relevant to characterising the nature of the contravention (for example, whether the breach is civil or criminal) and ascertaining the appropriate penalty.[38]

27 *Barboutis v Kart Centre Pty Ltd (No 2)* [2020] WASCA 41, [121] (Buss P, Mitchell and Vaughan JJA); *The Bell Group Ltd (in liq) v Westpac Banking Corporation* (No 9) (2008) 39 WAR 1, [1090] (Owen J).

28 *Australian Securities and Investments Commission v Plymin (No 1)* (2003) 175 FLR 124, [386] (Mandie J); *Smith v Boné* (2015) 104 ACSR 528, [31]-[32] (Gleeson J).

29 *Lewis, Re Damilock Pty Ltd (in liq) v VI SA Australia Pty Ltd* (2008) 252 ALR 533, [16] (Mansfield J).

30 *Lewis v Doran* (2005) 219 ALR 555, [103] (Giles JA, Hodgson JA and McColl JA agreeing); *Re Swan Services Pty Ltd (in liq)* [2016] NSWSC 1724, [136] (Black J).

31 *Westgem Investments Pty Ltd v Commonwealth Bank of Australia Ltd (No 6)* [2020] WASC 302, [1057] (Tottle J); see also *Duncan v Commissioner of Taxation, Re Trader Systems International Pty Ltd (in liq)* (2006) 58 ACSR 555, [39] (Young J); *Expo International Pty Ltd v Chant* (1979) 2 NSWLR 820, 839 (Needham J).

32 *Lewis v Doran* (2005) 219 ALR 555, [100]-[104] (Giles JA, Hodgson JA and McColl JA agreeing); *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1, [1128] (Owen J); *Re Cube Footwear* [2013] 2 Qd R 501, [50]-[55] (Jackson J); *Barboutis v Kart Centre Pty Ltd (No 2)* [2020] WASCA 41, [123] (Buss P, Mitchell and Vaughan JJA).

33 See *Anchorage Capital Master Offshore Ltd v Sparkes (No 3); Bank of Communications Co Ltd v Sparkes (No 2)* [2021] NSWSC 1025, [265]-[267], [298] (Ball J).

34 A reasonable person in this context is a director of ordinary competence who is capable of reaching a reasonably informed position about the financial capacity of the company: *Credit Corp Australia Pty Ltd v Atkins* (1999) 30 ACSR 727, 741 (O'Loughlin J); *Australian Securities and Investments Commission v Plymin (No 1)* (2003) 175 FLR 124, [423] (Mandie J).

35 *Corporations Act 2001* (Cth) s 588G(1)(c).

36 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017 [1.6].

37 *Green, Arimco Mining Pty Ltd (in liq) v CGU Insurance Ltd* (2008) 67 ACSR 398 (Einstein J).

38 *Australian Securities and Investments Commission v Plymin (No 1)* (2003) 175 FLR 124, [426] (Mandie J).

d) Defences

Section 588H of the Act outlines limited statutory defences that are available to a director who has engaged in insolvent trading.[39] Namely, that the director:

- had reasonable grounds to expect solvency
- placed reasonable reliance on information provided by others as to the company's solvency
- had a justifiable reason not to participate in the management of the company at the time the debt was incurred, or
- took all reasonable steps to prevent the company from incurring the debt.[40]

None of the aforementioned defences permit a director to knowingly engage in insolvent trading. Rather, the defences provide relief in circumstances where the director was unaware of the debt or actively attempted to prevent the debt from being incurred.

The court also possesses a broad discretion under sections 1317S and 1318 of the Act to excuse a director from liability where they have acted honestly and ought fairly be excused in the circumstances of the case.[41]

The safe harbour provisions provide a carve-out to the civil liability of directors under section 588G(2). However, they are not a carve-out to the criminal offence set out in section 588G(3). The Panel's consultation process did not reveal any concerns with the operation of the criminal offence for insolvent trading contained in section 588G(3). However, we note that this provision has rarely been engaged in practice.

e) Reflections on assessing insolvency

As can be seen from the above analysis, there is complexity in establishing solvency and insolvency under section 95A of the Act. This can make it difficult for directors to assess whether they are complying with the law.

In the period prior to an insolvency appointment, the major focus by directors is on cash flow, given its direct correlation with solvency. The balance sheet is relevant only to the extent that consideration is given to assets to be sold or pledged for the purpose of providing working capital or to repay debt. However, once an insolvency appointment occurs, the focus of stakeholders diverts to the balance sheet and whether the company has sufficient realisable assets to meet its liabilities.

Separately, the nature of a balance sheet pre-appointment and post-appointment can differ materially due to a variety of reasons, including:

- employee notice and redundancy provisions crystallising
- long-term lease liabilities (in particular landlord claims) being brought forward
- cash being swept by secured creditors under security arrangements
- an increase in the number of debtors claiming they are not obliged to pay amounts outstanding
- asset values being impacted by 'forced sale' implications as opposed to 'going concern' implications, and
- the value of many intangible assets, which can sometimes be a significant part of a balance sheet (such as goodwill), disappearing.

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39 *Corporations Act 2001* (Cth) s 588H.
40 *Corporations Act 2001* (Cth) s 588H(1)–(4).
41 *Corporations Act 2001* (Cth) s 1317S.

Due to the complexities in assessing solvency, experts often disagree as to whether a company is solvent or not. Different opinions can arise in relation to asset values, the extent of liabilities, and the borrowing capacity of a company. There can also be differences of opinion as to whether trading results and cash flow projections were prepared on reasonable assumptions. These complexities create uncertainty for both directors and creditors, as was evidenced in the recent *Arrium* judgment.[42] Further, solvency is not a fixed state: companies can go in and out of solvency, depending on their liquidity, trading conditions and the capitalisation of the company (among other things). Pinpointing a company's solvency at any given time can be a very difficult, multifaceted analysis that even experienced judges and insolvency experts find challenging, yet section 588G requires the common director to do just that.

5.2 Purpose of insolvent trading laws

When a company is insolvent, or nearing insolvency, there is a misalignment between the interests of the traditional stakeholders of that company (being its shareholders), and the interests of its creditors. In such circumstances, most jurisdictions (Australia included) regulate the directors' conduct to:

- protect creditors by ensuring that any remaining assets of a company are not further diminished and, also, to provide a form of recourse for creditors to recoup their financial losses in the event of liquidation, and
- encourage responsible directorial action as part of the broad suite of duties imposed on company directors.

The positive duty to prevent insolvent trading was introduced into the former *Corporations Act 1989* (Cth) by the *Corporate Law Reform Act 1992* (Cth). The *Corporate Law Reform Act 1992* (Cth) implemented recommendations from the Harmer Report.[43] Underpinning the Harmer Report's recommendations was a policy position that some of the risk for insolvent trading should be borne by directors. It was acknowledged that directors should be 'accountable for irresponsible behaviour, particularly where it affects creditors of the company'.[44]

Risk allocation is central to insolvent trading provisions. Who ought to bear the cost of failure permeates all substantive analysis of the underlying effectiveness of the prohibition on insolvent trading and the safe harbour provisions. In what circumstances, and to what extent, the risk of corporate failure should be borne by creditors, directors, advisers or the Commonwealth is a question that goes to the heart of Australia's insolvency regime. In allocating the risk, insolvent trading provisions attempt to strike a balance between protecting creditors' rights and preserving businesses.

In introducing the safe harbour regime in 2017, the Commonwealth was critical of how the threat of Australia's insolvent trading laws, coupled with uncertainty over the precise moment a company becomes insolvent, led directors to seek voluntary administration even when the company may be viable in the long term.[45] The insolvent trading provisions were never meant to be draconian and punitive, rather, they were intended to incentivise responsible conduct and companies 'putting their hand up' early.

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

43 Explanatory Memorandum to the Corporate Law Reform Bill 1992 (Cth), Part 4.

44 Australian Law Reform Commission, General Insolvency Inquiry [1988] ALRC 45, Chapter 7, p 121.

45 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p 3.

In recognising this, the safe harbour provisions are not only a re-allocation of the risk of corporate failure (away from directors). They also reflect a policy that the purpose of the insolvent trading provisions is not just protection of creditors, but also a governance tool to encourage directors to take a more proactive approach to restructuring the company and returning it to viability, where possible.

The impact of safe harbour in terms of shifting the distribution of risk between stakeholders has likely not yet been seen in full. The lack of recent insolvencies is primarily due to the unprecedented developments that have taken place over the past 2 years, including the introduction of the COVID-19 moratorium, government stimulus packages, the National Cabinet Mandatory Code of Conduct: SME Commercial Leasing Principles during COVID-19, reduced ATO recovery initiatives, interest and loan repayment holidays offered by the major banks, and the general forbearance of creditors throughout the pandemic.[46]

5.3 Background to safe harbour introduction

In 2016, the Commonwealth released the Improving Bankruptcy and Insolvency Laws: Proposals Paper (**Proposals Paper**). The Proposals Paper raised the possibility of introducing a safe harbour to limit the risk of personal liability for directors of an insolvent company where the directors become involved in restructuring efforts.[47] It argued that a safe harbour would strengthen Australia's start-up culture by encouraging entrepreneurship including by assisting start-ups to attract experienced and talented board members.

Adopting one of the 2 alternate models advanced in the Proposals Paper, the Commonwealth introduced safe harbour provisions into the Act via the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth).

The Explanatory Memorandum to the *Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017* (Cth) noted that current insolvent trading laws 'put too much focus on stigmatising and penalising failure'.[48] The safe harbour reforms aimed to promote 'a culture of entrepreneurship and innovation which will help drive business growth, local jobs and global success.'[49]

The key (overlapping) purposes of safe harbour were identified as:

- promoting a culture of entrepreneurship and innovation, as well as reducing the stigma of failure associated with insolvency[50]
- protecting honest and diligent company directors from personal liability when pursuing a restructure outside formal insolvency[51]
- encouraging company directors to keep control of their company by engaging early with possible insolvency and taking reasonable risks to facilitate the company's recovery[52]

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46 Deloitte submission, p 4.
47 Proposals Paper (Improving Bankruptcy and Insolvency Laws) 2016.
48 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p 3.
49 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p 3.
50 Second Reading Speech - Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p4908.
51 Second Reading Speech - Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p 4907.
52 Second Reading Speech - Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p 4907.

- reducing instances of otherwise viable companies proceeding to a formal insolvency process prematurely,[53] and
- where companies do enter a formal insolvency process, they will have a better chance of being turned around or of preserving value for creditors and shareholders, which in turn will promote the preservation of enterprise value for companies, their employees and creditors.[54]

5.4 Overview of safe harbour

The safe harbour provisions establish a carve-out to the insolvent trading prohibition and (in contrast to that prohibition) are centred on the conduct of directors when incurring debts.

In essence, they provide that the insolvent trading prohibition does not apply to company directors who, after beginning to suspect their company is or may become insolvent, start developing one or more courses of action that are 'reasonably likely to lead to a better outcome for the company'.[55] A better outcome is defined as 'an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company'.[56]

Matters that may be considered in working out whether that course of action is 'reasonably likely to lead to a better outcome for the company' include that a company director is:

- properly informing themselves of the company's financial position
- taking appropriate steps to prevent misconduct by company officers or employees that could adversely affect the company's ability to pay all its debts
- taking appropriate steps to ensure the company is keeping appropriate financial records consistent with its size and nature
- obtaining advice from an appropriately qualified entity, or
- developing or implementing a restructuring plan for the company to improve its financial position.[57]

To access safe harbour protection, the company is required to have substantially paid its employee entitlements and have substantially up-to-date tax lodgements.[58]

Directors will be protected by safe harbour unless, or up until the point at which:

- they fail to take the course(s) of action developed within a reasonable period
- they cease implementing the course(s) of action
- the course(s) of action ceases to be reasonably likely to lead to a better outcome for the company, or
- an administrator or liquidator of the company is appointed.[59]

A director who wishes to rely on safe harbour in response to a claim for breach of their duty to prevent insolvent trading bears the evidential burden of demonstrating they are entitled to safe

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53 Second Reading Speech - Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p 4908.
54 Second Reading Speech - Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), p 4908.
55 *Corporations Act 2001* (Cth) s 588GA(1).
56 *Corporations Act 2001* (Cth) s 588GA(7).
57 *Corporations Act 2001* (Cth) s 588GA(2).
58 *Corporations Act 2001* (Cth) s 588GA(4).
59 *Corporations Act 2001* (Cth) s 588GA(1)(b).

harbour protection (namely, that they satisfy the requisite elements and pre-conditions outlined in the provisions).[60]

There is also a parallel safe harbour provision which applies to holding companies in respect of their subsidiaries.[61]

The safe harbour provisions are extracted in full in Annexure C.

5.5 Overview of small business restructuring safe harbour

Section 588GAAB of the Act, which came into effect earlier this year as part of the adoption of the SBR reforms, provides a simplified safe harbour for SMEs undertaking a restructure. The SBR provisions are extracted in full in Annexure D.

The SBR reforms aim to provide a simpler, faster and more cost-effective insolvency process for SMEs to restructure,[62] and include the following key features:[63]

- total liabilities[64] of the company must not exceed $1 million (excluding any employee entitlements owing)
- none of the directors or the company (nor anyone who was a director in the past 12 months) may have used the restructuring or simplified liquidation process within the last 7 years
- all tax lodgements must be brought up to date by the time a restructuring plan is proposed to creditors
- all employee entitlements that are due and payable must be paid by the time a restructuring plan is proposed to creditors
- the board must resolve that it is insolvent or likely to become insolvent at some future time, and that a SBR practitioner should be appointed
- a SBR practitioner oversees the restructuring process, and works with the company to develop the restructuring plan and proposal statement
- creditors are notified
- the restructuring plan is put to creditors for a vote, and
- all debts incurred after the company enters restructuring are not part of the plan and must be paid off outside of the plan.

Section 588GAAB provides that the duty to prevent insolvent trading does not apply to a person and a debt incurred by a company if the debt is incurred:

- during the restructuring of the company, and
- in the ordinary course of the company's business (or otherwise with the consent of the restructuring practitioner or by order of the Court).

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60 *Corporations Act 2001* (Cth) s 588GA(1), Note 1.
61 *Corporations Act 2001* (Cth) s 588GWA.
62 Explanatory Memorandum to the Corporations Amendment (Corporate Insolvency Reforms) Bill 2020, p 63.
63 *Corporations Act 2001* (Cth) Schedule 3, item 8, s 500AA.
64 Liability is defined as any liability to pay an admissible debt or claim (see *Corporations Regulations 2001* (Cth), reg 5.3B.03(5) and the definition of 'admissible debt or claim' in reg 5.3B.01; *Corporations Act 2001* (Cth) s 553(1))

Critically, the SBR safe harbour is different to the primary safe harbour provisions in the following ways:

- a restructuring practitioner must be appointed, and must be a registered liquidator
- non-lodgement of taxes and non-payment of employee entitlements do not preclude the appointment of a SBR practitioner, nor the operation of the SBR safe harbour provisions (in each case, provided they are paid by the time a restructuring plan is proposed to creditors)
- creditors are notified, and ipso facto protections apply to impose a moratorium during the planning period, and
- the only consideration in relation to the debts incurred is, as noted above, that the company is restructuring, and that the debt was incurred in the ordinary course of the company's business (or otherwise with the consent of the restructuring practitioner or the Court).

A person seeking to rely on the SBR safe harbour bears a similar evidential burden to that which applies in the primary safe harbour provisions.

5.6 No judicial guidance on safe harbour

There has been little to no judicial guidance on the safe harbour provisions since they came into force.[65] The lack of judicial guidance was cited by stakeholders as a reason for the lack of certainty concerning the operation of the provisions, and underpinned requests for greater guidance throughout the Panel's consultation process.

There is also mixed judicial guidance on the insolvent trading prohibition, which creates an added difficulty for directors who seek to ascertain whether a company is insolvent or approaching insolvency.

65 The Panel notes the decision of the Victorian Supreme Court in *Re Balmz Pty Ltd (in liq)* [2020] VSC 652. Whilst the safe harbour provisions were raised by a party in that case, the Court did not engage in any in-depth consideration of how those provisions are to be interpreted.

Part II
The impact and availability of safe harbour

6. General awareness of safe harbour

6.1 Current state of awareness

One dominant theme emerging from the Panel's consultation process was insufficient awareness and understanding of safe harbour provisions among directors and many advisers. Stakeholders submitted that greater education is necessary to bolster directors' awareness of the options available to them when a company is in financial distress.

Stakeholders highlighted that awareness levels differ between large and small companies. Directors of large companies are more likely to have knowledge of safe harbour compared to their counterparts in the SME and medium-sized markets. Even where a director of a large company does not possess particularised knowledge about the safe harbour provisions, their advisers do.

Clearly advisers in the insolvency and restructuring space are likely to know about safe harbour. Whether general commercial advisers have knowledge of safe harbour and the insolvent trading provisions was a little less clear from the submissions received. The accounting bodies – CA ANZ, CPA and IPA – believe their members possess a general awareness of the safe harbour provisions. However, a survey conducted by the Australian Restructuring Insolvency & Turnaround Association (**ARITA**) of its members found that 70 per cent of respondents believed there was limited or no knowledge of safe harbour among accountants and lawyers in the members' referral networks.[66]

The Panel saw a marked difference in responses when it came to awareness of safe harbour among SME directors. The general consensus from our consultations is that there is little interest, awareness, knowledge or uptake of safe harbour in the SME market.

In ARITA's survey of its members, 25 per cent of respondents noted that SME directors did not even know what insolvent trading was.[67] The Panel notes that if directors do not possess an awareness of the underlying insolvent trading provisions, their knowledge of the safe harbour legislative carve-out to those provisions is likely to be even less.

A number of submissions contended that even if there was increased knowledge and awareness among SME directors, the fact that the personal wealth of these SME directors is often heavily intertwined with their company (that is, through personal guarantees and potential personal liability for tax debts) means they are unlikely to seek safe harbour protection. This is because the safe harbour provisions will not protect them from their existing or potential personal liability. Therefore, no matter how much the awareness of these SME directors increases, or no matter how they may be encouraged to seek professional advice early, there is concern that their behaviour may remain unchanged.

Submissions by firms which undertake formal insolvency appointments note that there have been relatively few instances of directors raising safe harbour protection when companies have been placed in liquidation. ARITA asked its members who had been involved in safe harbour engagements how many times safe harbour had been put forward by directors as an argument to protect them from an insolvent trading claim in a subsequent liquidation. Of the 34 respondents, 26 said 'zero times' and 8 said between 'one and 5 times'.[68] ARITA also asked its registered liquidator members how many times safe harbour had been relied on by directors in response to an insolvent trading

66 ARITA submission, p 27 and Appendix A, p 32.
67 ARITA submission, p 10.
68 ARITA submission, Appendix A, p 41.

claim by them in a subsequent liquidation.[69] 59 per cent of respondents to that question said 'never', 14 per cent of respondents said between 'one and 5 times', and one respondent said it had been raised with them '6 to 10 times'.[70]

The Panel also refers to the insolvent trading moratorium that applied during a large part of 2020. The moratorium was described as a 'temporary safe harbour' and was widely publicised. Considering the already low levels of awareness about primary safe harbour provisions, the Panel is concerned that directors may conflate the 2 and not appreciate that the primary safe harbour operates differently. Directors did not have to take any positive steps to receive protection under the moratorium. This is not the case with the primary safe harbour provisions that require directors to substantially meet certain pre-conditions (employee entitlement payment and tax reporting). The safe harbour provisions also require directors to be developing one or more courses of action 'reasonably likely to lead to a better outcome for the company' in order to receive protection.

6.2 Improving awareness

Ultimately, the prohibition on insolvent trading, and the safe harbour carve-out, are intended to encourage and uphold good governance. Education is key to attaining that objective. One of the best initial sources for directors is the corporate regulator, ASIC, which can perform the role of educator as well as enforcer. This can, and should be, supplemented by guidance from ARITA, the Turnaround Management Association (**TMA**), the AICD and other industry bodies, and that is considered further below.

The overwhelming feedback from the Panel's consultation process is that it needs to be easier for directors to find simple, plain English guides on their duties and responsibilities, particularly in relation to their personal liabilities for insolvent trading and the existence of the safe harbour provisions. The private sector can, and does, supplement that education. However, we see enormous benefits for directors and advisers who can access general introductory advice from ASIC and/or another reliable public source.

Submissions support the development of specific user-friendly, plain English safe harbour guides, an update of ASIC's Regulatory Guide 217 to refer to safe harbour, and practical policy guidance from ASIC on the application of the provisions – particularly in the absence of any case law.

We make the following observations about the information which is currently available to directors on the ASIC website:

- ASIC's Regulatory Guide 217, which is a guide on a director's duty to prevent insolvent trading, does not refer to safe harbour. ASIC has informed the Panel that this Regulatory Guide is due to be updated and that it has been awaiting the outcome of this Review before doing so. We strongly support an update to ASIC's Regulatory Guide 217 to reflect not only the prohibition on insolvent trading, but also the safe harbour provisions.
- More generally, the 'For business' page on the ASIC website does not reference restructuring, insolvency or turnaround, containing only a reference to 'Closing your company' (which details the process of deregistration). However, references to 'financial difficulty' can be found on the ASIC website via a link entitled 'Running a company – Company officeholder duties'. ASIC also provides some insolvency guides, including one for directors, which can be found under the 'Regulatory resources' tab. The Panel encourages ASIC to include co-ordinated references to 'financial distress' or 'financial difficulties' on its 'For business' page, with direct links to existing resources and any future safe harbour guides that are developed. This could also be supported by

69 ARITA submission, Appendix A, p 43.
70 ARITA submission Appendix A, p 43.

other government organisations (for example, the ATO) so that messaging to directors is consistent from a public policy perspective.

The AICD/BCA submission[71] encourages ASIC to develop guidance on existing best practice in consultation with industry participants.

The Panel believes it is sensible for a corporate regulator tasked with policing breaches of insolvent trading laws, such as ASIC, to make public its views on the relevant provisions, what conduct may raise alarm bells with regard to insolvent trading and/or which may entitle or disentitle a director to rely on the safe harbour provisions.

The Panel acknowledges that any ASIC guide needs to be qualified as representing ASIC's view. If a court subsequently formed a different view to ASIC, directors will nevertheless be armed with a minimum standard ASIC considers representative of good director behaviour when it comes to insolvent trading (which will necessarily need to address the safe harbour provisions). The provision of this information and educational resources would also be a step toward fostering cultural change and improving good director governance more broadly.

The Panel acknowledges that there can never be an exhaustive list of items to be ticked that satisfy directors' duties. The application of directors' duties to the individual circumstances they face requires an informed commercial judgement of the issues pertinent to their company. Accordingly, the Panel is cautious of any safe harbour guide that is too prescriptive.

Other issues raised by stakeholders include the general lack of knowledge among company directors of 'director fundamentals', including directors' duties (particularly in the twilight zone of insolvency), financial literacy and good governance. Stakeholders consulted during this Review recognise the role of industry bodies, such as the AICD, in promoting director fundamentals to larger corporations. However, not every company director is a member of the AICD. Indeed, it is highly likely most SME directors are not AICD members. As previously discussed, ASIC does provide guidance about directors' duties, but a director would need to be actively looking to find it. With the introduction of the Director Identification Number (a unique identifying number that a director applies for and keeps forever), there may be greater opportunity for information to be disseminated to directors (particularly newly appointed directors) which will assist in promoting ongoing awareness of their obligations.

Although this part of the report has focused primarily on the potential educative role of ASIC as the corporate regulator, stakeholders have commented on the need to increase and reinforce awareness of safe harbour as an informal restructuring tool among a company's external advisers, including external tax and general accountants, general commercial lawyers and business bankers. The Panel notes that guides published by key industry bodies often differ, and so would welcome a best practice guide produced by Treasury following consultation with, and endorsement by, key industry bodies. Such a guide could sit alongside ASIC's guidance, as invaluable information sources for directors and advisers.

