SUBMISSION IN RESPONSE TO THE INVITATION BY TREASURY TO REVIEW THE INSOLVENT TRADING SAFE HARBOUR ("REVIEW")

1. Introduction

1.1 Details of the relevant experience of Cole Corporate, the author of this submission, appear in the covering email to this submission.

1.2 Cole Corporate strongly supports Treasury in the Review of the insolvent trading safe harbour.

1.3 Attached to this submission is a paper recently prepared by Cole Corporate (not yet formally published) entitled "Zone of Insolvency – directors' responsibilities and protections" ("Paper").

1.4 Material sections of the Paper concerning the "insolvent trading safe harbour" are cross-referenced in this submission.

1.5 Further, the Paper assists in giving context, as well as an holistic perspective, as to the overall available directors' defences and safe harbour protections under the Corporations Act. It is submitted that this holistic perspective is critical as part of the Review rather than merely an isolated or piecemeal consideration only of S.588GA of the Corporations Act.

1.6 This submission will respond seriatum to the 13 "Questions for Discussion" as referred to in the request for feedback and comments, dwelling primarily on those questions where Cole Corporate believes it has valuable experience and insights to contribute, without material response to those questions where its contribution may not be of such informed value.

2. Key Points

Without derogation from its more detailed responses in Section 3 below to the Questions for Discussion, Cole Corporate wishes to summarise the key points of its submission as follows:

2.1 The principal policy objective of the insolvent trading safe harbour is to enhance either:

(a) the prospect for longer term going concern survival for a corporation, whose solvency has or may become problematic, through a work out or other means; and/or

(b) for a "better outcome" for the corporation than would be the case should an administrator/liquidator be immediately appointed due to the corporation's insolvent status (including on account of the responsibility placed on the corporation's directors to prevent insolvent trading with the associated risk of personal liability for debts incurred while trading insolvent).

2.2 The matter of the insolvent trading safe harbour cannot effectively be considered in insolation from all other insolvent trading safe harbour and deficiencies under the Corporations Act if the policy objective is to be achieved.

2.3 The principal policy objective has not materially been achieved with the insolvent trading safe harbour due to the complexity and uncertainty of pragmatic application of the regime as well as the onus of proof upon the corporation and its directors in satisfying all elements that need to be proven for the statutory safe harbour or defence to be established.

2.4 The insolvent trading safe harbour merely adds to a string of other defences or safe harbours under the Corporations Act (many illusory in practice due to the factorial commercial complexities facing a corporation and its directors when entering the "Zone of Insolvency"), each of variable availability, many with uncertainty in their interpretation and many with challenging evidentiary proof requirements, if the protection or defence is to be availed of.

2.5 Preferably a more generic overarching defence or safe harbour protection along the lines of a "Solvency Business Judgement Rule" should be enacted to more effectively achieve the principal policy objective (example provided in Section 7 of the attached Paper).

3. Specific Responses to the Questions for Discussion

Q #	Question	Response
1	Are the safe harbour provisions working effectively?	No. Refer generally to the paper with specific reference to Sections 4 and 6.5.
2	What impact has the availability of the safe harbour had on the conduct of directors?	Minimal due to the pragmatic issues concerning compliance with the threshold criteria for protection and discharging the onus of proof in establishing those criteria, as commented upon in Section 6.5 of the Paper.
3	What impact has the availability of the safe harbour had on the interests of creditors and employees?	Minimal as a consequence of the response to Q2, although: (a) Risk of deferral of recovery opportunity unless the "work out" is successful; (b) Due to lack of disclosure obligations on the solvency stressed corporation as to its solvency status, material enhanced risk for a creditor which legitimately may assume it is dealing with a solvent debtor when in fact it is not; (c) This lack of specific disclosure requirement not only may be prejudicial to a creditor who may be mislead by a reasonable presumption that the entity with which the creditor is dealing is solvent, but also poses a challenge for a continuously disclosing entity as to whether or not the corporation, by seeking to avail itself of the insolvent trading safe harbour, should be making a disclosure under S.674 of the Corporations Act, or if ASX listed, under Rule 3.1 of the ASX Listing Rules. (d) The uncertainty created, whether for the creditor or for the director seeking to assure statutory compliance in all respects, warrants attention.
4	How has the safe harbour impacted on, or interacted with, the underlying prohibition on insolvent trading?	Minimal. Refer generally to the Paper which seeks to give an holistic perspective of the overall regime impacting insolvent trading, safe harbour protections and related defences.
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?	No relevant experience.
6	Are you aware of any instances where safe harbour has been misused?	No relevant awareness.