71 AICD/BCA submission p 9.

7. Impact of the availability of safe harbour practices

The Panel's consultation process highlighted that the safe harbour provisions are a positive development that improve governance outcomes and deliver real options to directors of listed companies, large companies, and some medium companies. The evidence is less clear that it is a mechanism that directors of SMEs and smaller medium companies access successfully. For those SMEs that fit within the parameters which allow them to take advantage of the SBR reforms adopted earlier this year, the relevance of the primary safe harbour provisions (to the extent they were ever appropriate to such companies) has arguably diminished.

7.1 Impact of safe harbour on directors

a) General observations

The safe harbour was introduced to give directors of viable companies breathing space from insolvent trading laws conditional upon them undertaking a restructuring plan to provide a better outcome for the company. Accordingly, their experience of its impact is key to evaluating whether the safe harbour provisions are working as intended.

From the Panel's consultation process, many professionals are unclear on the workings of the safe harbour provisions as a governance tool and attempt to categorise it as a point-in-time event. The availability of the safe harbour provisions is not a set-and-forget concept. It requires directors to monitor performance and prospects as they pursue the plan, and to continually assess whether (with all the inevitable machinations of a turnaround as it develops) the plan is still reasonably likely to lead to a better outcome for the company. Using this framework mitigates against possible personal liability for directors by enabling them to focus on obtaining a better outcome for their company and encouraging better corporate governance.

In submissions received from the AICD/BCA, TMA and other leading practitioners, there is clear evidence many directors of large and larger medium-sized companies have used the safe harbour framework successfully to guide them through restructuring plans towards a better outcome. The relevant companies avoided voluntary administration or liquidation in most of the examples provided.

Larger companies are more likely to have access to capital, debt and resources sufficient to implement a restructuring plan. Often boards of these companies have sound governance structures, independent non-executive directors and sufficient resources to access lawyers and experienced advisers to assist their restructuring plans and implementation.

More detail on the experience of directors (and advisers) of safe harbour in practice is set out in section 7.3 below. The examples given show (albeit often from the perspective of advisers) that directors are:

- for the most part, engaging with the safe harbour provisions
- in many instances, obtaining advice from appropriately qualified entities (**AQEs**) which leads to better financial forecasts and financial models being produced, and
- seeking to ensure that their tax lodgments are up to date and employee entitlements paid.

Our consultations confirmed that this engagement by directors and advisers with the safe harbour provisions has led to a change in dialogue and emphasis among boards. After dealing with the gateway issues for whether safe harbour is available, directors have a greater focus on turnaround (rather than just avoiding personal liability). As noted, this change has been experienced particularly in larger companies and/or sophisticated boards.

Some stakeholders raised concerns that some boards faced with financial distress are concerned about a stigma associated with 'safe harbour', as well as potential consequences for the company under its material documents and (if listed) its continuous disclosure obligations. These concerns are addressed more fully in section 8.1 of this Report.

The impact of the availability of the safe harbour on directors of SMEs is considered separately below.

b) Directors of SMEs

In many of the submissions received, it was noted that directors in the SME market are either not aware of, or do not focus on, the legal consequences of trading while insolvent. The reason given is that capitalisation of most SME companies is so entwined with personal guarantees provided to third parties (such as landlords, other creditors or financiers) that the corporate veil offers little protection for such directors.

Accordingly, for many directors of companies in the SME market, their decision making is not driven by concerns of contravening insolvent trading laws. As such, whether they seek protection and guidance from the safe harbour provisions is of little consequence to them. Consultations also highlighted that directors of SMEs are more likely not to meet the pre-conditions of substantially paying employee entitlements and substantially complying with tax lodgments and are less to be able to pay external advisers.

Vantage, in its submission, provided a different viewpoint. In their submission and discussion with the Panel, Vantage confirmed they provided advice to SMEs and gave several examples where they knew (either directly or through third parties) of safe harbour advice being provided in the SME and mid-market. Vantage noted that in the SME market and mid-market, there are a number of individuals performing CRO, CEO, GM, CFO or COO roles (on an interim basis) who provide 'an excellent standalone solution at an appropriate price point'.[72] Vantage's only qualification concerned those they described as micro companies, for which they noted safe harbour advice was less common.[73]

c) Cost implications

The cost of safe harbour and safe harbour advice arose as an issue in the Panel's consultation process, although it appears to be a particular issue in the SME market. Stakeholders confirmed that larger companies are more willing and able to bear not just the cost of AQEs, but also the broader restructuring costs associated with engaging with the safe harbour provisions.

The perception safe harbour advice is costly has been put forward as another reason SME directors have not and will not engage with the provisions. Stakeholders advised that small companies lack the financial capacity to meet the cost of seeking safe harbour advice (even at rates of less than $5,000, as referred to in ARITA's survey)[74] and may not see value in spending any residual cash flow on restructuring. The cost of implementing restructuring may also be prohibitive for small businesses, if for example, it is dependent on downsizing a workforce and making employees redundant.

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72 Vantage submission, p 43.
73 Vantage submission, p 5.
74 ARITA Submission, p 30.

7.2 Impact of safe harbour on creditors and employees

a) Creditors

It is difficult to easily summarise creditors' interactions with the safe harbour provisions.

On the one hand, the Panel's consultation process found broad evidence that safe harbour has had a positive impact on creditors.

Wexted noted that 'better outcome' analyses undertaken during their engagements confirmed unsecured creditors and trade suppliers would have received lower returns if an external administrator had been appointed immediately.[75] In many cases this is because equity capital had been available in the course of action, which would not have been available in an insolvency appointment.

Deloitte also submitted that the impact of the safe harbour on creditors was positive, insofar as the overall better outcome was achieved (compared to a course of action which would have appointed an external administrator at the first possible indication of insolvency).[76] The AICD/BCA shared this perspective. In support of their claim that the safe harbour provisions had a generally positive impact on creditors, the AICD/BCA referred to an example of a large agriculture business with 200-300 employees that was facing liquidity challenges but received safe harbour advice from an experienced adviser and the directors were able to maintain the business and sell it as a going concern. They noted that the safe harbour was 'understood and supported by the main creditor, who provided further finance to complete the sale'.[77] Relevantly, participants in that example held the strong view that 'absent safe harbour, the business would have been placed in voluntary administration, with significant loss of employment and shareholder equity, as well as poor returns to creditors.'[78]

On the other hand, stakeholders emphasised the difficult intersection between the safe harbour provisions and Australia's unfair preferences regime.[79] If a creditor is on notice of the solvency concerns faced by a company, certain amounts it receives during that period are capable of being clawed back. Accordingly, there are practical obstacles to engaging too forthrightly with unsecured creditors during safe harbour.

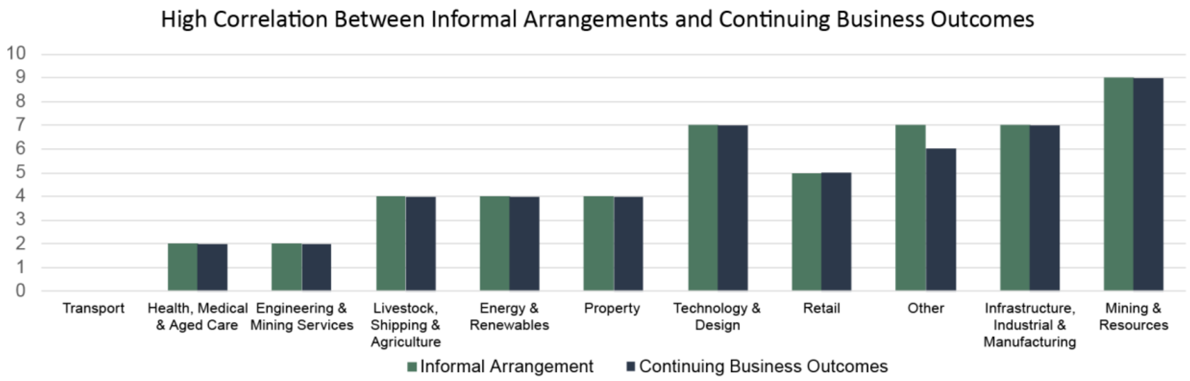
The Australian Institute of Credit Management (**AICM**) submitted that unrelated creditors should be protected from unfair preference claims during the period directors are relying on safe harbour, and commented that the 'mechanisms creditors need to employ to mitigate unfair preference claim risk impact all businesses through reduced availability for repayment arrangements, increased security requirements and reduced access to credit terms.'[80] This in turn can frustrate a business with longer-term viability prospects from being effectively restructured.

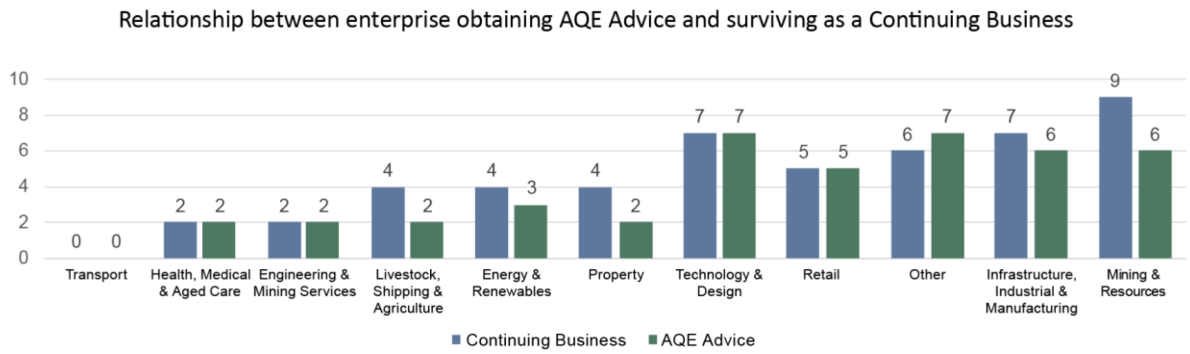
The Australian Credit Forum (**ACF**) submitted that there should be a similar moratorium (to the safe harbour) placed on unfair preferences 'and the use of those claims against creditors who are forced to continue to support and provide credit to directors and their company.'[81]

75 Wexted submission, pp 9-10.
76 Deloitte submission, p 4.
77 AICD/BCA submission, p 4.
78 AICD/BCA submission, p 4.
79 An 'unfair preference' is a payment made or other benefit given to a creditor by an insolvent company that causes the creditor to be in a more favourable position than other unsecured creditors in a liquidation.
80 AICM submission, p 2.
81 ACF submission, p 2.

The Panel considers unfair preferences further in section 15.2 of this Report.

The TMA provided helpful graphs to illustrate their members' experience with safe harbour, and the high rate of 'Continuing Business Outcomes' experienced in informal turnarounds.[82] This is relevant to creditors' approach to safe harbour – as a continuing business outcome must, by its nature, involve either creditors being paid in full, or creditors agreeing directly (or via a scheme of arrangement) to a compromise. The TMA provided examples of safe harbour protections resulting in a formal process, but where creditors were still better off (compared to an immediate appointment).[83] The notion of pre-planning formal appointments is considered further in section 7.4 of this Report.





[84]

Despite this, many creditors (as opposed to advisers) are deeply suspicious of the safe harbour protections provided to directors and are concerned that it has had a prejudicial impact on them. These concerns appear to be borne from the 'information asymmetry' between directors and creditors, as well as the lack of specification and guidance within the provisions.

The ACF submitted the lack of a requirement for directors to advise stakeholders (including creditors) of the implementation of their safe harbour plan would allow 'directors to take a course of action that may be more beneficial to their personal interest than those of the company and its creditors.'[85] In addition, Cole Corporate noted there may be an enhanced risk for creditors who 'legitimately may assume [they are] dealing with a solvent debtor when in fact [they are] not.'[86] The AICM and ACF also considered that the safe harbour provisions had been misused. However, the Panel notes this alleged misuse has not been directly observed or specifically referenced but is based on general suspicions

82 TMA submission, p 5 and Appendix C.
83 TMA submission, p 5 and Appendix C.
84 TMA submission Appendix C.
85 ACF submission, p 2.
86 Cole Corporate submission, p 2.

arising from creditors' concerns with perceived ambiguity of the provisions, and the ability for unregulated advisers to provide safe harbour advice. Allegations of misuse are discussed further in section 7.5 of this Report.

The Panel recognises that there is a general sense of mistrust and anxiety among creditors, and a concern that an influx of insolvencies in the future will demonstrate creditors have been adversely affected. Until and unless such appointments occur (accompanied by evidence of a worsening position of creditors), we think such fears are outweighed by evidence from the submissions of successful safe harbours. The Panel also notes that the circumstances in which creditors never find out about directors accessing safe harbour protection are invariably positive, as the safe harbour has enabled the company to continue to trade, which undoubtedly benefits creditors.

b) Employees

Submissions note that where the safe harbour provisions are used successfully to implement an informal restructure, it is difficult to see how employees would be adversely affected. The preservation of businesses and, therefore, the retention of employees is one of the primary benefits of safe harbour.

Submissions also point to the pre-condition requiring substantial compliance with the payment of employee entitlements as a positive for employees.

Safe Harbour case studies provided in submissions show instances of employment being saved either through the company being restructured or by a sale of the company's business as a going concern. Even where some operational restructuring was required that saw some employees made redundant, the case studies note those employees were paid relevant notice and redundancy provisions.

Some case studies provided by Wexted raised the issue of likely reliance on the Fair Entitlement Guarantee (**FEG**) scheme to fund employee entitlements had the directors moved to an immediate appointment of a voluntary administrator or liquidator.[87]

In the case studies provided by Wexted, the restructure implemented with the protection of the safe harbour provisions, meant there was no call on the FEG scheme.[88] Directors are also incentivised to keep payment of the company's employee entitlements up to date so they can avail themselves of safe harbour protection. This includes superannuation which is the most common employee entitlement not paid in the ordinary course of business. In any subsequent liquidation, if the FEG scheme was called on to pay employee entitlements, any return to the Commonwealth is also less likely to be eroded by significant outstanding superannuation obligations which, while not funded by the FEG scheme, rank equally with outstanding wages in the payment waterfall contained in section 556 of the Act.

c) FEG scheme and Recovery Program

The FEG scheme is administered by the AGD and provides financial assistance to cover certain unpaid employment entitlements to eligible employees who lose their jobs due to the liquidation of a company. The Commonwealth then has the right to stand in the shoes of the employee as a subrogated creditor and claim as a priority creditor in the liquidation.

The FEG Recovery Program is administered by the AGD for the purpose of funding actions by liquidators to recover amounts advanced under the FEG scheme. Between 1 July 2015 to

87 See case studies in Annexures to the Wexted submission.
88 See case studies in Annexures to the Wexted submission.

30 June 2021, $212.29 million was recovered under this Program.[89] Actions funded by the FEG Recovery Program include insolvent trading claims and, therefore, the AGD is a key stakeholder when considering how the underlying insolvent trading prohibitions and related safe harbour provisions should operate.

The interaction between the Commonwealth via the FEG scheme as a priority creditor in any liquidation and the safe harbour provisions, is discussed further in section 14.6 of this Report.

7.3 Success stories

It is clear from the Panel's consultation process that safe harbour is being used by directors. A number of submissions provided us with case studies and details of safe harbour being utilised, which are summarised below.

The ARITA survey of its professional members had 108 responses. Not all questions were answered by all respondents and the following percentages are calculated by reference to the total respondents who answered particular questions. 53 per cent of respondents had been engaged by a client to develop a safe harbour plan or 'better outcome' analysis[90] and 62 per cent of respondents had personally recommended using safe harbour protection since its inception.[91] 76 per cent of respondents said that when they had been engaged as a safe harbour adviser, a successful restructure/turnaround without any form of external administration had been achieved.[92] 40 per cent of respondents said there had been a successful restructure/turnaround through a form of external administration following a safe harbour engagement.[93] 27 per cent of respondents advised that despite the development of the plan, the company they were advising had been placed into liquidation.[94]

ARITA's view is that the safe harbour regime is achieving what it was conceived to deliver – provide breathing space, opportunity and confidence for directors, albeit primarily for larger companies.

Wexted's submission noted it had undertaken over 20 engagements, with most having been ASX-listed companies or significant private companies.[95] Wexted referred to 7 case studies which included examples of securing additional capital, restructuring debt facilities, divestment of non-core assets, operational restructures and negotiating exit strategies with particular stakeholders followed by a solvent wind down. The time required to complete the restructures in the case studies ranged from 5 months to over 12 months.

One of the case studies referred to a publicly listed manufacturing company with over 1,000 employees, high debt levels which had been exacerbated by COVID-19, and significant unsecured creditors including lease liabilities. In an external administration, the better outcome analysis estimated secured creditors would receive approximately 80 cents in the dollar, the potential for over $100 million of employee entitlements would need to be funded by the FEG scheme, no return to unsecured creditors or equity holders and industry disruption with downstream negative impacts on over 1,000 other businesses. The courses of action included undertaking a business review and evaluation, a capital raising, restructuring of debt facilities, implementing cost saving initiatives and negotiating/compromising key creditor claims. The safe harbour provisions resulted in board stability during an uncertain period together with time and security to formulate

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89 Fair Entitlements Guarantee Recovery Program Fact Sheet July 2021 (Attorney-General's Department), p 1.
90 See ARITA Question 3 (ARITA submission, Appendix A, p3.
91 See ARITA Question 9 (ARITA submission, Appendix A, p 13.
92 See ARITA Question 14 (ARITA submission, Appendix A, p 19.
93 See ARITA Question 15 (ARITA submission, Appendix A, p 20.
94 See ARITA Question 16 (ARITA submission, Appendix p 21).
95 Wexted submission, p. 9.

and execute the restructure which was undertaken over a period of approximately 12 months. The company continues to trade on the ASX, the jobs of approximately 75 per cent of employees were saved, the secured creditor and unsecured creditors continue to be paid in the ordinary course of business, noteholders converted debt to equity and existing equity was preserved in a diluted form.[96]

Vantage disclosed having undertaken 23 safe harbour engagements encompassing 195 Australian companies and over 5,000 employees. Of these:

- 78 per cent (or 18) were successful with 13 engagements resulting in the associated companies being turned around avoiding insolvency frameworks altogether;
- 5 engagements utilised a voluntary administration, deed of company arrangement (**DOCA**) or scheme of arrangement framework to implement part of the turnaround strategy. Four of those 5 were done under the protection of safe harbour with one not able to meet the employee entitlement payment and tax lodgement pre-conditions; and
- the remaining 5 engagements ultimately saw the companies being placed into liquidation.[97]

Deloitte's submission notes they have participated in over 50 safe harbour engagements nationally.[98] Three case studies were provided which included examples of negotiating a sale of a business, capital raising and negotiating with particular stakeholders to resolve outstanding litigation.[99] The outstanding litigation example resulted from the company receiving a significant adverse judgment debt which exceeded the company's assets.[100] The directors believed there were reasonable prospects of negotiating a more acceptable settlement, but those negotiations were likely to take some time to conclude.[101] The directors used the safe harbour provisions while the negotiations occurred. Those negotiations were ultimately successful, so the company continues to trade with jobs preserved and flow-on distress to other smaller businesses in the supply chain avoided.[102]

The TMA submission included 55 case studies from 20 TMA stakeholders covering engagements that used safe harbour (48) and others that did not (7).[103] The case studies include examples of operational restructures, renegotiating payment terms, other negotiations with particular stakeholders, balance sheet restructures, covenant waivers or rewrites, capital raisings, refinancing, new debt structures and sale and leasebacks of significant assets.[104] Successful restructure without a form of external administration was achieved in 85 per cent of cases, 15 per cent required some form of external administration, typically voluntary administration and only 2 of the 55 case studies resulted in the companies being placed into liquidation.[105] The length of time in the case studies that directors relied on the safe harbour provisions in successful restructures ranged from 2 months to more than 12 months.[106]

One TMA case study refers to a large industrial company with 200 employees and a high costs structure that experienced liquidity problems when customers unexpectedly reduced order volumes.[107] With the benefit of safe harbour protection, the directors pursued a dual track process of

96 Wexted submission, p. 9.
97 Vantage submission pp 6-8.
98 Deloitte submission, p 1.
99 Deloitte submission, p 8.
100 Deloitte submission, p 8.
101 Deloitte submission, p 8.
102 Deloitte submission p 8.
103 TMA submission, pp 3-4; The Panel notes that some of these case studies may also have been included as case studies in other submissions received by the Panel.
104 TMA submission, p 4, footnote 4.
105 TMA submission, p 5.
106 TMA submission, p 5.
107 TMA submission, Appendix B, p 23.

renegotiating loan facilities with a view to refinancing while also running a sale of business process. The loans were successfully refinanced, and the business sold, preserving all 200 jobs.[108]

The case studies illustrate the breadth of issues that companies can face and the myriad solutions that can be canvassed and ultimately used.

7.4 Where safe harbour is followed by a formal appointment

There are 2 main circumstances where a formal appointment follows safe harbour:

- First, where administrators or liquidators are appointed to the company because the restructuring plan has failed or is no longer 'reasonably likely to lead to a better outcome,' or because of other factors (including, for example, evidence of non-compliance with the pre-conditions to access).
- Second, where the restructuring plan itself envisages a formal appointment to give effect to one or more elements of it, and the period prior to that appointment is utilised to plan for a more orderly and efficient appointment.

Both of the above circumstances are, in the Panel's view, acceptable utilisations of the safe harbour provisions.

In respect of the former, the Explanatory Memorandum acknowledges that some companies may not be able to recover and will still proceed to voluntary administration or liquidation despite the directors' best efforts.[109] In respect of the latter circumstance, where companies do enter into particular formal insolvency processes, the safe harbour provisions are aimed at giving those companies a better chance of being turned around or of preserving value for creditors and shareholders.[110]

Consultations have provided either anecdotal evidence or actual case studies which have involved a formal appointment following a period in which directors have been operating under the safe harbour provisions.

References are made in submissions to turnaround plans and restructures that set out to use formal processes as part of the restructures and other examples of where a turnaround plan or restructure has been ultimately unsuccessful which resulted in the directors making the decision to place the company in voluntary administration or liquidation.

ARITA's survey refers to respondents having experience with safe harbour engagements that have resulted in a successful company restructure through a form of external administration subsequent to safe harbour work.[111]

As mentioned above, of the 18 successful restructures included in Vantage's submission, they note all but one was done under safe harbour protection.[112] Five were described as using a formal process to effect a restructure, 4 of which developed and implemented a turnaround plan under safe harbour protection, where one element of the overall turnaround involved a strategic pre-planned voluntary administration or scheme of arrangement to restructure certain but not all group entities.[113]

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108 TMA submission, Appendix B, p 23.

109 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) [1.21].

110 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) p 4.

111 ARITA submission, Appendix A p 20.

112 Vantage submission, p 7.

113 Vantage submission, p 7.

Vantage submitted that the safe harbour provisions provide opportunity for any voluntary administration to be well planned, in turn increasing the prospect of the return to creditors being greater than it might otherwise have been.[114]

The Law Council also made reference to the provisions being used effectively to drive better outcomes in formal insolvency processes, in particular by allowing directors time to formulate a DOCA proposal and to engage with creditors (particularly secured creditors) before placing a company into voluntary administration or liquidation.[115] They also reference feedback from insolvency practitioners who say that, even where directors' efforts have been unsuccessful in preventing formal insolvency, the provisions have been used effectively by enabling more efficient transitions into voluntary administration or liquidation resulting in improved returns for creditors.[116]

Wexted referred to the successful use of the safe harbour provisions in tandem with schemes of arrangement and included a case study which showed the safe harbour provisions being used and followed by a solvent wind down via a members' voluntary liquidation.[117] They refer to anecdotal knowledge that the provisions are being used to 'pre-plan' a voluntary administration process, which they see no problem with as long as the restructure through this mechanism proves a better outcome than an immediate appointment.[118]

The TMA's submission referred to examples of restructures that have required utilisation of formal (mostly voluntary administration) processes to, for example, access statutory moratoriums.[119] Even where some companies have ended up in liquidation after utilising safe harbour, contributors to TMA's submission considered that those examples ended up achieving better outcomes than expected via an unplanned insolvency process.[120] The better outcome success of the process came from pre-planning steps preceding appointments, including preparing for necessary court orders, ensuring funding lines were available to maintain the business during post-appointment turnaround and restructure events, and ensuring, amongst other matters, that key stakeholders had negotiated restructuring support agreements.[121] One example referred to a 2-week period during which directors were attempting to negotiate with lenders as also allowing them to place their project on 'care and maintenance' and to set terms of renegotiated contracts, which ultimately the voluntary administrators completed.[122] This was seen as resulting in a better outcome than an immediate appointment.[123] Another example, again where directors were unsuccessful in negotiating with a key stakeholder, saw the directors creating a database of interested buyers during this negotiation period, which was ultimately used by the voluntary administrators to sell the business and assets.[124]

The general consensus from those who addressed this issue is that the safe harbour provisions have assisted in achieving better outcomes in formal appointments than what would have been expected via unplanned insolvency processes.

Interestingly, the TMA observed that the past 18 months have been unprecedented both in terms of public support and liquidity in the market.[125] They contend that liquidity will not be there forever, so predict that some of the better outcomes achieved outside a formal process will most likely require statutory moratorium support in the future, and accordingly more voluntary administrations or

114 Vantage submission, p 16.
115 Law Council submission, pp 1-2.
116 Law Council submission, p 3.
117 Wexted submission, p 11.
118 Wexted submission, p 11.
119 TMA submission, p 5.
120 TMA submission, p 5.
121 TMA submission, p 5, footnote 8.
122 TMA submission, Appendix B, p 9.
123 TMA submission, p 4.
124 TMA submission, Appendix B, p 19.
125 TMA submission, p 6.

schemes of arrangement will be needed to execute strategies developed under safe harbour protection in the lead up to such appointments.[126] Their submission notes that safe harbour does not abrogate voluntary administrations – it provides a runway for directors to plan a turnaround strategy which may well be executed inside or outside a formal process, depending on what needs to be achieved.[127]

Finally, the Panel notes that it is not uncommon to have more than one course of action, whereby directors are pursuing 'Plan A', but also have a 'Plan B, C or D' which (whilst not as optimal a course of action as Plan A), is still reasonably likely to deliver a better outcome for the company than an immediate appointment. In such cases, directors may turn to their 'back up plan' during times that their primary Plan A is less than reasonably likely to succeed. In the Panel's experience (supported through the Panel's consultation process), one of those plans may be a pre-planned appointment. The safe harbour provisions can provide directors with time to shore up the support of secured creditors, enter into an 'implementation deed' or 'restructuring support deed' with key creditors and stakeholders, negotiate standstills, negotiate how best to fund the administration, and, often, to agree the terms of a proposed DOCA with stakeholders. It should be noted that a 'pre-planned' administration is different to a 'pre-packed' administration. The implementation of a 'pre-planned' administration is still subject to creditors' approval, the administrator's due process and the administrator's independence.

The Panel welcomes an interpretation of the safe harbour provisions that is flexible, dynamic and able to be applied in a multitude of circumstances. The Panel is also of the view that an orderly voluntary administration is not always the terrible outcome for companies that many assume it is and cautions against a categorisation of a voluntary administration as akin to 'safe harbour failure'. Clearly, there will be instances of 'safe harbour failure', but that should be determined by reference to what the directors' course of action was, and a failure to achieve that outcome.

7.5 Instances of misuse

In the vast majority of the Panel's consultations, there were no reports of misuse of the safe harbour provisions. In particular, there were no examples of the safe harbour provisions being used for illegal phoenixing purposes.[128] A number of stakeholders commented that illegal phoenixing and safe harbour don't sit easily together – as safe harbour requires a company to have its employee entitlements substantially paid and tax lodgements substantially up to date. If a company is going to 'illegally phoenix', then it will likely do so without satisfying those gateway items. ARITA made the comment that 'abuse of the eligibility requirements would seem to be difficult as they are generally quite binary, and it is not immediately obvious to us what other possible misuses may exist'.[129] The AICD/BCA observed that any perception that the safe harbour provisions provide an incentive for directors to 'make decisions that are reckless or lacking in due care and diligence is not supported by examples and practices shared with the AICD' and would in any event be inconsistent with the general directors' duties contained in sections 180-183 of the Act.[130]

Where misuse was referenced or raised in a written submission or by way of discussions with the Panel, it was as a generic comment, and no evidence was provided to substantiate any claims of misuse.

126 TMA submission, p 6.
127 TMA submission, p 7.
128 Illegal phoenix activity occurs when a new company, for little or no value, continues the business of an existing company that has been liquidated or otherwise abandoned to avoid paying outstanding debts, which can include taxes, creditors and employee entitlements.
129 ARITA submission, p 3.
130 AICD/BCA submission, p 5.

Wexted commented that misuse may arise from advisers implementing a low cost 'checklist' style approach to the legislation, rather than a meaningful analysis,[131] and identified that the risk of that occurring in the SME market was higher (because funds available to pursue an insolvent trading claim may be limited). Whilst there is a tension between accessibility of advice (where cost is a factor) and quality (good advice is often not cheap), ultimately the purpose of the safe harbour provisions is to encourage viable turnarounds. We think it unlikely that a 'tick the box safe harbour' will result in long term viability of a financially distressed business, and in that respect, this should be a risk that is monitored by reference to reports by administrators and liquidators on insolvent trading and safe harbour.

A number of creditor-focused submissions highlighted the lack of transparency in the safe harbour process and were concerned that the lack of transparency increased the risk of misuse. At present, this appears to be a theoretical rather than substantiated risk, borne out of a mistrust for the process, given that it is usually a private process to which creditors are not privy. Clearly, any potential misuse will only come to light where there is a subsequently appointed voluntary administrator or liquidator who investigates what the directors did under the auspices of 'safe harbour'. The Panel refers to section 14.1 of this Report, where we suggest data be collected as part of the general reporting undertaken in formal appointments, so that any safe harbour misuse can be more effectively monitored.

Separately, 'misuse' was also referred to in submissions in the context of the quality of advisers providing safe harbour advice. Those issues are separately addressed in section 9.2 of this Report.

7.6 Impact of safe harbour on enforcement

The 2 parties who can take action against directors in respect of insolvent trading are the appointed liquidator in question and ASIC.

Liquidators need to have funding available to them to undertake their investigations and pursue any consequent legal action. Whilst directors bear the evidentiary burden to establish safe harbour, the liquidator bears the burden of proof in respect of any legal action that follows. That is, the liquidator must show that, on a balance of probabilities, the course(s) of action taken by the directors were not reasonably likely to lead to a better outcome for the company. The Panel is not aware of any such legal proceedings being initiated to date.

The safe harbour provisions add an additional burden to a liquidator to demonstrate a breach of the insolvent trading provisions. The Panel suspects that insolvent trading actions may be more difficult to bring in the future. This is not a suspicion shared by all. ARITA notes that in some respects, the safe harbour provisions may make it easier for liquidators to bring proceedings for insolvent trading, because directors must provide books and records to the liquidator as a pre-condition for protection.[132] This is certainly a fear shared by some stakeholders in their review of the subjective elements of 588GA(1), and that is explored further in section 8.1 of this Report.

131 Wexted submission, p 11.
132 ARITA submission, p 16.

7.7 Impact of the COVID-19 Insolvent trading Moratorium

In March 2020, the Commonwealth introduced a temporary moratorium protecting directors from civil liability for insolvent trading (**Insolvent Trading Moratorium**).[133] The Insolvent Trading Moratorium formed part of a legislative package aimed at providing temporary relief for financially distressed businesses during the COVID-19 pandemic.[134]

Since the commencement of the Insolvent Trading Moratorium (as well as various other COVID-19 stimulus measures and protections afforded to companies), the number of insolvency appointments has substantially declined.[135]

The Insolvent Trading Moratorium was described as providing 'temporary relief for directors from any personal liability for trading while insolvent' and attracted significant media attention.[136] However, the provisions are more narrowly prescribed than that description suggested, as the Moratorium only applied to debts incurred 'in the ordinary course of the company's business'.[137]

The provisions of the Insolvent Trading Moratorium, which was extended until 31 December 2020, are extracted below:

Section 588GAAA safe harbour – temporary relief in response to the coronavirus

Safe harbour

(1) Subsection 588G(2) does not apply in relation to a person and a debt incurred by a company if the debt is incurred:

(a) in the ordinary course of the company's business; and

(b) during:

(i) the 6-month period starting on the day this section commences; or
(ii) any longer period that starts on the day this section commences and that is prescribed by the regulations for the purposes of this subparagraph; and

(c) before any appointment during that period of an administrator, restructuring practitioner or liquidator of the company.

(2) A person who wishes to rely on subsection (1) in a proceeding for, or relating to, a contravention of subsection 588G(2) bears an evidential burden in relation to that matter.

When the safe harbour does not apply

(3) Subsection (1) is taken never to have applied in relation to a person and a debt in the circumstances prescribed by the regulations for the purposes of this subsection.

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133 *Coronavirus Economic Response Package Omnibus Act 2020* (Cth); *Corporations Act 2001* (Cth) s 588GAAA.

134 *Coronavirus Economic Response Package Omnibus Act 2020* (Cth).

135 ARITA submission, p 17; See also weekly statistics compiled by ASIC on the ASIC website at: <https://asic.gov.au/regulatory-resources/find-a-document/statistics/insolvency-statistics/insolvencystatistics-series-1b-notification-of-companies-entering-external-administration-and-controller-appointmentsweekly/for weekly insolvency statistics compiled by ASIC.>

136 Treasury, Australian Government, Fact Sheet - Economic Response to the Coronavirus, 'Temporary Relief for financially distressed businesses'.

137 *Corporations Act 2001* (Cth) s 588GAAA(1)(a).

a) The impact of the Insolvent Trading Moratorium on director behaviour

As may be expected, the Insolvent Trading Moratorium had a mixed reception among directors, creditors and advisers.[138]

There is anecdotal evidence that some directors of less well-funded or less well-advised companies, including SME directors, viewed the Moratorium as a 'get out of jail free' card. ARITA in their submission noted that members believed the Insolvent Trading Moratorium was used, at least by directors of SMEs, to 'kick the can down the road.'[139]

It also emerged during the Panel's consultation process that safe harbour advisory work reduced dramatically during that period. Accordingly, whilst ARITA noted that 'sophisticated directors of larger enterprises used the Insolvent Trading Moratorium as an opportunity to seek advice to take steps to make safe harbour protection available to them at the end of the moratorium',[140] it was not an approach broadly taken by Australian directors during that period. The correlation between the removal of the 'stick', and the anecdotal drop off in directors receiving advice during that period, is relevant to any consideration of an overhaul of Australia's insolvency regime. It is a correlation that should be further tested (as the circumstances of COVID-19 are not reflective of a normal state).

A number of advisers expressed their surprise that, at the conclusion of the Insolvent Trading Moratorium, their formal insolvency appointments did not increase. Some advisers considered the Moratorium was only one factor that contributed to directors continuing to trade during the pandemic. Other factors included government stimulus payments, ATO inactivity, restrictions on the normal statutory demand process, lender forbearance, JobKeeper, the SME Loan Guarantee Scheme and changes to leasing codes.

A number of individuals and industry groups are fearful that the Insolvent Trading Moratorium, combined with other liquidity support measures, mean that Australian companies have not yet experienced the full economic consequences of COVID-19 from an insolvency perspective, and that many companies are continuing to trade despite underlying financial distress.[141] Much of this is summation and conjecture: there is insubstantial data available on the current broad economic health of Australia's corporations, and whether there is, indeed, an increase in 'zombie companies.' Whether or not this fear is well-founded will only be revealed once creditor enforcement action resumes and external administrations are 'forced' on companies.

Consultations undertaken by the Panel revealed a widely shared belief that the Insolvent Trading Moratorium provisions were simpler and more accessible for directors than the primary safe harbour provisions. Notably, the reference in the Moratorium provisions to debts incurred in the 'ordinary course of … business' is language that is readily understood by company directors, who would therefore have greater confidence that their actions would fall within the parameters of the safe harbour. Conversely, the primary safe harbour provisions do not refer to debts incurred in the 'ordinary course of … business'. The absence of a reference to 'ordinary course of business' debts has been cause for concern among some and is explored further in section 8.4 of this Report.

138 CA ANZ and CPA noted in their submission that the insolvent trading moratorium and inactivity by the ATO contributed to 'directors delaying action to address any solvency concerns' (CA ANZ / CPA submission, p 4). ACF considered that the moratorium 'had a negative impact on the interests of creditors and employees overall' because it 'resulted in a delay to the ordinary business life cycle process which is still yet to be fully played out.' (ACF submission, p 3).

139 ARITA submission, p 3.

140 ARITA submission, p 3.

141 ARITA's submission noted the significant decline in the number of insolvency appointments and that the ATO has 'not recommenced recovery actions for debt and lenders are still largely not taking enforcement action'. (ARITA submission, pp 17-18).

b) The interaction of the Insolvent Trading Moratorium and the primary safe harbour provisions

Two key (and somewhat contradictory) perspectives arose from advisers during the Panel's consultation process.

- In the first instance, many advisers observed that the Insolvent Trading Moratorium essentially negated the need for the primary safe harbour provisions during that time.[142] They further reported that safe harbour work decreased and, accordingly, there was an absence or dearth of data available from which to analyse the impact of the primary safe harbour provisions and how they would have been able to assist companies during the pandemic.[143]
- Others observed that many advisers viewed the Insolvent Trading Moratorium as only available if a company completed its turnaround during the Moratorium period or otherwise entered into formal insolvency proceedings prior to the expiry of that period. These advisers, therefore, believed directors needed to continue to engage with the primary safe harbour provisions in order to have a 'back up protection'.[144]

It emerged in the Panel's consultations that directors who continued to engage with the primary safe harbour provisions were from larger and listed entities.

7.8 Effectiveness of the insolvent trading prohibition

Some stakeholders believe that the insolvent trading prohibition in section 588G is ineffective, particularly at the SME level, pointing to ASIC statistics on insolvent trading allegations in support of this belief. A review of these statistics shows allegations of insolvent trading by liquidators in 41 per cent of section 533(1) reports in 2008-9, increasing year on year through to 71 per cent of reports in 2018-19. The way liquidators report to ASIC changed in March 2020. ASIC provided the Panel with statistics for subsequent years that have not yet been made public due to the change in reporting methods. Based on this preliminary, unpublished data, it appears the year-on-year increase continued into the 2019-20 year, but there was a decrease in the percentage of reported allegations of insolvent trading in the 2020-21 year. This may have had something to do with the Insolvent Trading Moratorium and we are not sure a conclusion about instances of insolvent trading allegations decreasing should be drawn from 2020-21 statistics.[145]

We are cautious about assessing the impact of safe harbour on the underlying effectiveness of the insolvent trading prohibition by reference to non-contextualised statistics. For example, it would be desirable to assess that data against other metrics, including increases to the average number of companies incorporated during those periods, improved reporting by liquidators and assessment of how many insolvent trading claims were pursued.

142 ARITA, in their submission, took the view that the Insolvent Trading Moratorium (in conjunction with various government stimulus packages and related COVID-19 initiatives for distressed businesses) 'significantly reduced the demand for and the uptake of safe harbour, particularly in the SME sector where directors have less knowledge of safe harbour and will accordingly not have taken the opportunity to plan ahead and implement safe harbour strategies.' (ARITA submission, p 9)

143 For example, both KPMG and the Law Council noted that the Insolvent Trading Moratorium reduced the requirement for directors to seek safe harbour advice and utilise safe harbour provisions as they were already protected (KPMG submission, p 3; Law Council submission, p 4).

144 For example, McGrathNicol noted the controversy around whether the Insolvent Trading Moratorium applies if a company did not appoint an EXAD prior to 31 December (McGrathNicol submission, p 5).

145 ASIC has advised that on further review the preliminary analysis may be subject to change before it is published.

7.9 Entrepreneurship

A stated purpose of the safe harbour reforms was to promote a culture of entrepreneurship and innovation to help drive business growth, local jobs and global success.

The safe harbour provisions were introduced to drive cultural change by encouraging directors to keep control of their company, engage early with possible insolvency and take reasonable risks to facilitate the company's recovery (instead of placing the company prematurely into voluntary administration or liquidation). This was expected to promote the preservation of enterprise value for companies, their employees and creditors, reduce the stigma of failure associated with insolvency and encourage a culture of entrepreneurship and innovation. The reforms were also intended to encourage businesspeople with the right skills, expertise and experience to serve as company directors without being deterred by personal liability for the company's debts.[146] For example, by addressing concerns about inadvertent breaches of insolvent trading laws which were discouraging early stage (angel) investors and professional directors from becoming involved in start-up companies.

Whether the reforms have achieved their aims of promoting innovation and entrepreneurship in the 4 years since their inception is hard to measure.

To the extent that the policy to encourage a culture of entrepreneurship was focused on start-ups, we query whether the safe harbour provisions would apply to many in practice, and whether the prohibitions on insolvent trading act as a deterrent to entrepreneurs starting a business. The Panel has received no evidence of what drives the economic risk-taking and investments of entrepreneurs in these circumstances, and further research and analysis is needed (in a broader economic context and in an individual investment context) as to whether the insolvent trading prohibitions are a relevant consideration (or any way linked to the stigma of failure).

We also note that start-up companies are commonly capital deficient and have not, and will not for some time, turn a profit. While the Explanatory Memorandum uses an example of the directors of a start-up company relying on safe harbour, we do query whether the financial position of a start-up may make it very difficult to satisfy the 'reasonably likely to lead to a better outcome' test.

The observations of safe harbour in practice that emerged from the Panel's consultation process (as set out in section 7 of this Report) indicate that directors of existing large and medium-sized companies appear to be taking informed risks and attempting restructures. From the submissions received, such behaviour has the effect, in many circumstances, of improving the businesses on a 'net present value' basis (which arguably is an indicator of entrepreneurism). Previously, directors (particularly professional or non-executive directors) may not have had the appetite for such risk when they bore personal responsibility for its failure.

Wexted's submission also provides anecdotal evidence of incoming directors taking comfort in the safe harbour provisions when accepting an appointment as a director.[147]

146 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) p 3.

147 Wexted submission, p 6 and Appendix B.

Part III
Legislative considerations

8. Analysis of Section 588GA(1)

8.1 Subjectivity of awareness

Two submissions raised concerns with the subjective element of section 588GA(1).[148]

Section 588GA(1)(a) provides that the safe harbour provisions can be enlivened where:

> *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*

It is important to understand the broader legislative framework in which that sub-section sits. As previously noted, section 588GA(1) provides a carve-out to the operation of section 588G. The relevant parts of section 588G are:

Section 588G – Director's duty to prevent insolvent trading by company

(1) This section applies if:

(a) a person is a director of a company at the time when the company incurs a debt; and

(b) the company **is insolvent at that time**, or **becomes insolvent by incurring that debt**, or by incurring at that time debts including that debt; and

(c) at that time, there are **reasonable grounds for suspecting** that the company **is insolvent**, or **would so become insolvent**, as the case may be; and

(d) that time is at or after the commencement of this Act.

(2) By failing to prevent the company from incurring the debt, the person contravenes this section if:

(a) the person **is aware** at that time that there are such grounds **for so suspecting**; or

(b) a reasonable person in a like position in a company in the company's circumstances would be so aware.

The concerns in respect of the subjective nature of section 588GA(1) centre around the use of the words '*the person starts to suspect*' in sub-paragraph (a). The reasons for the concern varied between the submissions, and can be summarised as follows.

a) Safe harbour stigma and reluctant directors

There were some reports that directors and their advisers are concerned that, in formally linking safe harbour to a subjective suspicion of insolvency, directors are making it easier for a future liquidator to prove the suspicion requirement under section 588G(2). This concern led to feedback during round table discussions that some directors have been reluctant to engage the safe harbour provisions for fear of admitting the company is insolvent.

That reluctance can be juxtaposed with the views that:

148 TMA submission, p 14; McGrathNicol submission, p 8.

- advisers want directors to engage early with the prospect of insolvency and, therefore, the words 'start to suspect' and 'may' allow for directors to realise that they don't need to wait to engage the safe harbour provisions, and
- some advisers and directors wanted more certainty about when safe harbour began, and used the subjective element of 588GA(1) as a reason to minute their concerns (and, therefore, create the records to support their evidentiary burden).[149]

The Panel does not agree that enlivening the safe harbour provisions, of itself, amounts to an admission of a breach of section 588G. The words between the 2 sections are importantly different: the prohibition on insolvent trading set out in section 588G refers to a company being insolvent or becoming insolvent as a consequence of the relevant debt incurred. That is, a liquidator needs to prove actual insolvency at the time the debt was incurred (or consequent upon the debt being incurred). Likewise, the subjective and objective components of section 588GA(2) require a director (or, as applicable, the 'reasonable person in a like position') to be aware that the company **is** insolvent or **would so become** insolvent.

While there are likely to be instances of directors only seeking to engage the safe harbour provisions after the company is already insolvent, the subjective element of section 588GA doesn't change the underlying application of sections 588G(1) and (2).

However, we are concerned by the feedback that the reference to subjectivity in the provisions somehow increases or creates a negative view of safe harbour or supports a finding that in order to obtain safe harbour protection, directors must somehow formally resolve to do so.

The Panel is of the view that the safe harbour provisions work flexibly and don't require formal resolutions or 'start dates' to apply. We see great benefit in directors seeking early access to appropriately qualified advisers, and developing alternative courses of actions. We also recognise that directors should be encouraged to document their safe harbour deliberations.

Accordingly, the Panel recommends amending section 588GA(1) to refer to financial distress (in addition to the prospect of insolvency). As noted in section 5.1(e) of this Report, the concept of insolvency is a difficult one for directors to engage with, and a concept of financial distress for which they are seeking assistance, may be more palatable to (and understood by) directors. Of course, the test for insolvent trading would still be the existence of insolvency. However, that doesn't need to be the prompt for safe harbour protection and may reduce the disclosure concerns and the 'inadvertent admission' concerns.

b) ASX disclosure

ASX has clearly stated that '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'.[150] In addition, the ASX has acknowledged that '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', noting that '[t]he 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.'[151]

149 Deloitte submission, p 6.
150 ASX Listing Rules, Guidance Note 8, p 42.
151 ASX Listing Rules, Guidance Note 8, p 42.

However, in some written submissions and during round table discussions, feedback was provided that the spectre of ASX continuous disclosure obligations in the context of the safe harbour provisions continues to be a source of angst and concern for directors in practice.

The prompt for continuous disclosure is, as the ASX has made clear, the underlying circumstances that are leading to solvency concerns. Separately, if a board of a listed company forms the view that the company is insolvent, or will become insolvent, then similarly, that should require disclosure to the market.

However, if linking 588GA(1) to a suspicion of financial distress rather than insolvency enables listed companies to more actively engage in pre-appointment turnarounds, and to better understand their continuous disclosure obligations in that context, then the Panel's view is that would be a positive development.

c) Events of default and termination rights under material documents

Another concern that arose during the Panel's consultation process related to reports of a developing trend that financiers (and in some instances, key suppliers) are including specific defaults and/or review events in their agreements with companies, that are triggered by a director engaging the safe harbour provisions.