Q #	Question	Response
7	Are the pre-conditions to accessing safe harbour appropriate?	No. Refer to Sections 4 and 6.5 of the Paper.
8	Does the law provide sufficient certainty to enable its effective use?	No. Refer to Sections 4 and 6.5 of the Paper.
9	Is clarification required around the role of advisers, including who qualifies as advisers, and what is required of them?	Yes. Refer to Sections 4.3(a) and 6.5(c)(v) of the Paper.
10	Is there sufficient awareness of the safe harbour, including among small and medium enterprises?	Anecdotally no. To the knowledge of Cole Corporate there has not been a concerted public awareness of the availability of the safe harbour other than in the most generalised of terms.
11	In relation to potential qualified advisors, what barriers or conflicts (if any) limit your engagement with companies seeking safe harbour advice?	No relevant comment to make.
12	Are there any other accessibility issues impacting its use?	Refer generally to the Paper especially Section 4 and 6.5.
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?	Yes: (a) the legislation of an overarching Solvency Business Judgement Rule – refer Section 7 of the Paper. (b) Clarification as to disclosure requirements – Refer Section 6.5(e) of the Paper and the response to Q3 above.

4. Conclusion

The principal policy objective of the insolvent trading safe harbour is commendable and warrants support.

Unfortunately the current provisions of S.588GA fail to adequately deliver this policy objective.

In considering how best to achieve the policy objective the overall regime of insolvent trading safe harbours protections and defences need to be considered holistically.

Rather than tinkering with practically problematic rewording of existing insolvent trading safe harbour and defence provisions to the Corporations Act, consideration be given to a new legislated overarching "Solvency Business Judgement Rule" along the lines of the proposal suggested in Section 7 of the Paper.

Steven Cole
Cole Corporate - 9 September 2021

Zone of Insolvency
- directors' responsibilities and protections -

Precis

This paper:

(a) identifies the profound economic and social cost to the Australian community of corporate failure, and the impact that Australia's relatively draconic (by international standards) corporate insolvency laws have towards encouraging external corporate administration and the consequential value destruction that accompanies such an outcome;

(b) seeks to summarise the principal provisions of the Corporations Act by which:

  (i) personal liability for debts arising when a corporation is insolvent may be claimed against the corporation's directors and (in some cases) officers;

  (ii) defences and "safe harbour" protctions may be available to directors and officers to refute such personal liability claims against them;

  (iii) "safe harbour" protection may be available to support a company continuing to trade even though it may technically be insolvent;

(c) gives guidance to directors and officers as to the various action steps, safeguards, evidentiary assurances, and their timing, if the currently available defences and "safe harbour" protections are to be availed of in practice, with questions arising as to the pragmatic efficacy of such defences;

(d) proposes a more simplified and generic relief for directors and officers modelled upon the existing business judgement rule principles of CA s.180(2) and (3), but modified and extended to apply to insolvent trading liability risks.

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September 2021

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1. Recognising the economic and social cost of corporate failure

1.1 Australia's economic and social prosperity can be ascribed to a combination of its natural resources, the enterprise of its people, and the effective structuring of its political, commercial, financial and social systems. Within these systems, the role of the limited liability corporation, with its statutory licence to operate and its acceptance within Australia as the dominant business governance model (with well over 2 million Australians, or towards 10% of the population, being a director of a corporation), must not be under estimated.

1.2 Functionally, limited liability corporations have achieved their success, and delivered their profound benefit to the communities of which they are a part, by:

- enabling the effective marshalling and deployment of capital and resources;
- facilitating the orderly and efficient management of business, despite diversity of ownership;
- attracting and empowering professional management expertise;
- encouraging enterprise through the prudential assumption and management of risk;
- stimulating economic growth and employment;
- limiting liability of investors; and
- sharing the fruits of the enterprise with a diverse stakeholder base from the community of which they are a part.

1.3 Economists ascribe 'multiplier effects' to productive business activity as the ripples of the transaction value of the activity permeate the economy and contribute to gross domestic product. Significant analysis is commonly applied to explain these 'multiplier effects'.

1.4 As a corollary, where a business enterprise ceases or fails, the effect is not only reflected in the loss in value of that particular business, but also in the significant loss in value to the community in which the business operates, as the negative 'multiplier effects' of that failure cascade down through both the economic and the social systems impacted by it.

1.5 The same multiplier effect principles apply irrespective of the scale and nature of the business enterprise involved, even down to the small to medium enterprise sector. For example, in a regional community, the failure of a local retail enterprise or a trade/service contractor, can have critical impact, conditional upon the "tipping point" viability and interdependency of other business enterprises and social systems within that regional community.

1.6 When assessing the extent of the loss suffered, it is important to measure not only the direct and indirect economic value destruction of the failed enterprise, but also the upstream and downstream cost in social and human terms of that failure. This loss, or destruction of 'value', in social and human terms is more ethereal and difficult to measure than the economic value destruction, but nevertheless is as profound.