This has led to a reluctance by directors to 'form the suspicion' or otherwise formally engage the safe harbour provisions, because to do so would trigger acceleration rights and termination rights by key financiers and creditors.

This is a concerning development and runs contrary to the public policy behind the safe harbour provisions. While a company in financial distress may already be liaising with its financiers and/or key creditors, this will not be true in all instances. It also has the potential to impact disclosure for ASX-listed entities (because if enlivening the safe harbour provisions constitutes a default or review event under a finance agreement or a material contract, that may very well require separate market disclosure). Obviously, any public announcement of safe harbour may undermine the course(s) of action the directors are seeking to undertake and, therefore, defeat one of the key purposes of the safe harbour provisions.

We are not convinced that removing the subjective element of section 588GA cures such a quandary (as presumably, any contractual provision may then turn to the appointment of an AQE as a trigger, for example). Two other potential ways to deal with this concern are set out below. However, the Panel has concerns with each of them, and is reluctant to recommend either on a standalone basis without further consultation, given the effect they could have on creditors, and their potential to heighten misuse:

- ipso facto provisions[152] could be extended to such 'safe harbour' specific defaults / review rights (to the extent they don't already). However, we note that such a development would need to be considered carefully, together with a review of unfair preferences, to ensure that creditors are not unfairly prejudiced, and the application of the ipso facto provisions in such circumstances does not encourage safe harbour misuse. For example, an outcome that could see a creditor forced to trade with a company in financial distress where its exposure increases during that time, is a different scenario to where it is forced to trade with an administrator during the same period (and where the administrator usually has personal liability for the debts incurred).

152 Ipso facto provisions apply to (non-excluded) agreements, contracts and arrangements entered into after July 2018 and give protection against termination rights arising out of certain corporate restructuring and insolvency procedures.

- any provision in a contract, agreement or arrangement that provides that a director seeking to rely on safe harbour:
  - is required to notify a third party of such reliance, or
  - is of itself, a separate event of default or termination event or review event,

  be considered unenforceable from a public policy perspective. For the avoidance of doubt (and similar to the ipso facto provisions) this would need to make clear that it did not extend to other defaults or termination rights (for example, payment defaults).

8.2 Reasonably likely test

There continues to be confusion in practice about the meaning of the term 'reasonably likely'. It is the Panel's experience that directors struggle to understand what this means, and advisers play a critical role in explaining this to them.

At least one written submission noted, and this point was also raised in round-table discussions, that the general market understanding of the term 'reasonably likely' is 'more likely than not'.[153] However, such a definition is inconsistent with the background provided in the Explanatory Memorandum, which notes, among other matters, the following in relation to whether a course of action is 'reasonably likely' to lead to a better outcome:

- that it 'does not require a better than 50 per cent chance of a better outcome than the immediate appointment of an administrator or liquidator'; rather, it requires the chance of achieving that outcome to be 'fair', 'sufficient' or 'worth noting', as opposed to 'fanciful or remote'; what constitutes a course of action which is reasonably likely to lead to a better outcome 'will vary on a case-by-case basis depending on the individual company and its circumstances at the time the decision is made'
- some directors may consider and then 'discard' several different options when deciding on a course of action. Of those available options, only some may be reasonably likely to lead to a better outcome for the company. It may also be necessary for adjustments to be made to a course of action to ensure it remains reasonably likely to lead to a better outcome (for example, the pursuit of a new course of action or the appointment of an administrator or liquidator)
- directors who take a 'passive approach' to the company's situation, who allow the company to continue trading 'as usual' despite severe financial difficulty, or who devise recovery plans which are 'fanciful' will not be eligible for safe harbour protection. Similarly, safe harbour protection will not extend to directors who fail to pursue and implement a course of action or who fail to appoint an administrator or liquidator within a reasonable timeframe once it becomes clear that the restructuring plan has failed (and there is no other course of action that satisfies the requirements of 588GA)
- if a proceeding is ultimately brought under section 588G(2), a director who wishes to rely on safe harbour protection bears an 'evidentiary burden' in relation to the matters in section 588GA(1). This means the director must, among other things, adduce or point to evidence which suggests a 'reasonable possibility' that the course of action pursued was reasonably likely to lead to a better outcome, and

153 Deloitte submission, p 6.

- directors must be able to point to evidence to assist with meeting that evidentiary burden – a 'mere statement' that the course of action developed or undertaken would be reasonably likely to lead to a better outcome would not suffice.[154]

While the Panel is not aware of instances where a misconception of the term 'reasonably likely' has led to a premature appointment, we note there is a real risk that it may. The content of the Explanatory Memorandum, and the nuance that it provides, is not readily accessible to many directors and advisers, and is another reason why an easily accessible guide to the key safe harbour provisions is plainly needed.[155] The Panel would prefer to address interpretation concerns through such guidance, rather than amending the reference to 'reasonably likely' in the provision.

A number of submissions received by the Panel[156] referred to the possibility of applying the 'business judgment rule' contained in section 180(2) of the Act, or something like it, to the prohibition on insolvent trading. For example, by incorporating the safe harbour provisions into the existing business judgment rule, with a view to integrating the safe harbour carve-out to the duty to prevent insolvent trading with the general directors' duties in Part 2D.1 of the Act. King & Wood Mallesons submitted this could involve the 'reasonably likely' test in section 588GA(1) being replaced with 'something more akin to the rational belief test' found in section 180(2)(d).[157]

A reframing (or wholesale replacement) of the safe harbour provisions in favour of the approach adopted for the business judgment rule would have flow-on consequences for the insolvent trading regime in the Act. Section 588G is framed as a 'default contravention' which focuses on when debts are incurred by a company, rather than a director's *conduct* in incurring that debt.[158] The introduction of a 'rational belief' element would shift the objective focus of the 'reasonably likely' assessment in section 588GA(1), to a more subjective analysis necessarily involving the assessment of a director's state of mind. For this, and other reasons outlined in section 15 below, the Panel considers this is a matter more appropriately dealt with as part of a holistic review of Australia's insolvency laws.

8.3 Better outcome analysis

The concept of a 'better outcome', and how it informs the approach taken by directors (and their advisers) when seeking to rely on the safe harbour, was addressed often throughout the Panel's consultation process. This is not surprising, given the touchstone for engagement of the safe harbour provisions is whether, after starting to suspect a company may be or become insolvent, a director starts developing one or more courses of action that are reasonably likely to lead to a 'better outcome' for the company.

Section 588GA(7) defines better outcome as 'an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company' (being, for the purposes of this report, the **better outcome analysis**). Many submissions queried what this means; is it just a better outcome for the company, or are other stakeholders also relevant?

154 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.18], [1.19], [1.44], [1.52], [1.58], [1.75] and [1.76].

155 See section 6.2 of this Report.

156 See, for example, the submissions from Cole Corporate, the Law Council, ARITA, Wellard, King & Wood Mallesons and the TMA.

157 King & Wood Mallesons submission, pp 4-5.

158 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.6]. See also the discussion in section 5.1(c) of this Report concerning the 'reasonable grounds to suspect' element of section 588G(1).

Definition of better outcome

The definition of better outcome is supported by the factors in section 588GA(2) which are intended to provide further guidance to directors when assessing whether a course of action is reasonably likely to lead to a better outcome.[159] These factors are 'indicative and non-exhaustive',[160] to recognise that the approach which is reasonably likely to lead to a better outcome for a company will vary depending on the company's individual circumstances and the situation faced by directors at the point in time they formulate a particular course of action.[161]

For these reasons, what represents a better outcome for a company for the purpose of engaging the safe harbour is fact-dependent and difficult to prescribe. Sections 588GA(2) and 588GA(7) provide some assistance in this regard. However, the analysis of whether a course of action is reasonably likely to lead to a better outcome requires directors to, among other things:

- proactively engage in an assessment of what course(s) of action may be available to the company and the likelihood of them being achieved – this analysis requires directors to consider and inform themselves of the company's management and financial position, including its compliance with various legal and regulatory obligations and its relationships with creditors and other key stakeholders
- accommodate what are often complex, dynamic and uncertain circumstances in their decision-making processes, meaning a range of options may be considered and discarded when settling on or revising a course of action, a point acknowledged in the Explanatory Memorandum,[162] and
- continually assess the course(s) of action being pursued in light of the relevant counterfactual, of whether their plan is reasonably likely to lead to a better outcome for the company than the immediate appointment of an administrator or liquidator – for example, directors may be faced with options to either continue trading (and, thereby continue depleting the company's available cash reserves) in pursuit of a turnaround strategy, or to appoint an administrator or liquidator when funds are still available to enable those processes to be undertaken in a more timely and orderly manner.

The safe harbour provisions aim to 'strike a better balance' between protecting creditors and encouraging directors to 'innovate and take reasonable risks'.[163] In the context of the better outcome analysis, this balancing exercise involves the interaction of various factors affecting a director's ability and appetite to undertake a particular course of action, including:

- the expectation that directors continue to comply with their general duties to the company when invoking the safe harbour – this includes the duty to exercise their powers and exercise their duties in good faith in the best interests of the company and for a proper purpose[164]

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159 The Explanatory Memorandum notes that the factors in section 588GA(2) may be considered by a court in proceedings where 'the safe harbour is at issue': Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.65].

160 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.61].

161 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.18] and [1.61].

162 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.18].

163 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.12].

164 *Corporations Act 2001* (Cth) s 181; Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.64] and [1.78].

- that, when a company is insolvent or nearing insolvency, a director must take the interests of company's creditors into account as part of complying with their general duty to act in the best interests of the company
- the viability of engaging with the safe harbour process, which may depend on the nature of the industry within which the company operates, and
- in circumstances where turnaround efforts are unsuccessful, the need to have regard to and promote, to the extent possible, the object of Part 5.3A of the Act, which is to provide for the administration of the business, property and affairs of an insolvent company in a way that:
  - maximises the chances of the company, or as much as possible of its business, continuing in existence, or
  - if it is not possible for the company or its business to continue in existence —results in a better return for the company's creditors and members than would result from an immediate winding up of the company.[165]

The question is how the better outcome analysis in section 588GA(1)(a) is operating in practice. Overall, and subject to some submissions calling for more holistic corporate governance reform (discussed further in section 15), there appears to be general support for its inclusion in the safe harbour provisions. Some of the main concerns and suggestions for improvement raised with the Panel are outlined in further detail below. They focused mainly on the lack of clarity concerning the meaning of a better outcome, in light of the 'guiding' (rather than prescriptive) nature of the factors in section 588GA(2),[166] and the lack of judicial consideration of section 588GA.

Nature of the analysis – qualitative and/or quantitative

Several parties queried whether the better outcome analysis was intended to be purely quantitative in nature, or whether it necessarily requires consideration of qualitative factors. A quantitative analysis focuses on the return to creditors under both scenarios, whereas a qualitative analysis also takes into account other factors such as the ability of the company to continue to trade.[167]

For example:

- the Law Council noted it was unclear whether the concept of a 'better outcome' involved a quantitative analysis of whether creditors would obtain a greater return via the successful invocation of the safe harbour provisions, as compared to in an administration or liquidation (and if so, there is a question as to how the 'counterfactual benchmarking return' is calculated), or whether it also involved consideration of qualitative factors such maintaining enterprise and goodwill value through the avoidance of formal appointments[168]

165 *Corporations Act 2001* (Cth), s 435A.

166 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.65].

167 Macaire Bromley notes relevant qualitative information may include the position of secured creditors, employees and general creditors (such as retention compared with loss of employment, the opportunity for ongoing trade and repayment under plans), going concern considerations (including goodwill, market reputation and any potential loss of key contracts or customers), forced sale implications, ability to access short-term working capital and refinance opportunities, the crystallisation of material liabilities or damages claims (for example, under employment contracts, leases and key supplier contracts), key stakeholder support (whether it is forthcoming consensually as opposed to the impact of insolvency moratoriums) and execution risk, time delay and transaction costs (including administrator or liquidator costs): see Bromley, M 'Safe harbour: a best practice guide for directors' (2021) Practical Law ANZ Practice Notes (Reproduced from Practical Law Australia with the permission of the publishers. For further information, visit www.practicallaw.com.)

168 Law Council submission, p 7.

- Vantage submitted, based on its industry experience, that the better outcome analysis is utilised most effectively when it leverages both quantitative and qualitative data[169]
- Deloitte highlighted that while adoption of a quantitative analysis is compelling having regard to the counterfactual prescribed in section 588GA(7), there are also compelling qualitative factors for directors to consider. Deloitte posed the question: 'what if a liquidation achieved a higher return than a restructuring, but the restructuring allowed the economic entity to continue to trade, support its suppliers with continuing business and provide employment?'[170]

The Panel agrees that the concept of a better outcome involves consideration of both quantitative and qualitative factors. To focus solely on quantitative factors would unduly narrow directors' assessment of the courses of action available to a company. The Explanatory Memorandum makes it clear that, when formulating and assessing the viability of a course of action, directors are expected to investigate and remain informed of a range of matters affecting a company's operations and management. This is consistent with the level of diligence and rigour expected of directors generally, as well as what is expected in order for directors to continue to comply with their general directors' duties.

However, those quantitative and qualitative assessments need to be considered in the circumstance of each company and weighed accordingly. The weight that is given to each will differ depending on the circumstances, but while the overall return to creditors is a significant factor, it is not the only factor and would also not appear to reflect how directors are engaging in this assessment in practice. For example, one participant in the Panel's consultation process noted that while directors engaging in the better outcome analysis may initially default to consideration of financial returns when exploring potential turnaround strategies, they will inevitably (and necessarily) turn their minds to broader factors such as preserving jobs and supply relationships.

Prescribed counterfactual – administration and liquidation, or just liquidation

Of relevance to the submissions made concerning the nature of the better outcome analysis is the counterfactual prescribed in section 588GA(7), being the immediate appointment of an administrator or liquidator. Several parties linked the perceived lack of clarity or confusion regarding the meaning of a better outcome to directors being required to compare the potential outcomes of their turnaround plans with an administration or liquidation scenario.

- ARITA noted that best outcomes for a liquidation or administration scenario were relatively clear (particularly in light of the stated object of Part 5.3A of the Act), but the concept of a better outcome for the purpose of Safe Harbour is less clear.[171] ARITA submitted that directors undertaking the better outcome analysis are faced with a difficult task, given a company's creditors would form differing views on what that outcome entailed.[172] Accordingly, ARITA suggested that 'the reference point for what is a 'better outcome' ought to be expressly stated in section 588GA of the Act, with reference to the continued existence of the company or its business or otherwise the achievement of a better financial return for creditors'.[173] In their view, this would align the better outcome in section 588GA(1)(a) with the object of Part 5.3A of the Act, which necessarily informs the conduct of the formal insolvency processes referred to in the counterfactual in section 588GA(7).[174]

169 Vantage submission, p 40.
170 Deloitte submission, p 6.
171 ARITA submission, p 34.
172 ARITA submission, p 34.
173 ARITA submission, p 34.
174 ARITA submission, p 34.

- King & Wood Mallesons submitted that the counterfactual should refer only to the immediate appointment of a liquidator (rather than an administrator and a liquidator), but they also submitted that the provision should be more closely aligned with the object of Part 5.3A of the Act.[175]
- Vantage noted that the source of confusion may be that the prescribed counterfactual encompasses several outcomes, in particular in an administration scenario where creditors may vote for the company to be wound up (ultimately leading to the same outcome as a liquidation), or consider a proposal for a DOCA (which may require consideration of additional factors including potential delays and execution risks).[176] Vantage emphasised that an administration outcome via a DOCA arrangement would only need to be considered by directors 'where there is a genuine DOCA proposal being canvassed that is a real and viable option'.[177]
- In various round-table discussions, it was noted by some stakeholders that a liquidation scenario may be a more appropriate comparator for the purpose of the safe harbour given its more obvious link to insolvent trading and the liability imposed on directors in section 588G.

The Panel is concerned by the prospect of limiting a counterfactual to only liquidation, as it opens the potential for misuse. Imagine a large company that has unsecured corporate bonds on issue and faces financial distress. The directors seek advice from various qualified advisers, one of whom provides it with a better outcome analysis based only on a liquidation counterfactual that sees the unsecured corporate bond holders paid 20 cents in the dollar. At that time, the board's course of action is to continue to trade while negotiating a long-term standstill for its lenders, together with other debt raisings. While the directors are pursuing that plan, the bond holders provide the company with a detailed proposal of a debt for equity swap (where all other creditors are kept whole), to be achieved through an administration and a DOCA. If the prospects of the DOCA being adopted and effectuated are reasonable (that is, if voting in favour of the DOCA is likely), then surely it is that counterfactual that should be relevant in determining whether the directors' plan is reasonably likely to lead to a better outcome for the company. To compare it to liquidation only is to ignore a key input for value realisation.

However, the Panel is also concerned with linking a better outcome too expressly to the objects of Part 5.3A. The motherhood statements contained at the start of Part 5.3A are clearly important and shape much of the policy and framework behind voluntary administration, but ultimately under Part 5.3A the implementation of those objects is via an independent administrator, and (in the context of a DOCA at least) is subject to the vote of the affected creditors. Caution must be applied in allowing directors (who usually and naturally wish to retain control of the company) to determine a better outcome by reference solely to the business continuing and without regard to what creditors may achieve via an administration.

Notwithstanding the potential options available to a director, the protection of the safe harbour extends to a course of action that is reasonably likely to lead to a better outcome for the company. The Explanatory Memorandum notes this 'requires that there is a chance of achieving a better outcome that is not fanciful or remote, but is 'fair', 'sufficient' or 'worth noting'.'[178] As such, the necessary comparator for the purposes of the counterfactual is an administration or liquidation scenario which is fair and reasonable taking the company's circumstances – when engaging in this comparison, a director is not required to canvass a myriad of theoretical scenarios which have only remote prospects of eventuating. Rather, the focus must be on a counterfactual which has a real,

175 King & Wood Mallesons submission, p 5.
176 Vantage submission, p 15.
177 Vantage submission, p 15.
178 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.52].

and not remote, prospect of eventuating, as Vantage submitted using the example of a DOCA proposal in an administration scenario.

The Panel does not recommend any amendments be made to section 588GA(7). We consider that the appropriate counterfactual will depend on the circumstances the company is facing and, accordingly, the definition of better outcome needs to be flexible enough to accommodate a range of scenarios. The inclusion of both administration and liquidation scenarios provides such flexibility. Furthermore, a more prescriptive counterfactual is likely to create inflexibility and heighten risk of misuse.

Interests of key stakeholders

Another issue raised during the Panel's consultation process was how the interests of key stakeholders are factored into the better outcome analysis, and whether certain stakeholders' interests should be prioritised in that assessment.

ARITA submitted that whilst the better outcome analysis does not expressly refer to the interests of any specific stakeholders, it is implicit that a better outcome for the company than the immediate appointment of an administrator or liquidator would also deliver a better outcome for creditors and employees. Similarly, the Law Council noted that to the extent safe harbour is used to successfully implement informal restructuring plans, 'this generally serves the interest of creditors and employees as better outcomes will often be achieved through informal restructures than by use of formal processes which result in enterprise value loss and diminished returns to creditors.'[179] Other parties, including the ABA, ACF and the AICM, suggested that the interests of creditors should be at the forefront of the better outcome analysis. Some parties, such as KPMG, recommended an amendment to the wording of section 588GA(1)(a) to clarify it is a better outcome for both the company and its creditors.

In our view, the interests of creditors are already covered by the reference to 'company'. A director seeking to rely on the safe harbour provisions is doing so because the company is in financial distress and is seeking protection, ultimately, from the duty not to trade the company while it is insolvent. In those circumstances, the case law is clear: directors are under a duty to consider the interests of creditors (being an aspect of their general duty to act in the best interests of the company).[180] Accordingly, in determining whether something is a better outcome for the company, the directors must have regard to creditors.

We are also wary of any suggestion that the better outcome needs to be better for creditors *as a whole*. The reality of a company in financial distress, is that there are often creditors that are 'in the money' and those that are 'out of the money'. This was a point raised in King & Wood Mallesons' submission, which stated:

> *In this regard 'outcome for the company' should be viewed predominantly (but not exclusively) from the perspective of the stakeholders who are at marginal risk depending on the level of financial distress – if the financial distress has not reached the point of insolvency, that may be the shareholders; if it has reached the point of cash-flow insolvency, but not balance-sheet insolvency, that may be the unsecured creditors; if balance-sheet insolvency has been reached, it may be secured lenders and/or other priority creditors.*

For these reasons, the Panel considers it unnecessary for any amendment to be made to the wording of section 588GA(1)(a) to expressly recognise the interests of creditors in the better outcome

179 See also Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.8].

180 See *Termite Resources NL (in liq) v Meadows* (2019) 370 ALR 191 at [197]-[209], and the authorities cited therein.

analysis. We are comfortable that the provision, as currently drafted, requires consideration of the interests of key stakeholders, including creditors and employees.

Classes of creditors

Submissions were also received that suggested the better outcome should be compared against a better outcome for the company and 'all classes of creditors'. In other words, that directors be required to assess that each class of creditor is better off under the proposed course of action. This strikes the Panel as a dangerous concept, which would be not only unduly onerous on directors to determine but would create many of the same difficulties experienced in propounding schemes of arrangement. Classes can be nebulous and a requirement to ensure each class of creditor is better off will create complexity, cost and ultimately frustrate many turnaround plans.

That is not to say directors should ignore differences between creditors. The Explanatory Memorandum refers to 'new' creditors, when it observes that a director taking on new debt in connection with a course of action that the directors know will not see that creditor paid in full, would be 'ostensibly a breach of the general directors' duties as well as being dishonest'.[181]

This point is relevant where the director's 'course of action' is a better-planned insolvent solution (for example, a planned administration). Voluntary administrations are often the best way to re-set a failing company. To embrace the voluntary administration structure as another way of rescuing and supporting viable business for long-term success, is (in our view) important. That the safe harbour provisions give directors the ability to plan an administration in a way that maximises the company's ability to emerge from the administration as a going concern, is one of the safe harbour provisions' strengths.

However, where a planned administration is the proposed 'course of action', incurring debt in the meantime can appear blatantly unfair and wrong. For example, each of the following would appear (at least initially and without context) to be problematic:

- directors drawing down on bank facilities, knowing that the funds drawn cannot be repaid in full (and not disclosing that to the banks at the time), or
- directors ordering from a new third-party creditor (with whom they have not previously dealt) a large supply of new stock not paid for on delivery which the directors know will not be paid in full under their current preferred course of action.

However, some circumstances in which the directors find themselves will not be as stark. For example:

- a director's course of action is to pre-plan a DOCA with its key stakeholders and place the company into administration in 3 weeks' time
- that DOCA will see creditors compromised but still paid more than they would be in an immediate appointment, and
- it is important for the success of the DOCA, and for the better outcome analysis, that the company continues to trade as a going concern in the meantime.

Asking the directors in those circumstances to turn their minds to each individual creditor they deal with during the period they seek to rely on the safe harbour provisions (to work out whether each creditor is better off) could be a challenging task. The Panel is concerned that such a blanket proposition undermines the ability to use safe harbour provisions to effectively pre-plan a more efficient administration appointment. However, we recognise that the rights of creditors are also

181 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.39].

important, and that any re-allocation of that risk should only be considered in the context of a holistic review of insolvency laws. The Panel otherwise notes that there are some strategies directors in those circumstances may employ (for example, changing to 'cash on delivery', and/or ensuring a DOCA prioritises any debts incurred during the safe harbour period), which may assist directors in managing a pre-planned administration.

Desire for clarity and education

The Panel notes stakeholders' suggestions for further clarity regarding the meaning of a 'better outcome' in section 588GA(1)(a), such as additional guidance on the factors which must be taken into account when conducting the better outcome analysis, and when assessing the prescribed counterfactual in section 588GA(7).

There is a clear benefit in maintaining a flexible approach in the statutory provisions. An overly prescriptive approach risks failing to adequately strike the balance Parliament intended between 'the protection of creditors and encouraging honest, diligent and competent directors to innovate and take reasonable risks'.[182] Accordingly, the Panel does not recommend any legislative change. However, the Panel notes its recommendation in section 6.2 for further guidance and considers such guidance should include a non-exhaustive list of factors which may be taken into account when conducting the better outcome analysis.

8.4 Types of debts that can be incurred

Section 588GA(1)(b) provides that safe harbour provisions apply only to debts '*incurred … directly or indirectly in connection with any such course of action*'.

The main query raised in consultations was whether the terms 'directly or indirectly in connection with such course of action' extend to debts incurred in the ordinary course of business.

The Panel's view (which is consistent with feedback received through consultations) is that, in most circumstances, a course of action being pursued will involve the business continuing to operate as a going concern. In those circumstances, we consider it appropriate that debts incurred in the ordinary course of the company's business will be considered to be incurred in connection with the course(s) of action that see the company continue as a going concern. This is consistent with the Explanatory Memorandum which states that debts 'incurred directly or indirectly in connection with' a course of action would include 'ordinary trade debts incurred in the usual course of business'.[183]

However, King & Wood Mallesons noted in their submission that the different terminology used in the Insolvent Trading Moratorium (which referenced ordinary course of business debts) was language that, in their experience, directors better understood.[184] They commented that a reference to ordinary course of business debts 'had a marked effect on the comfort levels of directors'.

In the Panel's view, an amendment to section 588GA(1)(b) to specifically include debts incurred in the ordinary course of business (where the course of action involves the business continuing as a going concern) is beneficial. While we do not think it is strictly necessary, if it assists in facilitating directors' understanding of the provisions, we support that amendment.

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182 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.12].

183 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.48].

184 King & Wood Mallesons submission, p 3.

9. Analysis of Section 588GA(2)

Section 588GA(2) – Working out whether a course of action is reasonably likely to lead to a better outcome

(2) For the purposes of (but without limiting) subsection (1), in working out whether a course of action is reasonably likely to lead to a better outcome for the company, regard may be had to whether the person:

(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

(e) is developing or implementing a plan for restructuring the company to improve its financial position.

We received a number of submissions on the operation of section 588GA(2). Stakeholders raised concerns about whether one or more of the factors set out in that subsection should be mandatory (in particular the appointment of an AQE), and also queried the meaning of the term 'an appropriately qualified entity'.

9.1 Should factors be prescriptive?

A number of submissions perceive the flexibility in the safe harbour provisions as a negative. They view it as creating uncertainty, which undermines their confidence that the provisions would protect the relevant director from a subsequent insolvent trading claim. Stakeholders suggested it would be helpful for a set of criteria to be developed that, if met, provided directors with reassurance that they have obtained safe harbour protection.

The Panel is of the view that 'safe harbour protection' is not something that can just be 'obtained' without also being constantly monitored. The Explanatory Memorandum makes it clear that while not all the factors need to apply, the flexibility of the legislation also means that even where all of the factors have been addressed, a court could still find that directors are not 'in' safe harbour.[185] Accordingly, even if the factors were mandatory and flexibility was removed, that wouldn't achieve a set-and-forget outcome because that is the antithesis of what the safe harbour provisions seek to achieve.

Other stakeholders argued that the flexibility of the provisions has encouraged exploration of whole-of-business strategies. They compare this to a tick-the-box or checklist approach that could

185 Per the Explanatory Memorandum, 'The factors in subsection 588GA(2) … 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': Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.65].

never accommodate the endless set of circumstances a particular company may be facing when they are in financial distress. It was put to the Panel that if safe harbour is to work as a restructuring and governance tool rather than as a compliance tool, users will have to accept some level of uncertainty and responsibility. The benefit of the flexibility of section 588GA(2), including the flexibility around the appointment of an AQE, was seen by them as outweighing any benefit in prescribing certain matters.

The Panel shares the concern that by making factors prescriptive, a tick-the-box approach to safe harbour would be encouraged which, in turn, heightens the risk of the directors obtaining bad advice.

The submissions were more specific regarding the appointment of an AQE. There were suggestions by Wexted, CA ANZ/CPA and AICM that the appointment of an AQE should be prescriptive or mandatory, rather than just a factor that directors should consider. Their reasons included that it is appropriate in the context of larger companies, and that knowing an experienced advisor would be involved would provide credit professionals with greater confidence in the safe harbour process generally.

The Panel agrees that the larger the company, the more likely it is that directors would see the appointment of an AQE as a necessity despite it not being prescribed. Consultations confirmed this is what is happening in practice. The Panel is not aware of any examples of a large company where its directors (wishing to avail themselves of safe harbour protection) have not appointed an AQE.

Some advisers point to the fact that, even though they are not prescriptive, it would be a brave director who did not review the factors listed in section 588GA(2) and make some effort to actively consider and apply them.

However, while there are many reasons safe harbour is not being utilised by smaller companies, the legislation, as enacted, is intended to be available to companies of all sizes and circumstances, and therefore needs to be flexible enough to apply in a variety of circumstances.

It is also important to consider the appointment of an AQE in the broader timeline applicable to companies in financial distress. There is often a short delay between the time directors become aware of underlying causes for concern, and an AQE being appointed. If an AQE is a mandatory factor for safe harbour to apply, then the directors may not be given enough lead time to ensure that they are appointing the right adviser. The Panel was informally provided with a couple of examples where an AQE was appointed in circumstances where, in that AQE's opinion, the directors were already actively engaging in safe harbour prior to the AQE's appointment.

For these reasons, we are of the view that the flexibility built into section 588GA(2) remains appropriate.

9.2 Role of advisers in the safe harbour: what is an 'appropriate qualified entity'?

One of the main points of contention about safe harbour provisions to emerge in the consultation process was the identity of an AQE.

Technically, section 588GA(2)(d) provides that one of the factors to be taken into account in working out whether a course of action will lead to a better outcome for the company, is whether the director *'is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice*'.

In the Panel's experience (and this is supported by the Panel's consultation process) this is a hotly debated phrase in practice. It is divisive because it goes to the heart of who should support and advise companies through their financial distress, and what their role should be.

The divergence of opinion centres around whether there is just one AQE, whether there is a separate 'safe harbour master', whether the AQE needs to be a registered liquidator, and whether such an adviser needs to be regulated.

We think it helpful to analyse the role of the AQE first, as that then informs the identity of the AQE.

Role of AQE

The role of the AQE is to advise in connection with an assessment of whether a course of action is reasonably likely to lead to a better outcome for the company. What is involved in that assessment will differ from company to company and will depend on the course of action being pursued. For example, if the course of action is to raise capital in a listed entity, legal advice as to placement capacity or take-over provisions may be required, as well as advice from capital markets advisers as to the likelihood that such capital raising would be successful. If the course of action is to sell assets or property of the company, then advice from a valuer may be required. And, if the course of action is to increase capacity for a manufacturing plant, advice from an engineer or other expert in the field may be required. In many instances, each of these advisers may need to be supplemented by other turnaround specialists. Finally, a determination of the better outcome requirement also needs to be made. As noted above, the 'better outcome' is defined as an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company.

There are some who suggest that there is a single AQE who takes the reigns of the safe harbour assessments, and either by itself, or with other qualified advisers and turnaround specialists, provides advice to the directors about the course of action and how reasonably likely it is to lead to a better outcome. Such a person is sometimes colloquially referred to as the 'safe harbour adviser' or 'safe harbour master'.

The concept of a single entity that then rallies other advisers as required, to provide safe harbour advice, appears to emerge from the use in the legislation of the singular '**an**' when referencing the appropriately qualified entity.

We are concerned that in creating a role of a 'safe harbour master' or a singular 'safe harbour adviser', there is a threat that the directors seek to delegate their responsibility to determine whether a course of action is reasonably likely to lead to a better outcome for the company. Ultimately, the directors need to make that commercial call. Those directors can take into account the advice of the informed and qualified adviser(s), but it needs to be the directors' decision to continue to pursue, or cease pursuing, the relevant course of action. To do otherwise appears to us to cede to an adviser the essence of the responsibilities and duties of the directors. It is also the director's responsibility to ensure that the cash flow forecasts and other financial information on which the advisers will base their 'better outcome' analysis, are reasonable.

It may be in practice that the distinction is unnecessary, and that the reality is that the 'safe harbour master' is a central adviser that acts as a project manager of the relevant advisers. However, while this role may be necessary in the application of the safe harbour provisions in large turnarounds, we do not think such a role is enshrined (or should be enshrined) in the legislation.

Rather, we view the reference to an 'appropriate qualified entity' to be one or more appropriately qualified advisers who provide the 'appropriate advice'. This is supported by the background provided in the Explanatory Memorandum.[186] We recommend that the reference to 'an appropriately

186 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.35].

qualified entity' be amended to 'one or more appropriately qualified advisers', to clarify that the necessary factor is the receipt of appropriate advice, not that it needs to come from, or through, one entity. We also discuss the implications of who retains an AQE below.

Who can be an AQE?

In recognising that the role of an AQE can be varied and needs to be flexible, it is self-evident that an AQE may be someone other than a registered liquidator. However, there is an important role for registered liquidators to play. The Panel recognises that in most circumstances, the experience of either a registered liquidator with turnaround experience or a turnaround specialist with deep insolvency knowledge will be required to analyse the 'better outcome'.

Certainly, in more complex or large safe harbour engagements, the Panel's experience (which is consistent with the feedback received) is that registered liquidators invariably are the advisers in respect of analysing the better outcome requirement. A better outcome assessment often requires experience as to the real cost of an administration and/or liquidation, applications of unfair preferences law, antecedent transactions, employee entitlements, security reviews, voting entitlements and priority waterfall entitlements. It will usually involve the preparation of a 'security statement' or 'security position'. A security statement or security position is a common industry tool which generally reflects a statement of the company's assets on a comparative basis between book values and the realisable values that may occur in a formal insolvency process. Estimates are also made of the likely quantum of liabilities of the company that may ultimately prove for payment in a formal appointment. These liabilities are considered in the context of the priorities under the payment waterfall contained in section 556 of the Act, and regard is also had to any costs of realisation and the external administrator's remuneration. Security statements or security positions, although they may not be termed that way, are commonly used by voluntary administrators to present the difference in returns to creditors under a DOCA versus liquidation scenario. It is in this context, comparing returns to creditors under the restructuring plan versus the formal insolvency counterfactual, that security statements or security positions would be used in a better outcome analysis.

ARITA's position is that only registered liquidators have the appropriate skillset to undertake such an analysis.[187] GSE Capital and KPMG support this position, but KPMG extends it to contemplate that it could be provided by an 'equivalently regulated person'.[188] Others who support the concept of the AQE being either a registered liquidator or regulated entity are ACF and AICM.[189]

While not requiring the entity performing the better outcome analysis to be a regulated entity, many submissions saw benefit in further clarification of what constitutes an AQE. CA ANZ/CPA's submission noted that in identifying the relevant qualifications an AQE may have, it is important to recognise 'that advice from several experts with differing skill sets may be required and will vary by the size of the company, the complexity of a corporate structure and the financial health of the business when safe harbour is entered'.[190]

We find the argument for flexibility compelling and are reluctant to endorse a view that requires a specific person to be appointed in all circumstances. As various submissions have noted,[191] the deliberate flexibility contained in section 588GA(2)(d) allows for a nuanced and adaptable application to companies of all shapes and sizes. A general theme running through this report is that SMEs' access of safe harbour is limited in practice, but absent any wholesale reform of insolvency laws that

187 ARITA submission, pp 24-26.
188 GSE Capital submission, p 7; KPMG submission, p 12.
189 ACF submission, p 2; AICM submission, p 5.
190 CA ANZ / CPA submission, p 4.
191 McGrathNicol submission, pt 6; Law Council submission, p 8; Vantage submission, p 40.

separately addresses SMEs, the provisions should still be capable of application to SME directors. Accordingly, the provisions need to be able to be enlivened by access to circumstance-appropriate advice in the SME market.

Other observations: factors to consider in appointing an AQE

We make 2 further observations on this point.

First, although we fall short of recommending that a registered liquidator be prescribed to provide the better outcome advice, we do wish to reiterate that in most circumstances a registered liquidator or someone with deep insolvency experience will be the appropriate adviser to provide the liquidation and voluntary administration analysis that informs and underpins the better outcome analysis. The unique position that the registered liquidator occupies is having the same lens (based on experience) that another liquidator will have when assessing the liquidation/ administration position in its better outcome analysis, and that a court may place greater weight on that.

However, a better outcome analysis also requires an analysis of the 'upside counterfactual'. No doubt, there are some registered liquidators with experience and skills to analyse financial models and forecasts, and to compare and evaluate the administration/liquidation analysis with the 'upside position', but not all have that experience. Further, in many (particularly complex) matters, industry-specific experts will be required to attest to models and forecasts. In addition, ARITA's survey suggests that there are registered liquidators who have not provided safe harbour advice to date and some, for various reasons, who are not likely to engage in performing safe harbour advisory work.

Second, that anyone providing the AQE advice should be insured to do so. The Explanatory Memorandum refers to accountants being possible AQEs.[192] It may be that particular advice can be appropriately provided by, for example, the SME's local accountant. However, our consultation process revealed that it was clear that many accountants are simply not insured to provide insolvency or turnaround advice, and to the extent that was what they were being briefed to provide, they may not be 'appropriately qualified' to do so. In those instances, directors think they are receiving 'appropriate advice' but do not understand how to evaluate the appropriateness of it.

Each of these observations highlight, once more, the gap in awareness of what directors should be looking for in seeking to engage an AQE.

Regulation

A number of submissions suggested that AQEs should be separately regulated. Given the Panel's view that AQEs are not limited to registered liquidators, the Panel has considered that suggestion in the context of who performs the better outcome analysis. We have already noted that in most circumstances that will be a registered liquidator or someone with deep insolvency experience.

We see no immediate need for this to occur as a separate category of regulation. Such regulation would undoubtedly come at increased cost. Further, many advisers are already subject to regulation in their relevant industry (for example, registered liquidators). While we received some feedback relating to 'dodgy advisers', such references were anecdotal and we have not received evidence or examples of specific instances where shonky advisers have corrupted or otherwise tainted the application of the safe harbour provisions. For the moment, there are insufficient reports of misuse to justify such additional bureaucracy. This may be an area government needs to monitor, as if the

192 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.35].

instances of dishonest or negligent advisers becomes more prevalent, specific regulation may be needed.

Conflicts

Finally, some stakeholders raised concerns about conflicts in the context of AQE appointments. These arose in 2 contexts.

- First, should any existing relationships between a proposed AQE and a company preclude an AQE appointment? We are of the view that there are some roles where conflicts will be difficult to overcome (for example, the proposed AQE is also the auditor of the company). We fall shy of recommending an AQE be independent and free of conflict as we think that is too prescriptive and limiting and difficult to regulate, particularly in longer-term safe harbour appointments. However, we are of the view that it is a factor directors should consider when appointing an AQE. In some circumstances the 'appropriate' requirement will also mean they should be independent.
- The second context is when an AQE later seeks a role in a formal restructuring (either as an administrator or liquidator). Several stakeholders (including Deloitte, Wexted and ARITA) were clear in their submissions that if a registered liquidator took on a role as an advisor in safe harbour, then he or she should not later act as either voluntary administrator or as liquidator of the company. This is to avoid registered liquidators being placed in positions of actual conflicts, as well as perceived conflicts.

Others, such as the Law Council and McGrathNichol, thought the position uncertain as to whether a registered liquidator who provided safe harbour advice is capable under the law of accepting a formal appointment. The Law Council noted that there may be some merit in not excluding such parties outright. There are obvious efficiencies and synergies in a company (and, in a derivative sense, its creditors) not duplicating the costs of an AQE and the costs of an administrator/liquidator. Of course, 'efficiencies' is a vexed question, because there are also problems associated with an administrator or liquidator of a company being asked to opine on whether solvency advice they previously provided or their better outcome analysis was right. However, there is precedent for certain conflicts or perceived conflicts being managed by the appointment of an independent third party.[193] Ultimately it is a question of fact that has regard to the work undertaken, remuneration received and the bespoke situation of the company.

The concern, from the perspective of the safe harbour provisions, is that advisers often hold back from engaging with a company, or do not want to provide safe harbour advice, for fear of losing a potential formal appointment role. This is a common theme that emerged from consultations. It also has implications for the impartiality of the advice a company receives: if an adviser has a vested interest in a particular course of action, there is a greater risk the adviser's personal preferred course of action is the one that is recommended. This will not be the case for all advisers, or all companies. The Panel recognises that there are conflicts (and perceived conflicts) on both sides of this debate.

When an AQE assists with pre-planning administration advice, the Panel can envisage occasions where their involvement should not automatically conflict with them acting in a formal capacity in any later appointment,[194] and we caution against any amendments to the safe harbour provisions which would seek to exclude absolutely any AQE from a later formal role. We also note that the safe harbour provisions are not the right place to address any such concerns, and that matters of independence for the appointment of administrators and liquidators are best dealt with by Courts (in considering the independence of such registered liquidator by reference to the independence

193 Korda, in the matter of Ten Network Holdings Ltd (Administrators Appointed) (Receivers and Managers Appointed) [2017] FCA 914.

194 Korda, in the matter of Ten Network Holdings Ltd (Administrators Appointed) (Receivers and Managers Appointed) [2017] FCA 914.

requirements set out in section 532(2) the Act), as well as by the relevant professional bodies who oversee the codes of conduct governing such registered liquidator. It is outside the ambit of our Review to consider the appropriateness of those sections or standards.

Summary

The Panel endorses the suggestion of the Law Council that AQE eligibility criteria be produced. The Panel's view is that such criteria should be general in nature, and could draw on the criteria referred to in the Explanatory Memorandum,[195] and otherwise include:

- a statement that the appropriate qualifications of the adviser will depend on the nature of the advice being sought
- where applicable, a person's membership of relevant industry bodies will be a relevant indicator of qualification (for example, whether they are a registered liquidator, lawyer, financial adviser or accountant), and
- that the adviser holds professional indemnity insurance for the type of advice being sought.

It would be helpful if the criteria or guide gave examples, but the Panel cautions against it being too prescriptive.

The Panel is of the view that a combination of the following 2 points will provide clarity and flexibility to directors, advisers and industry participants:

- legislative clarification that an AQE can be 'one or more appropriately qualified advisers', and
- a publicly available, easily sourced (high level) guide as to how the 'appropriateness' of an AQE is to be assessed.[196]

9.3 Section 588GA(2): Other factors

Two other questions emerged from the Panel's consultation process on section 588GA(2).

a) Financial Position

The first related to whether 'in properly informing himself or herself of the company's financial position' a director needed to have regard to only the current financial position of the company, or also to forecasts and cashflow.

In the Panel's view, the assessment of solvency (as summarised in section 5.1 of this Report) includes an element of forward-looking analysis which requires directors to also be considering the company's future debts. Many of the industry participants with whom we spoke emphasised that one of the first tasks they undertake following any safe harbour appointment (or indeed, any turnaround or restructure appointment), is a 13-week cash flow forecast and 3-way financial model. The Panel views such an approach as sensible and appropriate. It is not clear to us how a reliable assessment of whether a course of action is reasonably likely to lead to a better outcome for the company can be made where the company's forecasts and cashflows are not tested and considered. The Panel considers that no change is required to the current drafting of the provision.

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195 See [1.69] and [1.74] of the Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth).

196 See section 6.2 of this Report in respect of how guides may be produced.

b) Misconduct

The second question related to what is meant by a director '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'. In particular, what is meant by 'misconduct' and whether:

- it is limited to only misconduct that could adversely affect the company's ability to pay all its debts (that is, that there needs to be a causation element), or
- a failure of the restructuring plan such that a company cannot ultimately pay all its debts constitutes misconduct.

The question of misconduct only arose in a small number of written submissions and round-table discussions. Most stakeholders indicated that it is not a regularly engaged factor (that is, there are few examples of safe harbour in practice where misconduct needs to be assessed in any particular detail).

The factors set out in section 588GA(2) are illustrative only, and are not an exhaustive list of factors that a Court would consider. Nonetheless, we are of the view that:

- where misconduct of officers or employees has no effect on the company's ability to pay all its debts, it is unlikely to be a relevant factor in the availability of the safe harbour protections (although it may be relevant to other director duties), and
- a failure of the restructuring plan and the ultimate inability of the company to repay its debts should not, of itself, constitute misconduct (as that would substantially undermine the utility of the safe harbour provisions). Of course, if the restructuring plan itself didn't meet the legislative requirements for being 'reasonably likely to lead to a better outcome', then that will be the relevant analysis. This is also consistent with the explanation given in the Explanatory Memorandum,[197] which noted 'there are many variables that could impact on a company's rehabilitation, some of which may not be possible to predict.'

Whether the misconduct factor is relevant will depend on the bespoke circumstances of each safe harbour analysis. However, we are of the view that it has more obvious application in instances of fraud or bribery and other asset-diminishing activities, rather than taking steps to ensure full compliance with all of the company's codes of conduct. The Panel is of the view that the current drafting is appropriate.

c) Restructuring

Section 588GA(2)(e) uses the term 'restructuring' which is now a defined term in section 9 of the Act and is defined inappropriately (for the purposes of section 588GA(2)(e)) by reference to restructuring under the SBR regime.

The Panel recommends that either the reference to the term 'restructuring' in section 588GA(2) be replaced, or the definition of restructuring in section 9 be updated to include a definition for the purposes of section 588GA(2)(e).

197 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.50].

10. Analysis of Section 588GA(3)

10.1 Evidential Burden

Section 588GA(3) states that any person who wishes to rely on section 588GA(1) in a proceeding bears the evidential burden to prove the elements set out in that section. That means the director must adduce or point to evidence that suggests a reasonable possibility that the matter did or did not exist (that is, whether or not the director is entitled to the safe harbour protection in section 588GA(1)).

A related provision is section 588GB, which is titled '*when books or information not admissible for the safe harbour*'. It requires directors to hand over the books of the company to an administrator or liquidator (as relevant), or else be barred from seeking to have them admitted as evidence in a relevant proceeding (which includes a proceeding alleging a breach of insolvent trading laws). The intention behind section 588GB is to require that administrators and liquidators are provided with the materials evidencing safe harbour at the start of their appointment.[198]

10.2 Analysis

Most stakeholders were comfortable with directors bearing that evidential burden. However, some identified confusion about who appoints the AQE and questioned to whom the AQE's 'work product' belongs. In particular, this was raised in the context of legal advice obtained by the directors, which (absent sections 588GA(3) and 588GB) may have been subject to legal privilege.

Safe harbour blurs the lines between advice provided to directors (given the prohibition on insolvent trading is primarily a director matter), and advice provided to the company (given that a 'course of action' is usually one to be taken by the company at the behest of the directors and therefore is something in which the company is intimately involved).

In the Panel's view, it is the directors' duty to avoid insolvent trading, and it is the directors who need to avail themselves of the legislative carve-out to defend an insolvent trading claim. As currently constructed, it is the fact that the director is obtaining advice from an AQE which is an express relevant factor under 588GA(2)(d). Therefore, in most circumstances, the retainer for any AQE is likely to be with the directors, although we are aware of some circumstances involving a joint retainer for the directors and the company if the AQE is providing advice generally in respect of restructuring options. There are also circumstances where the retained lawyer engages the other advisers pursuant to the legal retainer, including in respect of obtaining a better outcome analysis.

The concern raised relating to work papers or product is whether they are the property of the directors or whether they belong to the company. The answer is fact dependent. The terms of the AQE's retainer and how the work product has been produced will be relevant factors. There may be circumstances in which this work product would (unless relied on) be material over which a director may also make a claim of legal privilege. In larger companies there is often an army of advisers (including, for example, separate counsel for non-executive directors) which may make the boundaries between work product produced for the company and the directors easier to define, but this is a luxury many smaller companies cannot afford.

The prospect that materials evidencing safe harbour may not fall under the 'books and records of the company' does not appear to have been contemplated in the drafting of section 588GB and undermines the legislative intent behind that section. We note that sections 438B and 530A, which

198 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.20], [1.21] and [1.23]-[1.24].

would otherwise require a director to deliver all books in the director's possession that relate to the company, may not apply to material over which a director asserts privilege.

A legislative change to section 588GB to extend it to books and records (in the directors' possession or control) that constitute materials evidencing safe harbour (even when they do not form part of the books and records of the company) should be considered.[199] The effect of that amendment would be, unless the director handed over such material at the time of appointment, the director would be barred from producing those books and records to establish safe harbour in any relevant proceeding.[200] This amendment is not meant to extend to a requirement that the director be compelled to provide such materials (which may raise concerns regarding maintenance of privilege), but only that they not be permitted to produce that evidence at a later date to satisfy the evidentiary burden.

Some stakeholders separately raised the concern that handing over work product (to satisfy the evidential burden) may negate certain Directors & Officers' Liability (**D&O**) insurance policies. The Panel has not received evidence of circumstances where this has occurred, or has been alleged, but notes it is likely that such evidence would only emerge if an insolvent trading claim against a director is progressed, and there have been few instances of this since the safe harbour provisions came into effect.

The confusion over ownership of the safe harbour work product is amplified in a company group scenario. Pursuant to section 588V of the Act, the holding company of the insolvent (or about to become insolvent) subsidiary becomes liable for the debts incurred by that subsidiary while insolvent.

Section 588V provides that a holding company contravenes the section if at the time the subsidiary incurs a debt:

- the subsidiary is insolvent or becomes insolvent by incurring that debt
- there are reasonable grounds for suspecting the subsidiary is insolvent, or would become insolvent, and
- either or both of the following apply:
  - the holding company or one or more of its directors is aware there are grounds for so suspecting, or
  - having regard to the nature and extent of the holding company's control over the subsidiary's affairs, it is reasonable to expect that the holding company would be so aware (or that any of its directors would be so aware)

Section 588WA of the Act provides safe harbour protection for the holding company, if:

- the holding company takes reasonable steps to ensure that the safe harbour protections apply to the directors of the subsidiary and the relevant debt; and
- the safe harbour provisions do so apply.

On that basis, the holding company would need to see evidence of compliance with the safe harbour provisions by the directors of the subsidiary, which may mean that the directors are required to provide copies of work product produced for them (some of which may potentially be privileged) to the holding company. That would then become part of that holding company's books and records, further blurring the line between the books and records of the company, and those of the directors.

199 This would also be consistent with the director's obligations under, for example, sections 438B and 530A.

200 Matters of privilege may also need to be addressed (particularly so that privilege is not waived in respect of third parties such as shareholders or other creditors).

The Panel considers it appropriate that section 588GA(3) remains as drafted, and that directors continue to be obliged to bear the (relatively low) evidential burden to enliven the safe harbour protection. However, given the potential implications this issue has for disputes concerning legal privilege, and D&O insurance coverage, consideration should be given to whether section 588GA(2)(d) should be amended to include (in addition to the current drafting) circumstances where the *company* obtains advice from an AQE.

11. Analysis of Section 588GA(4)

Section 588GA(4) – Matters that must be being done or be done

Matters that must be being done or be done

(4) Subsection (1) does not apply in relation to a person and either a debt or disposition if:

(a) when the debt is incurred, or the disposition is made, the company is failing to do one or more of the following matters:

(i) pay the entitlements of its employees by the time they fall due;

(ii) give returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the Income Tax Assessment Act 1997); and

(b) that failure:

(i) amounts to less than substantial compliance with the matter concerned; or

(ii) is one of 2 or more failures by the company to do any or all of those matters during the 12 month period ending when the debt is incurred;

unless an order applying to the person and that failure is in force under subsection (6).

Note: Employee *entitlements* are defined in subsection 596AA(2) and include superannuation contributions payable by the company.

(5) Subsection (1) is taken never to have applied in relation to a person and either a debt or a disposition if:

(a) after the debt is incurred, or the disposition is made, the person fails to comply with paragraph 429(2)(b), or subsection 438B(2), 475(1), 497(4) or 530A(1), in relation to the company; and

(b) that failure amounts to less than substantial compliance with the provision concerned;

unless an order applying to the person and that failure is in force under subsection (6).

(6) The Court may order that subsection (4) or (5) does not apply to a person and one or more failures if:

(a) 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

(b) an application for the order is made by the person.

As noted previously in this Report, there are preconditions (sometimes referred to as safeguards) that need to be satisfied for a director to be able to rely on the safe harbour provisions. A director may not avail themselves of the protections in section 588GA(1) if the company is failing to pay the entitlements of its employees by the time they fall due, or is failing to lodge all tax lodgements as required under taxation laws, and such failure either amounts to less than substantial compliance or is one of 2 or more failures in the last 12 months.

Three concerns have been raised about this provision. First, in a general sense, whether the preconditions are appropriate, or whether they should be removed entirely. Second, whether the drafting of the section is appropriate, considering other sections of the Act and *Corporations Regulations 2001* (Cth) (**Corporations Regulations**) which deal with similar subject matter. Third, what is meant by 'substantial compliance' and the technical failures described in subsection (4)(b)(ii).

11.1 Appropriateness of pre-conditions

Some stakeholders say the preconditions are too onerous and should be removed, and others suggest the provisions would be improved by the introduction of 'cure periods.'[201] The majority of submissions consider the pre-conditions to be appropriate, noting that they:

- are necessary in understanding the true current financial position of a business
- reflect the minimum standard for good governance and managerial diligence that should be afforded to a director seeking safe harbour protection
- are not overly burdensome, unduly onerous, or unreasonable, and
- are seen as important safeguards to prevent misuse.[202]

Vantage makes the observation that the mandatory preconditions assist in 'identifying those companies that might be said to be poorly run, inadequately resourced and lacking in appropriate controls – in turn, picking up companies that are not viable.'[203]

The Panel considers the emphasis on viability key. Safe harbour is not a mechanism to save every business and it is important to distinguish between businesses that have a reasonable prospect of long-term viability (not withstanding short-term challenges) and those that are not viable. Businesses that are not viable should be wound up early, and the pre-conditions to safe harbour are intended to assist in that differentiation.

In relation to SMEs in particular, a number of submissions raise the issue of the pre-conditions being a reason why SME directors are unable to avail themselves of safe harbour protection. For example, the majority of respondents to a specific question on this issue in ARITA's survey of its professional members, suggested that fewer than 10% of SMEs would qualify due to these requirements.[204]

In the Panel's view, based on the policy intent behind the safeguards, it is not appropriate to remove or relax the pre-conditions for all companies to make safe harbour more accessible for SME directors. Amendments to the existing legislation to relax the pre-conditions are unlikely to fix accessibility concerns for SME directors in any event.[205] Rather, we would prefer that accessibility issues are addressed by some of the amendments considered below in relation to clarifying that technical or trivial non-compliance should not exclude a director from the safe harbour protections.

The ambit of section 588GA(4(a)(ii) was also queried by several stakeholders. Their issue relates to the expansive definition of taxation reporting obligations in section 588GA(4)(a)(ii), which refers to the ITAA. Stakeholders noted that such a far-reaching definition makes it very difficult for directors to be comfortable that they have complied with the pre-condition. Most directors are aware of their major reporting obligations being BAS lodgements for pay as you go (**PAYG**) and goods and services tax (**GST**), FBT returns, Income Tax returns, Single Touch Payroll reporting and super guarantee charge (**SGC**) statements. It was submitted to the Panel that having a defined list of reporting obligations (similar to that in section 588FGA), rather than a generic reference to the entire ITAA, will create more certainty for directors.

It was also put to us that having a defined list of reporting obligations would assist in removing unnecessary time and cost involved in determining whether a company had substantially complied.

201 See submissions by the Law Council, ABA, IPA and ASBFEO.
202 See submissions by CA ANZ / CPA, ARITA, Wellard, Wexted, ACF, Vantage, Deloitte, TMA,McGrath Nicol, AICM, KPMG, AICD.
203 Vantage submission, p 18.
204 ARITA submission, Appendix A, p 29.
205 See sections 6.1 and 7.1(b) of this Report for further explanation on the safe harbour accessibility concerns for SME directors.

For directors, there should be as little uncertainty as possible about whether the pre-conditions have been met, and legislative clarification on what directors must achieve in order to be able to access the safe harbour provisions is important. Consultations have shown significant support for prescribing the list of tax lodgement obligations under section 588GA(4)(a)(ii) that must be complied with, and the Panel supports this suggestion.

11.2 Inconsistent provisions

ARITA's submission raises the issue of inconsistency in the eligibility requirements between the safe harbour provisions in section 588GA(4), the obligations in regulation 5.3B.24 for a company undergoing a SBR under Part 5.3.B of the Act and the obligation under section 500AA(1)(g) for a company to be eligible to undergo a simplified liquidation process.[206]

Regulation 5.3B.24

This regulation is satisfied in relation to a company under restructuring if:

(a) the company has:

  (i) paid the entitlements of its employees that are payable

  (ii) given returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the Income Tax Assessment Act 1997); or

(b) the company is substantially complying with the matter concerned.

Section 500AA(1)(g) states: the company has given returns, notices, statements, applications or other documents as required by taxation laws (*within the meaning of the Income Tax Assessment Act 1997)*.

There are 3 alternative expressions dealing with the same matters in the Act. We agree with ARITA's submission that this creates inconsistency and a lack of coherence and consistency in implementing the underlying policy issues.[207]

Section 588GA(4)(a) refers to the payment of employee entitlements 'by the time they fall due', whereas the wording of Regulation 5.3B.24 refers to the payment of employee entitlements 'that are payable'. Consultations have shown a preference for the wording in Regulation 5.3B.24.

Section 588GA(4)(b) refers to 'less than substantial compliance' and 'is one of 2 or more failures by the company to do any of all of those matters during the 12-month period ending when the debt is incurred'. Regulation 5.3B.24 refers to the company 'substantially complying with the matter concerned' only and section 500AA(1)(g) does not mention substantial compliance at all, although we understand a 'substantial compliance' amendment to section 500AA(1)(g) is currently before the Senate.

There does not appear to us an obvious policy reason why the 3 references should not be consistent. The Panel considers (subject to the qualification in respect of what is required under taxation laws) that the wording contained in Regulation 5.3B.24 is more user-friendly and should be preferred.

206 ARITA submission, pp 20-21.
207 ARITA submission, p 20.

11.3 Substantial compliance – Section 588GA(4)(b)

A number of submissions raised concerns over technical or trivial non-compliance that may be caught by the wording of section 588GA(4)(b) and more generally what 'substantial compliance' means.

There appears to be particular confusion over the reference to the failure being 'one of 2 or more failures by the company to do any or all of those matters during the 12-month period ending when the debt is incurred'. Stakeholders advised the Panel that considerable effort and cost is being expended in trying to determine if companies are technically complying with this provision, when the policy intent was focused on serious or serial failings.[208]

The Panel's consultation process has revealed support for an amendment to section 588GA(4)(b) which removes 588GA(4)(b)(ii), leaving the 'substantial compliance' safeguard. This is consistent with the drafting of Regulation 5.3B.24.

In our view, simplifying the wording of the legislation would make it easier and less costly for directors to determine if they are complying with the pre-conditions. Directors' focus should be on the better outcome analysis rather than detailed analysis of technical compliance with the pre-conditions.

Separately, some stakeholders noted that the safe harbour provisions would be enhanced by a definition of substantial compliance.

As it is currently framed, there is an argument that 'substantial compliance with the matter concerned' would require substantial compliance with each return or type of notice that is required by taxation laws (under section 588GA(4)(a)(ii)). The Panel's view is that substantial compliance should be assessed broadly with regard to all employee entitlements or tax lodgements (as relevant), and not pick up technical, trivial or minor matters. The Panel is supportive of a definition of substantial compliance being included in section 588GA(4) to provide greater certainty to directors about the necessary thresholds that must be met before safe harbour protection is engaged.

A matter that has occurred to the Panel and been raised as part of the consultation process, is the prevalence of wage underpayment issues which have arisen since the safe harbour legislation was introduced. The Panel considers there may be a gap where honest, competent directors who would otherwise believe they had substantially complied with the pre-conditions during a safe harbour, discover an employee wage underpayment issue that they were not previously aware of. In such circumstances there may be good policy reasons to allow the directors to still avail themselves of safe harbour protection.

The Panel does not have any specific recommendations in response to this concern, other than to note that it may be a situation that can be addressed by section 588GA(6). Pursuant to that provision, the Court has power to make orders that section 588GA(4) does not apply where the relevant failures were due to exceptional circumstances or where it is otherwise in the interests of justice to make such an order. Whether such circumstances would enliven the Court's discretion would turn on the facts of each case.

208 Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth), [1.79].

12. Analysis of Section 588GA(5)

Section 588GA(5)

(5) Subsection (1) is taken never to have applied in relation to a person and either a debt or a disposition if:
- (a) after the debt is incurred, or after the disposition is made, the person fails to comply with paragraph 429(2)(b), or subsection 438B(2), 475(1), 497(4) or 530A(1), in relation to the company; and
- (b) that failure amounts to less than substantial compliance with the provision concerned;

unless an order applying to the person and that failure is in force under subsection (6).

Relatively few submissions referenced this subsection and those that did, did not query its application in relation to the books and records of the company.

ARITA's submission refers to the law incentivising 'the provision of comprehensive, complete and accurate books and records…This means that liquidators are more likely to receive books and records where directors seek to rely on safe harbour – resolving a common issue in SME liquidations of books and records not being provided.'[209] The submission also suggests that the safeguard assists in preventing general misuse of the safe harbour provisions.[210]

The Panel refers to the discussion of the evidentiary burden in section 10 of this Report, which also addresses section 588GA(5). Subject to the views expressed in that section, the Panel is of the view that the safeguard in section 588GA(5) (and by extension section 588GB) to require a person to assist an external administrator in a subsequent formal insolvency by providing them with information about the company's affairs and providing the company's books and records to an administrator or liquidator remains appropriate.

209 ARITA submission, p 16.
210 ARITA submission, p 19.

13. Analysis of Section 588GA(6)

Section 588GA(6)

(6) The Court may order that subsection (4) or (5) does not apply to a person and one or more failures if:

(a) 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

(b) an application for the order is made by the person.

While some submissions suggested clarity around terminology to reduce a director's potential need to rely on the discretionary relief in subsection (6), no submissions queried its general application.

We are of the view that it remains appropriate for discretionary relief to be available to directors.

Part IV
Other Considerations

14. Other considerations

14.1 Reporting

Several submissions raise the point that, due to the confidential nature of safe harbour, there is a lack of data available to determine if directors are relying on the safe harbour provisions. There are suggestions that this data be captured through the following mechanisms:

- to determine directly from directors if they have been relying on the safe harbour provisions, provide an ability to capture use in the company annual statement issued by ASIC each year
- where a director seeks to rely on safe harbour protection in a subsequent administration or liquidation, capture that through the Form 507 (Report on Company Activities and Property) which directors must complete
- to determine use identified by registered liquidators, capture that through the Form 908 Annual liquidator return or Initial Statutory Reports (**ISR**) prepared by liquidators.

Even those submissions that suggested capturing this data acknowledged that confidentiality must be maintained, particularly where they are suggesting directors provide acknowledgement of their use of the provisions in company annual statements. The AICD/BCA submission acknowledges that lack of visibility on the use of safe harbour is a by-product of the confidential nature of the regime and that a requirement to report, even if it is confidential, may provide a disincentive for directors to use the provisions. The Panel cautions against any reporting regime that requires directors to contemporaneously acknowledge reliance on the safe harbour provisions. We are of the view that it will act as a disincentive to directors utilising the safe harbour provisions, for fear of such acknowledgment becoming public.

Collection of data from registered liquidators in their Form 908 Annual liquidator return will only capture information where they have been appointed either as a safe harbour adviser or as a subsequent administrator or liquidator. Although this will not capture all AQEs, the Panel is of the view that (provided the cost of collecting data is not too high), there is utility in using existing forms to garner information from at least one key industry participant.

In respect of ISRs by liquidators (under section 533 of the Act), these are only required if there is misconduct, or a liquidator expects to pay a dividend of less than 50c in the dollar. So, by definition, while most liquidations end up having an ISR prepared and lodged with ASIC, not every liquidation will. ISRs do capture misconduct which may include insolvent trading, however, the Panel is advised it is only supplementary reports to ASIC that may include information about section 588GA reliance.[211]

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211 ASIC undertook a preliminary review of supplementary reports lodged under section 533(2) of the Act for the Panel. Between 29 March 2020 and 29 October 2021 there were 659 reports lodged under section 533(2) of the Act, of which 576 (87.4%) alleged that the director traded while insolvent. Of those 576 reports, 81(14 per cent) indicated the liquidator was aware the director may have a defence. ASIC also reviewed the free text descriptions of the potential defence and identified 4 that specifically referred to safe harbour under section 588GA. However, none of those referred to the steps taken to seek the protection of safe harbour. Seven reports referred to the section 588GAAA temporary safe harbour. ASIC has advised that, on further review, the preliminary analysis may be subject to change before it is published by ASIC.

The Panel sees utility in a data collection point being included in reports provided by voluntary administrators and liquidators. While this would relate only to safe harbours that have ended in formal appointments, it would allow for further quantitative analysis on the use of safe harbour in such circumstances, and its success in preventing a worse outcome for the company. Such reports would also assist in assessing any difficulties for registered liquidators in pursuing insolvent trading actions.

14.2 Transparency and engagement

Most stakeholders, when considering issues of transparency, were adamant that confidentiality of a director relying on safe harbour should be maintained, other than where the company chooses to engage with a third party in connection with implementing its course of action. Stakeholders observed that such engagement is quite common with financiers and, more variably, other key creditors, because without the support of those key creditors it is unlikely a plan can be successfully implemented.

ARITA's submission noted that, generally speaking, without creditor engagement and support, creditors would need to be paid in the ordinary course of business during a restructure, otherwise the company runs the risk of recovery actions including winding up applications being taken.

Credit agencies, however, are concerned about a lack of engagement. AICM, in particular, noted increased disengagement by directors during the period the Insolvent Trading Moratorium was in force and are concerned this practice will continue under the guise of safe harbour.[212] They see early engagement as the most effective way for all stakeholders to achieve a better outcome and note that credit professionals will look to support viable businesses.[213] From a director's perspective, raising safe harbour with creditors runs the risk of those creditors being alarmed enough to curtail future supply, which may be enough to put an end to any restructuring plan.

The issue of transparency for creditors is complex. The more a creditor knows, the more they could be exposed to unfair preference recovery action in a subsequent liquidation. The credit agencies again submit that it is unfair for directors to be protected by the safe harbour provisions, when creditors are not protected from being penalised for supporting a debtor through a turnaround plan that fails. Some submissions asserted that creditors should be excused from unfair preference claims for payments made while a director was relying on the safe harbour provisions.

We have some sympathy for this position, but the issue of preferences is also complex, as the original policy intent behind them was to ensure that the assets of an insolvent company are distributed equally among creditors and that no one creditor (particularly those with more knowledge or power than others) receives preferential treatment. We discuss this further in section 15.2.

14.3 Listed companies

One submission commented that safe harbour protections should not be available for public company directors.[214] The Panel disagrees and thinks the availability of safe harbour protections for all directors is not only appropriate but an important part of the turnaround armoury for the directors of listed companies that find themselves in financial distress.

212 AICM submission, p 3.
213 AICM submission, p 4.
214 GSE Capital submission, p 7.

14.4 Time limits

The Panel received some submissions about imposing formal time limits on the duration of the safe harbour protections.[215] We are concerned that an arbitrary time limit will constrain the way in which the safe harbour protections can apply, particularly in complex scenarios (when a process is included to seek Court approval to have time limits extended). Any such extension request would come with increased costs and is also likely to be public.

Subsections 588GA(1)(b)(i) and (ii) already specify that safe harbour protections cease on the earlier of: the person failing to take such course of action within a reasonable time and when the person ceases to take any such course of action. A 'reasonable time' will differ depending on the complexities involved and the actions required. We are of the view that this flexibility is important given the myriad different scenarios to which the safe harbour protections are applicable. This, coupled with the requirement under subsection 588GA(1)(b)(iii) that the safe harbour protections cease if the plan ceases to be reasonably likely to lead to a better outcome for the company (which requires the directors to monitor progress and evaluate the likelihood), offer sufficient protection from a stagnating safe harbour. Accordingly, we are of the view that the existing language is appropriate, and that formal time limits are not required to prevent potential abuses.

14.5 Creditor defeating dispositions

The Commonwealth's legislation targeting illegal phoenix activity came into effect in 2020.[216] The new law makes safe harbour available to officers and other persons as a defence against an alleged contravention of the creditor-defeating disposition prohibitions. In effect, a creditor-defeating disposition is not voidable (nor subject to court orders under section 588F of the Act) if the disposition was made in connection with a course of action that satisfies the safe harbour provisions.

The Panel notes that the illegal phoenixing provisions were enacted too recently to ascertain their interaction with safe harbour. The Panel did not receive any submissions that considered the application of safe harbour vis-à-vis the recently enacted illegal phoenixing provisions.

The safe harbour carve-out as it applies to the illegal phoenixing provisions should be recognised as a tool that promotes good governance; one that can only be utilised by honest, diligent directors acting in the best interests of the company.

14.6 Section 596AC

In 2019, by virtue of the introduction of sections 596AB (dealing with criminal offences) and 596AC (dealing within civil contraventions) into the Act,[217] the Commonwealth introduced general obligations (including on directors and officers of a company) to preserve employee entitlements. It provides that an officer of the company contravenes section 596AC(3) where the person causes the company to enter into a relevant agreement or transaction where they know (or a reasonable person in their position would know) that the relevant agreement or the transaction is likely to either avoid or prevent the recovery of the entitlements of employees of the company, or significantly reduce the amount of the entitlements of employees of the company that can be recovered. Under section 596AB(1C), it is an offence if the contravention by the officer is reckless as to whether the relevant agreement or the transaction is likely to either avoid or prevent the recovery of the entitlements of

215 GSE Capital submission, p 7; KPMG submission, p 14.

216 *Treasury Laws Amendment (Combatting Illegal Phoenixing) Act 2020* (Cth).

217 *Corporations Amendment (Strengthening Protections for Employee Entitlements) Act 2019* (Cth), effective 6 April 2019.

employees of the company, or significantly reduce the amount of the entitlements of employees of the company that can be recovered.

An extract of the relevant sections is included as Annexure E.

At the time directors are seeking to rely on the safe harbour provisions while pursuing a course of action that will lead to a better outcome for the company, sections 596AB and 596AC appear to require that a separate analysis be undertaken to determine whether any agreement or transaction entered into during that period (or at any other time) has the effect of significantly reducing the amount of any entitlements to employees of the company that can be recovered.

Wellard gives the hypothetical example of a restructuring plan that involves the sale and transfer of a business from a company in the twilight zone of insolvency, to a purchaser.[218] The terms of the sale do not see all liabilities transferred (including, for example, some employees). This is not an uncommon feature in an informal restructuring plan: that a 'stub company' remains post a sale, with assets and/or liabilities that are not to be transferred, which will then be wound up through a process.

Under the safe harbour provisions, the restructuring plan would need to satisfy the better outcome requirements. However, in some circumstances, it may be that while a restructuring plan satisfies the requirement that it be better for the company *as a whole* (and even creditors *as a whole*), it may not be better for employees as a whole (or may not be better for a sub-set of employees). The introduction of sections 596AB and 596AC require directors to have particular regard to the difference in position of employees under any plan, and, if there is a difference, then the relevant transactions will need to be entirely effectuated through a formal insolvency process rather than informally.

As the Wellard submission points out, there are conflicting signals sent to directors via the introduction of these new provisions.[219] Wellard highlights that in the Explanatory Memorandum to the Corporations Amendment (Strengthening Protections for Employee Entitlements) Bill 2018 (Cth), the following explanation was provided as a reason for excluding DOCAs from the ambit of the new provisions:

> *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 financial distressed businesses.*[220]

In addition, the safe harbour Explanatory Memorandum also highlighted that the reason for introducing the safe harbour provisions was to recognise that the insolvent trading provisions can 'result in the unnecessary liquidation of companies that could otherwise be successfully restructured and continue to operate'.[221]

It is not clear to us why the safe harbour protections do not also operate as a carve-out to the obligations in section 596AC of the Act and are not considered a 'legitimate option to rescue, reorganise or restructure a financially distressed business'. We recommend that, just as cross references to the creditor defeating dispositions were included in the safe harbour provisions, so should section 596AC of the Act.

218 Wellard submission, p 5.

219 Wellard submission, p 3.

220 Wellard submission, p 3; Explanatory Memorandum to the Corporations Amendment (Strengthening Protections for Employee Entitlements) Bill 2018, [2.56].

221 Explanatory Memorandum to the Corporations Amendment (Strengthening Protections for Employee Entitlements) Bill 2018, [2.56]. Explanatory Memorandum to the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017, [1.7]-[1.10].

14.7 Application of safe harbour to directors of NFPs

A further matter raised for the Panel's consideration was the availability of safe harbour to directors of NFPs. The AICD/BCA submitted it had received feedback that there is some uncertainty regarding the way in which safe harbour applies to NFP directors.[222] The AICD/BCA submission noted that the 'patchwork' nature of the state and Commonwealth legislation which regulates NFPs, as well as the requirements imposed by the ACNC,[223] has contributed to this lack of certainty.[224] It was suggested there would be benefit in the ACNC and ASIC issuing joint guidance to clarify, at least for those entities incorporated under the Act, that 'safe harbour is a potential protection available to them'.

The Panel acknowledges that NFPs, and their directors, are subject to a multi-faceted regulatory regime, which may give rise to some complexities for directors who seek to ascertain the scope and content of their duties and obligations. In the Panel's view, it is intended for safe harbour to be available to directors of NFPs. This is made clear in Part 1.6 of the Act, concerning the Act's interaction with the *Australian Charities and Not-for-profits Commission Act 2012* (Cth). Section 111L lists provisions of the Act which are not applicable to bodies corporate registered under the *Australian Charities and Not-for-profits Commission Act 2012* (Cth). While the general directors' duties in sections 180-183 are referred to in that section, there is no reference to the duty to prevent insolvent trading in section 588G, or safe harbour provisions. As such, it can be inferred that Parliament intended for sections 588G and 588GA to apply to directors of NFPs which are subject to regulation by the Act.

It is possible the lack of certainty identified by the AICD/BCA stems in part from issues associated with a wholesale application of the concept of 'solvency', as defined in the Act, to NFPs. The operations of NFPs are distinct from those of ordinary proprietary companies. For example, NFPs may be operating with little to no capital, and may be reliant on grants to fund their continuing operations. As such, the Panel sees benefit in the unique circumstances of NFPs being given closer consideration as part of a holistic review of the broader insolvency law framework.

222 AICD/BCA submission, p 8.

223 Notably, Governance Standard 5 concerning 'Duties of Responsible Persons', which requires charities to take reasonable steps to make sure certain duties apply to Responsible Persons and that those persons follow them. It includes a duty not to allow the charity to operate while it is insolvent.

224 AICD/BCA submission, p 8.

PART V
HOLISTIC REFORM

15. Holistic Reform

A consistent theme through this Report is the call for a holistic review of Australia's insolvency laws.

Set out in this section are some compelling reasons for a comprehensive review of Australia's insolvency laws, from an economic, legal, and social perspective.

15.1 Examples of inconsistencies and conflicts within current law

If one of the main drivers behind implementation of the safe harbour provisions is to remove in certain circumstances, the threat of directors being personally liable for the debts of the company, what efficacy can those provisions have when other legislative provisions continue to impose liability on the director in the same circumstances? Some examples of the inconsistency of approach are set out below.

For the Panel, it is a powerful argument for holistic reform, where public policy imperatives can be considered and applied consistently. Other than where stated below, we are cautious about recommending wholesale changes to insolvency laws to rectify the apparent lack of statutory compatibility, without the wider impact on business practice and the economy being properly assessed. A piecemeal approach will only lead to further inconsistencies.

a) Section 588FA – unfair preferences

While safe harbour can be used without the knowledge of creditors, there are occasions where directors may need the support of key creditors to implement their restructuring plans. To obtain creditor support, management of a distressed company may provide financial information to a creditor which evidences a suspicion of the company's insolvency. This in turn may create evidence of a creditor's knowledge to be used in an unfair preference claim by a liquidator, should the company enter a formal process. Accordingly, a creditor will often be reluctant to engage in such discussions, which may frustrate implementation of the restructuring plan. Some creditors submitted they should be released from remitting preference payments received from a company during a period where its directors are relying on safe harbour.

However, unfair preferences, along with antecedent transactions, are a significant contributor to the way in which liquidations are funded, which in their absence, will need to be funded by other means. That raises a question as to the role of the state and the private profession in the insolvency system, what the insolvency profession should be asked to do in winding up companies, and who bears the cost of that. Accordingly, it is the Panel's view that any removal or tweaking of unfair preferences requires further consideration (from a public policy and practical perspective) as to how liquidations could be funded in their absence.

b) Section 588FGA – directors to indemnify Commissioner of Taxation if certain payments set aside

Under section 588FGA of the Act, directors may be liable to indemnify the ATO where the ATO has been ordered to repay an amount received by the company as an unfair preference. This means that where a company makes a payment to the ATO in circumstances where the directors are seeking to rely on safe harbour, and the course of action that the directors were pursuing ultimately fails and the company is wound up, the director ends up bearing the risk of such payment being found to be an unfair preference. In other words, even though the safe harbour provisions applied during that time, the director may still be liable.

Rather than risk this possible exposure, a director may choose to wind the company up rather than strive for a possible better outcome for the company through a restructuring.

c) Director Penalty Notices and resulting personal liability

Where a company does not pay in full its obligations relating to its PAYG withholding, GST, and/or its SGC, the ATO may seek to recover the unpaid amounts from a director of the company personally via issuance of a Director Penalty Notice (**DPN**).

The DPN regime is an onerous one for directors and, from our consultation process, is only starting to be more broadly understood. While on some level, it appears unrelated to the safe harbour reforms, from a policy perspective, it looks to be inconsistent with the principles behind the safe harbour provisions. In our consultations, many stakeholders raised it as another reason why the safe harbour provisions are not resonating with SMEs. However, the problems that arise from the intersection of DPNs with a company in safe harbour are not limited to SMEs.

For example, where a new director is appointed to a company, that director has 30 days to ensure that all unpaid PAYG, GST and SGC is paid in full, or otherwise (unless the company appoints an administrator, begins to be wound up or appoints a small business restructuring practitioner), the director is liable for the unpaid amounts. That director remains liable for historical unpaid amounts, even if they resign.

It is not difficult to imagine circumstances where a director has no option but to place the company into administration (notwithstanding that such a course of action may be worse for the company and its creditors).

Separately, if a director is already liable for ATO debts (because their company is behind in payments), then there may be little incentive to engage substantively with the safe harbour provisions. This may seem a little trite, but because the ATO is one of the main debtors of many SMEs and medium-sized companies, directors may not feel incentivised to lodge their taxes, or seek the counsel of an appropriately qualified adviser, if it is not going to remove a large part of their (already existing) personal liability.

If the purpose behind the safe harbour provisions is to encourage companies to seek advice early and put their companies in the best possible position for a viable future (including improving the books and records, lodging taxes and paying employee entitlements), then DPNs act as a disincentive and, in practice, may be counterproductive to those aims.

d) Section 596AC – relevant agreements or transactions that avoid employee entitlements

The implications of section 596AC are considered in more detail in section 14.6 of this Report.

From a policy perspective, section 596AC is at odds with one of the stated purposes of section 588GA, being to avoid premature appointments. The Law Council also identified this in their submission, asking whether '*the new employee entitlement-defeating voidable transaction provisions and the broader creditor-defeating disposition provisions are better suited to achieving the policy* *goals behind the introduction of the insolvent trading prohibition … to protect employees and creditors?'*[225]

The Panel is of the view that this is one inconsistency that can be readily addressed on an individual basis, by including the safe harbour provisions as a legislative carve-out to section 596AC.

15.2 Alternatives to the underlying insolvent trading prohibition: a 'business judgement rule' model

As noted in section 8.2 above, several submissions received by the Panel queried whether the safe harbour provisions could be made more fit-for-purpose if they were aligned with, or replaced, the business judgment rule in section 180(2) of the Act (or something like it). The points highlighted in those submissions included:

- the need to strike a better balance between the threat of personal liability for insolvent trading and supporting directors' decision-making when a company is experiencing financial distress
- the lack of clarity concerning the interaction between the safe harbour provisions and the general directors' duties in Part 2D.1 of the Act, and the confusion surrounding the application of directors' duties in an insolvency context, and
- finding ways to incentivise better behaviour and decision-making by directors, in particular, during periods of financial distress.

The business judgment rule is, at present, concerned exclusively with the general directors' duties in Part 2D.1 of the Act, and specifically with the duty in section 180 which requires a director or other officer of a corporation to exercise their powers and discharge their duties with care and diligence. The note to section 180(2) stipulates that the business judgment rule only operates in relation to the duty in section 180 and its equivalents at common law and equity. It does not operate in relation to duties under any other provisions of the Act or under any other laws. We have extracted section 180 in full below.

Section 180 – Care and Diligence – Civil Obligation Only

Care and diligence — directors and other officers

(1) A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:
  (a) were a director or officer of a corporation in the corporation's circumstances; and
  (b) occupied the office held by, and had the same responsibilities within the corporation as, the director or officer.

Note: This subsection is a civil penalty provision (see section 1317E).

Business judgment rule

(2) A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:
  (a) make the judgment in good faith for a proper purpose; and
  (b) do not have a material personal interest in the subject matter of the judgment; and

225 Law Council submission, p 4.

(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
(d) rationally believe that the judgment is in the best interests of the corporation.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

Note: This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (including the duty of care that arises under the common law principles governing liability for negligence) — it does not operate in relation to duties under any other provision of this Act or under any other laws.

(3) In this section:

business judgment means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.

The business judgment rule operates as a 'rebuttable presumption',[226] which is 'enlivened' by a director establishing each of the 4 criteria contained in section 180(2).[227] A director who establishes those criteria will be taken to have met the requirements of the duty of care and diligence in section 180(1) (and its equivalents at common law and equity). It includes the criterion in section 180(2)(d) that the director 'rationally believed' the judgment was in the best interests of the corporation. This requires a subjective assessment of whether a director's process of reasoning was rational, followed by an objective assessment of whether the relevant belief was one no reasonable person in the director's position would have held.[228]

The business judgment rule was introduced into the Act by the *Corporate Law Economic Reform Program Act 1999* (Cth). It is clear, when having regard to the Explanatory Memorandum of the aforementioned legislation,[229] that there are conceptual similarities between the business judgment rule and the safe harbour provisions which commenced operation almost 2 decades later. For example, the Explanatory Memorandum stated:

> In general terms a statutory business judgment rule will offer directors a *safe harbour* from personal liability in relation to honest, informed and rational business judgments.[230]

Notwithstanding the conceptual similarities, Parliament has maintained the narrowed scope of operation of the business judgment rule to the director's duty of care and diligence.[231] Although, in the years since its enactment, there have been calls for the business judgment rule (or something like

226 Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998 *(*Cth), [6.10].
227 *Australian Securities and Investments Commission v Mitchell (No 2)* (2020) 382 ALR 425, [1425] (Beach J). His Honour also held that the 'legal and evidentiary onus' is on a defendant director to establish the criteria in section 180(2). His Honour observed that 'each of the criteria is within the purview, personal knowledge of and proof by the defendant director, suggesting that it was the statutory intent that he bears the relevant legal and evidentiary onus' (at [1425]).
228 Ford, Austin and Ramsay's Principles of Corporations Law (LexisNexis at July 2020) at [8.310.24], referring to the decision of Beach J in Australian Securities and Investments Commission v Mariner Corp (2015) 241 FCR 502.
229 Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998 (Cth).
230 Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998 (Cth), [6.1]. [6.3] and [6.4] (original emphasis).
231 The Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1998 (Cth) stated with respect to the business judgment rule that '[t]he proposed provision does not apply, for example, to business judgments made by directors in the context of insolvent trading or in relation to misstatements in a prospectus or takeover document. These are discrete areas that are each regulated by a separate liability regime (at [6.8]).

it) to be extended to the insolvent trading regime in the Act.[232] The reigniting of these calls in the submissions received by this Panel highlight the utility of this matter being reconsidered as part of a holistic review of the insolvent trading framework.

15.3 Alternatives to the underlying insolvent trading prohibition: wrongful trading

A number of submissions referred to a wrongful trading regime as a potential replacement of the current insolvent trading framework in the Act (and noted in particular the United Kingdom and Singapore as examples of jurisdictions which have adopted such a regime).

Whilst there are differences in the provisions in force in the United Kingdom and Singapore, the key elements of those 'wrongful trading' models can be distilled as follows:

- a company becomes insolvent
- the company continued incurring debts or liabilities while it was insolvent, or became insolvent as a result of incurring those debts or liabilities
- a director is liable if they knew or ought to have known that trading was 'wrongful' (that is, due to the company being unable to meet those debts or liabilities).[233]

Under the United Kingdom model, there is a focus on whether there was 'no reasonable prospect' that the company would avoid entering insolvency. A director will not be liable if they took steps with a view to minimising potential losses to creditors, once he or she concluded there was no reasonable prospect the company would avoid becoming insolvent. Most submissions to the Panel that raised this topic were supportive of consideration being given to the adoption of such a regime in Australia, although some who had practiced in the United Kingdom spoke of difficulties with such a regime in practice.

Wellard submitted that a wrongful trading provision would be a substantial improvement on the duty to prevent insolvent trading in section 588G because it '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'.[234]

The AICD/BCA challenged the Panel to consider whether 'increasing the threshold' of the duty in section 588G to 'wrongful trading' in line with the United Kingdom model warrants further analysis, noting the threshold for director liability in the United Kingdom is higher than that under section 588G, which requires 'only that there was reasonable suspicion in the mind of the director that the company was insolvent'.[235] The TMA commented that it might be timely to explore with the community whether insolvent trading ought to be replaced with wrongful trading, 'which focus[es] on the propriety of the decision according to community expectations'.[236]

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232 See Leanne Whitechurch, 'Should the law on insolvent trading be reformed by introducing a defence akin to the business judgment rule?' (2009) 17 *Insolvency Law Journal* 25, 26-27.

233 We have deliberately simplified what are quite extensive provisions. For more detail see *Insolvency Act 1986* (UK), section 214 and *Insolvency, Restructuring and Dissolution Act 2018* (Singapore), s 239. For a more detailed overview of the Singapore model, as well as some consideration of the United Kingdom model, see Stacey Steele, Ian Ramsay and Miranda Webster, 'Insolvency law reform in Australia and Singapore: Directors' liability for insolvent trading and wrongful trading' (2019) 28(3) *International Insolvency Review* 363.

234 Wellard submission, p 2.

235 AICD/BCA submission, p 3.

236 TMA submission, p 13.

The Law Council's submission was along similar lines and noted that a wrongful trading prohibition could operate in tandem with 'the existing suite of directors' duties and antecedent transaction provisions (including in particular those dealing with creditor defeating dispositions and transactions avoiding payment of employee entitlements)'. The Law Council submitted this would facilitate the dual objectives of protecting creditors and 'effectively facilitating and promoting corporate rescue in appropriate cases'.[237]

ARITA provided a different view, commenting that there was 'limited support for the repeal of the insolvent trading and safe harbour provisions' among their members and that there were 'very mixed views about whether a 'wrongful trading' framework of the kind adopted in the United Kingdom would be a better approach'.[238]

It is beyond the scope of this Review to consider the different models of wrongful trading around the globe, or to consider whether Australia's prohibition on insolvent trading should be replaced with such a model. The adoption of a wrongful trading model in Australia would have significant ramifications for the insolvent trading regime, the broader corporate governance framework provided for in the Act, and related regulatory mechanisms. As flagged in the Law Council's submission, a wrongful trading prohibition would intersect with general directors' duties (including those contained in Part 2D.1 of the Act). It would also interact with the external administration framework in Chapter 5 of the Act. Accordingly, if such a proposal is to be considered, it should be the subject of in-depth consideration and consultation with key stakeholders including creditors, directors, regulators and advisers.

While the safe harbour provisions are, in the Panel's view, an enhancement to the prohibition on insolvent trading and how it operates in practice, there are still significant queries about the underlying effectiveness of the prohibition, and its interaction with corporate governance, risk allocation and other legislative obligations of directors. Those difficulties arise because of the starting position of the duty: directors are liable for all insolvent trading, unless carve-outs or defences apply.

The appropriateness of that base position (from a policy perspective) is worthy of being questioned. To the extent a 'wrongful trading' model can achieve similar policy objectives while also clarifying and simplifying the concept of insolvent trading from the perspective of directors, is, at least on its face, appealing. However, its appropriateness within the Australian jurisdiction must be considered.

15.4 The call for holistic review

The Panel's terms of reference asked us to consider, among other things, any particular issues experienced by directors of SMEs when engaging with financial distress. We have addressed a number of these in our analysis of the safe harbour provisions set out above, but perhaps one of the most significant issues is Australia's insolvency laws themselves. For many non-lawyers and non-insolvency specialists (and indeed, many lawyers and insolvency specialists too), it is an impenetrable quagmire that is scary, complex and unknown.

ARITA and TMA submissions in particular, point to their views that Australia's bankruptcy, restructuring, insolvency and turnaround regimes are among the most complex in the world. For corporations, insolvency processes are contained, and must be navigated by users, in:

- Chapter 5 of the Act
- Schedule 2 – Insolvency Practice Schedule (Corporations)
- the Corporations Regulations, and

237 Law Council submission, p 11.
238 ARITA submission, p 33.

- Insolvency Practice Rules (Corporations) 2016 (Cth).

To illustrate how layered and complex the provisions have become, consider that the new safe harbour carve-out for the SBR reforms is located in a part of the Act labelled section ‘588***GAAB***’.

We would welcome a review that considers how to best update Australia’s insolvency laws for the 2020s and beyond. As we noted in the Executive Summary, one of the drivers of the Harmer Report was the acknowledgment that economic and social change are factors that indicate a need for review of insolvency law and procedure.[239] There has been significant economic and social change in Australia since the publication of the Harmer Report in 1988. The way in which capital (both public and private) is sourced, and the globalisation of debt and equity capital markets, are just some illustrations of the ways in which Australia in 2021 is a very different place to Australia in the early 1990s. During the intervening period, Australia also adopted the UNCITRAL Model Law on Cross-Border Insolvency. The Model Law is designed to assist signatory states (including Australia) to more effectively manage cross-border insolvencies. The Panel considers that it would be timely to consider the Model Law’s impact on and inter-relationship with Australia’s insolvency laws (particularly in the context of international trade, and complex cross-border insolvencies).

Without being too prescriptive about what other matters a comprehensive review should consider, it should focus on balancing the competing interests of debtors, creditors, and the wider community. To promote a culture of entrepreneurship, it is necessary to establish benchmarks of acceptable director behavior which the capital markets, and our international trading partners, will support.

Fundamental to such a review is establishing principles with respect to who should bear the financial risk during a corporate restructuring and what is the most effective process of protecting the interests of stakeholders throughout the restructuring. Any review should consider the different challenges faced by companies in the SME and mid markets compared to larger companies. It may be that a ‘one size model’ does not fit all.

239 Australian Law Reform Commission, General Insolvency Inquiry [1988] ALRC 45, Chapter 7, p 4.

Part VI
Recommendations

16. Recommendations

Recommendation 1

The Panel recommends that section 588GA(1)(a) be amended to include a reference to a person starting to suspect the company is in financial distress (in addition, and as an alternative to, a person starting to suspect that the company may become or be insolvent).

Recommendation 2

The Panel recommends that the safe harbour protections extend to the obligations of directors under section 596AC, and that section 588GA be amended to refer to subsections 596AC(1) and (3).

Recommendation 3

The Panel recommends that section 588GA(1)(b) be amended to specifically refer to debts incurred in the ordinary course of business.

Recommendation 4

The Panel recommends that a plain English 'best practice guide' to safe harbour be developed by Treasury in consultation with key industry groups. The Panel recommends that this guide set out general eligibility criteria for appropriately qualified advisers.

Recommendation 5

The Panel recommends section 588GB be amended, to clarify that:

- if books and records are in a director's possession and control (even if they are not the books and records 'of the company'), and
- those books and records are not provided to the administrator or liquidator at the time of a formal appointment,

then the director will also be prevented from producing those books and records to establish safe harbour in any relevant proceeding.

Recommendation 6

The Panel recommends either the reference to the term 'restructuring' in section 588GA(2) be replaced or the definition of restructuring in section 9 be updated to include a definition of that term for the purpose of section 588GA(2)(e).

Recommendation 7

The Panel recommends that section 588GA(2)(d) be amended by replacing the reference to 'an appropriately qualified entity' with 'one or more appropriately qualified advisers'.

Recommendation 8

The Panel recommends that section 588GA(2)(d) be amended to expressly state that regard may also be had as to whether the *company* is receiving advice from one or more appropriately qualified advisers who have been given sufficient information to provide appropriate advice.

Recommendation 9

The Panel recommends amending subsections 588GA(4)(a) and 588GA(4)(a)(i) to align the wording of those provisions with the wording of the employee entitlement safeguard in Regulation 5.3B.24.

Recommendation 10

The Panel recommends that a finite list of tax reporting obligations be included in subsection 588GA(4)(a)(ii).

Recommendation 11

The Panel recommends the deletion of subsection 588GA(4)(b)(ii).

Recommendation 12

The Panel recommends that a definition of substantial compliance be included in the Act, to assist stakeholders to interpret the requirements of subsection 588GA(4).

Recommendation 13

The Panel recommends that data on safe harbour utilisation be collected and reported upon, as part of the reports received from voluntary administrators and liquidators.

Recommendation 14

The Panel recommends that Treasury commission a holistic in-depth review of Australia's insolvency laws.

Specific guidance suggestions

In addition to Recommendation 4, the Panel strongly supports an update being made to ASIC Regulatory Guide 217 to refer to the insolvent trading prohibition, and the safe harbour provisions, together with general guidance on the operation of the relevant provisions.

Part VII
Glossary and annexures

17. Acronyms and Abbreviated terms

Acronym	Term
ACNC	The Australian Charities and Not-for-profits Commission
AQE	Appropriately Qualified Entity
ASIC	Australian Securities & Investments Commission
ATO	Australian Taxation Office
DOCA	Deed of Company Arrangement
DPN	Director Penalty Notice
FEG	Fair Entitlements Guarantee
ITAA	*Income Tax Assessment Act 1997* (Cth)
NFP	Not-for-profit organisation
SBR	Small Business Restructuring
SME	Small and Medium-sized Enterprise
The Act	*Corporations Act 2001* (Cth)

Annexure A: Written Submissions

No.	Entity	Referred to as
1	Cole Corporate	Cole Corporate
2	Law Council of Australia	Law Council
3	Chartered Accountants Australia and New Zealand and CPA Australia	CA ANZ/CPA
4	Australian Restructuring Insolvency and Turnaround Association	ARITA
5	Mark Wellard (University of Technology Sydney)	Wellard
6	Wexted Advisors	Wexted
7	Australian Credit Forum	ACF
8	Australian Small Business and Family Enterprise Ombudsman	ASBFEO
9	King & Wood Mallesons	King & Wood Mallesons
10	Australian Banking Association	ABA
11	Vantage Performance	Vantage
12	Deloitte	Deloitte
13	Turnaround Management Association	TMA
14	McGrathNicol	McGrathNicol
15	Institute of Public Accountants	IPA
16	GSE Capital	GSE Capital
17	Australian Institute of Credit Management	AICM
18	KPMG	KPMG
19	Australian Institute of Company Directors and Business Council of Australia	AICD/BCA
20	Australian Retailers Association	ARA

Annexure B: Consultations undertaken

Date	Entity
10 September 2021	Jason Harris, Mark Wellard and Michael Murray
28 September 2021	Council of Small Businesses Organisations Australia
29 September 2021	Chartered Accountants Australia and New Zealand, CPA Australia and Institute of Public Accountants
30 September 2021	Australian Institute of Company Directors
6 October 2021	International Association of Restructuring, Insolvency & Bankruptcy Professionals
14 October 2021	Restaurant and Catering Association
21 October 2021	Attorney-General’s Department
25 October 2021	Turnaround Management Association
26 October 2021	Australian Restructuring Insolvency and Turnaround Association
27 October 2021	Australian Securities and Investments Commission
28 October 2021	Law firm round table discussions with representatives from Allens, Ashurst, Clayton Utz, Corrs Chambers Westgarth, Herbert Smith Freehills and Minter Ellison.
29 October 2021	Wexted Advisors and Vantage Performance

Annexure C: Safe harbour provisions

Section 588GA – safe harbour — taking course of action reasonably likely to lead to a better outcome for the company

Safe harbour

(1) Subsection 588G(2) does not apply in relation to a person and a debt, and subsections 588GAB(1) and (2) and 588GAC(1) and (2) do not apply in relation to a person and a disposition, 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; and

(b) the debt is incurred, or the disposition is made, directly or indirectly in connection with any such course of action during the period starting at that time, and ending at the earliest of any of the following times:

(i) if the person fails to take any such course of action within a reasonable period after that time—the end of that reasonable period;

(ii) when the person ceases to take any such course of action;

(iii) when any such course of action ceases to be reasonably likely to lead to a better outcome for the company;

(iv) the appointment of an administrator, or liquidator, of the company.

Note 1: The person bears an evidential burden in relation to the matter in this subsection (see subsection (3)).

Note 2: For subsection (1) to be available, certain matters must be being done or be done (see subsections (4) and (5)).

Working out whether a course of action is reasonably likely to lead to a better outcome

(2) For the purposes of (but without limiting) subsection (1), in working out whether a course of action is reasonably likely to lead to a better outcome for the company, regard may be had to whether the person:

(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

(e) is developing or implementing a plan for restructuring the company to improve its financial position.

(3) A person who wishes to rely on subsection (1) in a proceeding for, or relating to, a contravention of subsection 588G(2) bears an evidential burden in relation to that matter.

Matters that must be being done or be done

(4) Subsection (1) does not apply in relation to a person and either a debt or a disposition if:

(a) when the debt is incurred, or the disposition is made, the company is failing to do one or more of the following matters:

(i) pay the entitlements of its employees by the time they fall due;

(ii) give returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the *Income Tax Assessment Act 1997*); and

(b) that failure:

(i) amounts to less than substantial compliance with the matter concerned; or

(ii) is one of 2 or more failures by the company to do any or all of those matters during the 12 month period ending when the debt is incurred;

unless an order applying to the person and that failure is in force under subsection (6).

Note: Employee entitlements are defined in subsection 596AA(2) and include superannuation contributions payable by the company.

(5) Subsection (1) is taken never to have applied in relation to a person and either a debt or a disposition if:

(a) after the debt is incurred, or after the disposition is made, the person fails to comply with paragraph 429(2)(b), or subsection 438B(2), 475(1), 497(4) or 530A(1), in relation to the company; and

(b) that failure amounts to less than substantial compliance with the provision concerned;

unless an order applying to the person and that failure is in force under subsection (6).

(6) The Court may order that subsection (4) or (5) does not apply to a person and one or more failures if:

(a) 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

(b) an application for the order is made by the person.

Definitions

(7) In this section:

better outcome, for the company, means an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company.

evidential burden, in relation to a matter, means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Section 588GB – Information or books not admissible to support the safe harbour if failure to permit inspection etc.

When books or information not admissible for the safe harbour

(1) If, at a particular time:

(a) a person fails to permit the inspection of, or deliver, any books of the company in accordance with:

(i) a notice given to the person under subsection 438C(3), section 477 or subsection 530B(4); or

(ii) an order made under section 486; or

(iii) subsection 438B(1), paragraph 453F(1)(c), section 453G or subsection 477(3) or 530A(1); or

(b) a warrant is issued under subsection 530C(2) because the Court is satisfied that a person has concealed, destroyed or removed books of the company or is about to do so;

those books, and any secondary evidence of those books, are not admissible in evidence for the person in a relevant proceeding.

Note: For subparagraph (a)(i), a liquidator could give such a notice if this is necessary for winding up the affairs of the company and distributing its property (see paragraph 477(2)(m)).

(2) If, at a particular time, a person fails to give any information about the company in accordance with:

(a) a notice given to the person under section 477; or

(b) paragraph 429(2)(b) or subsection 438B(2) or (3), paragraph 453F(1)(b) or subsection 475(1), 497(4) or 530A(1) or (2);

that information is not admissible in evidence for the person in a relevant proceeding.

Exceptions

(3) However, subsection (1) or (2) does not apply to a person, and a book or information, if:

(a) the person proves that:

(i) the person did not possess the book or information at any time referred to in that subsection; and

(ii) there were no reasonable steps the person could have taken to obtain the book or information; or

(b) each entity seeking to rely on the notice, order, subsection, paragraph or warrant referred to in that subsection fails to comply with subsection (5) in relation to the person; or

(c) an order applying to the person, and the book or information, is in force under subsection (4).

(4) The Court may order that subsection (1) or (2) does not apply to a person, and a book or information, if:

(a) the Court is satisfied that the failures by the person as mentioned in that subsection were due to exceptional circumstances or that it is otherwise in the interests of justice to make the order; and

(b) an application for the order is made by the person.

Notice of effect of this section must be given

(5) An entity that seeks to rely on a notice, order, subsection or warrant referred to in subsection (1) or (2) must set out the effect of this section:

(a) for a notice under subsection 438C(3), section 477 or subsection 530B(4)—in that notice; or

(b) for an order under section 486 or for subsection 438B(3), 477(3) or 530A(2)—in a written notice given to the person when the entity seeks to rely on that order or subsection; or

(c) for a warrant issued under subsection 530C(2)—in a written notice given to the person when the entity seeks to exercise the warrant.

This subsection does not apply to an entity that seeks to rely on paragraph 429(2)(b) or subsection 438B(1) or (2), section 453G or subsection 475(1), 497(4) or 530A(1).

(6) A failure to comply with subsection (5) does not affect the validity of the notice, order, subsection or warrant referred to in subsection (5).

Definitions

(7) In this section:

relevant proceeding means a proceeding:

(a) for, or relating to, a contravention of subsection 588G(2) or 588GAB(1) or (2) or 588GAC(1) or (2); and

(b) in which a person seeks to rely on subsection 588GA(1) or 588GAAA(1).

Example: A proceeding under section 588M.

588WA – safe harbour — taking reasonable steps to ensure company's directors have the benefit of the directors' safe harbour

(1) Subsection 588V(1) does not apply in relation to a corporation that is the holding company of a company, and to a debt, if:

(a) the corporation takes reasonable steps to ensure that either subsection 588GA(1) or 588GAAA(1) (the ***safe harbour provision***) applies in relation to:

(i) each of the directors of the company; and

(ii) the debt; and

(b) the safe harbour provision does so apply in relation to each of those directors and to the debt.

(2) A corporation that wishes to rely on subsection (1) in a proceeding for, or relating to, a contravention of subsection 588V(1) bears an evidential burden in relation to that matter.

(3) In this section:

evidential burden, in relation to a matter, means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Annexure D: SBR Safe harbour provisions

Section 588GAAB – Safe harbour – companies under restructuring

Safe harbour

(1) Subsection 588G(2) does not apply in relation to a person and a debt incurred by a company if the debt is incurred:
   (a) during the restructuring of the company; and
   (b) in the ordinary course of the company's business, or with the consent of the restructuring practitioner or by order of the Court.

(2) A person who wishes to rely on subsection (1) in a proceeding for, or relating to, a contravention of subsection 588G(2) bears an evidential burden in relation to that matter.

When the safe harbour does not apply

(3) Subsection (1) is taken never to have applied in relation to a person and a debt in the circumstances prescribed by the regulations for the purposes of this subsection.

Definitions

(4) In this section: evidential burden, in relation to a matter, means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Section 500AA – Eligibility Criteria for the Simplified Liquidation Process

(1) The eligibility criteria for the simplified liquidation process are met in relation to a company if:
   (a) a triggering event occurs in relation to the company; and
   (b) subsection 497(4) (report on company's business affairs etc.) and section 498 (declaration of eligibility for simplified liquidation process) have been complied with, or are taken to have been complied with, in relation to the company; and
   (c) the company will not be able to pay its debts in full within a period not exceeding 12 months after the day on which the triggering event occurs; and
   (d) if the regulations prescribe a test for eligibility based on the liabilities of the company — that test is satisfied on the day on which the triggering event occurs; and
   (e) no person who:
      (i) is a director of the company; or
      (ii) has been a director of the company within the 12 months immediately preceding the day on which the triggering event occurs;

   has been a director of another company that has undergone restructuring or been the subject of a simplified liquidation process within a period prescribed by the regulations, unless exempt under regulations made for the purposes of subsection (2) of this section; and

(f) the company has not undergone restructuring or been the subject of a simplified liquidation process within a period prescribed by the regulations, unless exempt under regulations made for the purposes of subsection (2) of this section; and

(g) the company has given returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the *Income Tax Assessment Act 1997*).

(2) The regulations may prescribe:

(a) tests for eligibility based on the liabilities of companies for the purposes of paragraph (1)(d); and

(b) circumstances in which the directors of companies are exempt from the requirement in paragraph (1)(e); and

(c) circumstances in which companies are exempt from the requirement in paragraph (1)(f).

Regulation 5.3B.24

This regulation is satisfied in relation to a company under restructuring if:

(a) the company has:

(i) paid the entitlements of its employees that are payable; and

(ii) given returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the Income Tax Assessment Act 1997); or

(b) the company is substantially complying with the matter concerned.

Note: Employee entitlements are defined in subsections 596AA(2) and (3) of the Act and include superannuation contributions payable by the company.

Annexure E: Relevant agreements or transactions that avoid employee entitlements provision

Section 596AB - Relevant Agreements or Transactions that Avoid Employee Entitlements — Offences

Offences of entering into relevant agreement or transaction

(1) A person contravenes this subsection if the person enters into a relevant agreement or a transaction with the intention of, or with intentions that include the intention of:

(a) avoiding or preventing the recovery of the entitlements of employees of a company; or

(b) significantly reducing the amount of the entitlements of employees of a company that can be recovered.

Note: A contravention of this subsection is an offence (see subsection 1311(1)).

(1A) A person contravenes this subsection if:

(a) the person enters into a relevant agreement or a transaction; and

(b) the person is reckless as to whether the relevant agreement or the transaction will:

(i) avoid or prevent the recovery of the entitlements of employees of a company; or

(ii) significantly reduce the amount of the entitlements of employees of a company that can be recovered.

Offences of causing company to enter into relevant agreement or transaction

(1B) A person contravenes this subsection if:

(a) the person is an officer of a company; and

(b) the person causes the company to enter into a relevant agreement or a transaction; and

(c) the person does so with the intention of, or with intentions that include the intention of:

(i) avoiding or preventing the recovery of the entitlements of employees of the company; or

(ii) significantly reducing the amount of the entitlements of employees of the company that can be recovered.

Note: A contravention of this subsection is an offence (see subsection 1311(1)).

(1C) A person contravenes this subsection if:

(a) the person is an officer of a company; and

(b) the person causes the company to enter into a relevant agreement or a transaction; and

(c) the person is reckless as to whether the relevant agreement or the transaction will:

(i) avoid or prevent the recovery of the entitlements of employees of the company; or

(ii) significantly reduce the amount of the entitlements of employees of the company that can be recovered.

Note: A contravention of this subsection is an offence (see subsection 1311(1)).

Application of offence provisions

(2) Subsections (1) and (1A) apply even if the company is not a party to the relevant agreement or the transaction.

(2A) Subsections (1), (1A), (1B) and (1C) apply even if:

(a) the relevant agreement or the transaction is approved by a court; or

(b) the relevant agreement or the transaction has not had the effect or effects mentioned in paragraph (1)(a) or (b), (1A)(b), (1B)(c) or (1C)(c), as the case may be; or

(c) despite the relevant agreement or the transaction, the entitlements of the employees of the company are recovered.

(2B) However, subsections (1), (1A), (1B) and (1C) do not apply if the relevant agreement or the transaction is, or is entered into under:

(a) a compromise or arrangement between the company and its creditors or a class of its creditors, or its members or a class of its members, that is approved by a Court under section 411; or

(b) a deed of company arrangement executed by the company; or

(c) a restructuring plan made by the company.

Note: A defendant bears an evidential burden in relation to the matters in this subsection (see subsection 13.3(3) of the Criminal Code).

(2C) Subsections (1A) and (1C) do not apply if a liquidator or provisional liquidator of the company causes the relevant agreement or the transaction to be entered into in the course of winding up the company.

Note: A defendant bears an evidential burden in relation to the matters in this subsection (see subsection 13.3(3) of the Criminal Code).

(3) A reference in this section to a ***relevant agreement or a transaction*** includes a reference to:

(a) a relevant agreement and a transaction; and

(b) a series or combination of:

(i) relevant agreements or transactions; or

(ii) relevant agreements; or

(iii) transactions.

Note: A relevant agreement is an agreement, arrangement or understanding (see the definition of ***relevant agreement*** in section 9).

Section 596AC - Relevant Agreements or Transactions that Avoid Employee Entitlements — Civil Contraventions

Entering into relevant agreement or transaction

(1) A person contravenes this subsection if:
- (a) the person enters into a relevant agreement or a transaction (within the meaning of subsection 596AB(3)); and
- (b) the person knows, or a reasonable person in the position of the person would know, that the relevant agreement or the transaction is likely to:
  - (i) avoid or prevent the recovery of the entitlements of employees of a company; or
  - (ii) significantly reduce the amount of the entitlements of employees of a company that can be recovered.

Note: This subsection is a civil penalty provision (see section 1317E).

(2) A person who is involved in a contravention of subsection (1) contravenes this subsection.

Note 1: Section 79 defines ***involved***.

Note 2: This subsection is a civil penalty provision (see section 1317E).

Causing company to enter into relevant agreement or transaction

(3) A person contravenes this subsection if:
- (a) the person is an officer of a company; and
- (b) the person causes the company to enter into a relevant agreement or a transaction (within the meaning of subsection 596AB(3)); and
- (c) the person knows, or a reasonable person in the position of the person would know, that the relevant agreement or the transaction is likely to:
  - (i) avoid or prevent the recovery of the entitlements of employees of the company; or
  - (ii) significantly reduce the amount of the entitlements of employees of the company that can be recovered.

Note: This subsection is a civil penalty provision (see section 1317E).

(4) A person who is involved in a contravention of subsection (3) contravenes this subsection.

Note 1: Section 79 defines involved.

Note 2: This subsection is a civil penalty provision (see section 1317E).

Application of contravention provisions

(5) Subsections (1) and (2) apply even if the company is not a party to the relevant agreement or the transaction.

(6) Subsections (1), (2), (3) and (4) apply even if:
- (a) the relevant agreement or the transaction is approved by a court; or
- (b) the relevant agreement or the transaction has not had the effect or effects mentioned in paragraph (1)(b) or (3)(c), as the case may be; or
- (c) despite the relevant agreement or the transaction, the entitlements of the employees of the company are recovered.

(7) However, subsections (1), (2), (3) and (4) do not apply if:

(a) the relevant agreement or the transaction is, or is entered into under:

(i) a compromise or arrangement between the company and its creditors or a class of its creditors, or its members or a class of its members, that is approved by a Court under section 411; or

(ii) a deed of company arrangement executed by the company; or

(iii) a restructuring plan made by the company; or

(b) a liquidator or provisional liquidator of the company causes the relevant agreement or the transaction to be entered into in the course of winding up the company.

(8) A person who wishes to rely on subsection (7) in a proceeding for, or relating to, a contravention of subsection (1), (2), (3) or (4) bears an evidential burden in relation to that matter.

Proceedings may be begun only after liquidator appointed

(9) Proceedings under section 1317E for a declaration of a contravention of this section may only be begun after a liquidator has been appointed to the company.

Linked debts

(10) If a person contravenes this section by incurring a debt (within the meaning of section 588G), the incurring of the debt and the contravention are linked for the purposes of this Act.

Linked dispositions

(10A) If there is a contravention of this section involving a disposition of property of a company that is voidable under subsection 588FE(6B), the disposition and the contravention are linked for the purposes of this Act.

(11) In this section: ***evidential burden***, in relation to a matter, means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Annexure F: Consultation paper

Review of the insolvent trading safe harbour

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Contents

Consultation Process

Request for feedback and comments

Closing date for submissions: 01 October 2021

Email	SafeHarbourReview@treasury.gov.au
Mail	• Market Conduct Division • The Treasury • Langton Crescent • PARKES ACT 2600
Enquiries	Enquiries can be initially directed to SafeHarbourReview@treasury.gov.au

The principles outlined in this paper have not received Government approval and are not yet law. As a consequence, this paper is merely a guide as to how the principles might operate.

Review of the insolvent trading safe harbour

Overview

In 2017, Parliament enacted the *Treasury Laws Amendment (2017 Enterprise Incentives No.2) Act 2017*. The amendments introduced a safe harbour for company directors from personal liability for insolvent trading if the company is undertaking a restructure.

The aim of the safe harbour reforms is to promote a culture of entrepreneurship by providing breathing space for distressed businesses to facilitate restructuring their affairs and continuing to do business. The safe harbour encourages directors to seek advice earlier on how to restructure and save financially distressed, but viable companies, rather than entering into administration or liquidation prematurely to avoid personal liability.

As part of the 2021-22 Budget, the Government announced that it would commence an independent review into the insolvent trading safe harbour, to ensure that the safe harbour provisions remain fit for purpose and its benefits can extend to as many businesses as possible.

To support this commitment, an independent panel has been appointed to undertake the review. The review will take place for a three-month period, concluding in November 2021. Following the completion of the review, the review panel will provide a written report to the Government, as specified in the review's terms of reference.

Background to the safe harbour reforms

Australia's insolvent trading laws impose a duty on company directors to prevent a company from trading while insolvent. Under section 588G of the *Corporations Act 2001* (the Corporations Act), a director of a company may be personally liable for debts incurred by the company if at the time the debt is incurred there are reasonable grounds to suspect that the company is insolvent. Breaching these provisions can result in civil and criminal penalties against the company's directors.

Prior to the passage of the reforms, it had been suggested that the threat of action under insolvent trading provisions was encouraging directors of distressed companies to resolve the companies enter formal administration, instead of pursuing other restructuring opportunities, even where continuation of the business outside formal administration may be more appropriate. In its 2015 report, 'Business Set-up, Transfer and Closure', the Productivity Commission noted 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, sometimes prematurely.*

To address this, the Commission recommended that a safe harbour from insolvent trading liability be established, to allow directors to make decisions relating to the restructuring of the company without fear of personal liability. This would also enable directors to retain control of the company, rather than giving up control to an external administrator.

On 19 September 2017, following passage of the *Treasury Laws Amendment (2017 Enterprise Incentives No.2) Act 2017*, reforms to establish the insolvent trading safe harbour came into effect.

Operation of the safe harbour defence to insolvent trading

At their core, the reforms provide directors with a safe harbour defence from the civil insolvent trading provisions of section 588G(2) of the Corporations Act.

When the safe harbour defence applies, directors will not be personally liable for debts incurred while the company was insolvent where it can be shown that they were developing or taking a course of action that at the time was reasonably likely to lead to a better outcome for the company than proceeding to immediate administration or liquidation.

The reforms acknowledge that a course of action that is reasonably likely to lead to a better outcome for the company may vary on a case-by-case basis. The provisions are deliberately flexible as to what constitutes a course of action. They identify a number of factors that could be considered in determining if such a course of action was taken. These include whether the company directors:

- kept themselves informed about the company's financial position
- had taken steps to prevent misconduct by officers and employees of the company that could adversely affect the company's ability to pay all its debts
- had taken appropriate steps to ensure the company maintained appropriate financial records
- obtained advice from an appropriately qualified adviser, and
- had been taking appropriate steps to develop or implement a plan to restructure the company to improve its financial position.

The flexibility embedded into the safe harbour provisions is designed to encourage its uptake, including among SMEs (who might not have the resources to meet more prescriptive requirements).

The safe harbour provisions include rules around when the safe harbour protection is available to directors. The safe harbour is not available if the company has failed, within the previous 12 months, to substantially comply with:

- its obligation to pay its employees (including their superannuation), and
- its tax reporting obligations.

The protections provided as part of the safe harbour defence do not extend beyond the civil liability set out in section 588G(2). Directors must continue to comply with all their other legal obligations, such as their director's duties, which is intended to protect against misuse. The safe harbour does not extend to criminal liability for insolvent trading, noting that this requires dishonest conduct by directors.

Assessing the impact of the safe harbour

Section 588HA of the Corporations Act requires that the Minister cause an independent review of the impact of the availability of the safe harbour, including on the conduct of directors, and the interests of creditors and employees.

When assessing their impact, it should be noted that the safe harbour provisions have only been in effect for a relatively short period. Also, the confidential nature of company restructuring that may have taken place under the safe harbour protection limits the availability of quantitative data, further emphasising the importance of stakeholder submissions to this process.

Noting these challenges, the review seeks feedback from stakeholders who may have experience in corporate distress and turnaround, including the degree to which they have engaged with the safe harbour reforms, both from an adviser and any potential subsequent administrator or liquidator point of view, and (for those involved in companies whose directors utilised the safe harbour defence) their experience engaging with the reforms in practice. The perspective of creditors and other stakeholders is also sought.

The overarching intent is to determine the effectiveness of the reforms, and whether they are fit for purpose in enabling company turnaround, and promoting a culture of entrepreneurship and innovation.

Questions for discussion

1. Are the safe harbour provisions working effectively?
2. What impact has the availability of the safe harbour had on the conduct of directors?
3. What impact has the availability of the safe harbour had on the interests of creditors and employees?
4. How has the safe harbour impacted on, or interacted with, the underlying prohibition on insolvent trading?
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?
6. Are you aware of any instances where safe harbour has been misused?
7. Are the pre-conditions to accessing safe harbour appropriate?
8. Does the law provide sufficient certainty to enable its effective use?
9. Is clarification required around the role of advisers, including who qualifies as advisers, and what is required of them?
10. Is there sufficient awareness of the safe harbour, including among small and medium enterprises?
11. In relation to potential qualified advisors, what barriers or conflicts (if any) limit your engagement with companies seeking safe harbour advice?
12. Are there any other accessibility issues impacting its use?
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?