2. Traditional Australian response to corporate failure

2.1 Historically, and perhaps as a factor of Australia's English heritage:

- bankrupts ended up in "debtors prison" and with the enduring stigma attaching to bankruptcy, in many cases, being terminal to a continuing business career or social position;
- social mores reflect more formal risk averse values with a normative preparedness to penalise financial failure and castigate those perceived to be responsible for that failure.

2.2 Over the 20th century, Australian society:

(a) embraced the 'miracle' of the limited liability corporation and became more accepting of the association between risk and reward, and the competitive advantage for those enterprises which could assume and better manage risk in order to deliver higher order returns; but at the same time

(b) maintained its claim for retribution where corporate endeavour failed, consequential loss was suffered by other stakeholders to the enterprise, and the standards of conduct and performance of the enterprise, and those in charge of it, fell short of societal expectations having regard to the nature, risk profile, and strategic objectives of the corporation.

2.3 By global comparison amongst developed countries, traditionally Australia, and perhaps also New Zealand, have some of the most stringent laws dealing with corporate failure and the holding to account of those persons who are in charge at the time the corporation founders.

2.4 Despite the introduction of the concept of voluntary administration (**"VA"**) in 1993, as a consequence of the Harmer Report, a very worthwhile and laudable initiative at the time designed to provide greater flexibility and expediency (compared with schemes of arrangement) for corporate insolvency workouts, when a corporation becomes insolvent (ie. it is unable to meet its debts as and when they fall due for payment):

(a) the corporation ceases being a 'going concern' for accounting purposes (usually with significant asset value write-downs which will impact borrowing covenant ratios of the corporation with its financiers) and business relationship purposes;

(b) control of the corporation is effectively wrested from the existing directors and vested in the hands of an external administrator, usually a registered insolvency practitioner, either through a voluntary administration, a provisional liquidation or a liquidation, and whether with or without the parallel appointment of a receiver, or a receiver and manager, by secured creditors or the court;

(c) the primary focus of effort moves from value 'creation' for shareholders and broader stakeholders, to value 'salvage' for creditors;

(d) other than for the occasional case where a VA has led to a deed of company arrangement (**"DOCA"**) which has truly maintained business continuity and restructured the underlying business enterprise of the corporation (ignoring cases where the corporate carcus has merely been recycled with a view to preserving tax losses and facilitating an ASX back door listing), the most common outcome is:

- closure of business operations;
- dismissal of employees;
- termination of key contractual arrangements with suppliers and customers with likely consequential losses to be suffered by those stakeholders;
- self-interested recovery of value by secured creditors, suppliers with retention of title protection, landlords and others with commercial leverage;
- sell off of assets in what invariably becomes to be known as 'distressed sale' circumstances;
- priority payment of the costs of the external administration (not necessarily inconsiderable especially in the case of larger scale corporate groups);
- distribution of the net surplus (if any) to proving unsecured creditors on a pro rata, cents in the dollar, basis depending upon the net financial position following the distressed sale of assets of the failed business enterprise and the payment of priority creditors;

- personal liability risk to the corporation's directors (and in some cases officers) who seek to maintain business operations notwithstanding the organisation's insolvency.

2.5 The very nature of the contemporary capital efficient business model is to minimise the extent of 'lazy' hard assets on the balance sheet, through the leasing of premises, plant and equipment, and ensuring 'appropriate' leverage by way of debt to equity gearing to enhance equity returns. A consequence of this practice is to expose a corporation which is in financial stress, and its investors and creditors, to greater risk of value destruction on insolvency, as the corporation will have less resilience and readily realisable asset resources to fall back on once it is no longer a 'going concern' in traditional accounting standards and operating cashflow terms.

2.6 At a director level, despite commercial pressures encouraging a decision to trade on for the benefit of all stakeholders of the corporation (shareholders, employees, suppliers, customers, contractors and creditors generally), legislative forces work to the contrary with CA s.588G of the Corporations Act providing:

(a) a proscription against allowing a corporation to continue to trade if the corporation is unable to meet its debts as and when they fall due for payment; and

(b) a personal legislative contravention and liability for directors who fail to comply with that proscription (refer CA s.588G(2)), as well as the prospect of committing a legislative "offence" with severe penalties and even incarceration in the case of egregious failure to comply through dishonesty (refer CA s.588G(3)).

2.7 Australia's traditional legislative regime with respect to corporate insolvency had been described by a number of credible industry experts' as a "blunt instrument", arguing it was structured in a manner:

- which encourages and mandates those in charge of corporations to move to external administration as soon as a corporation's financial viability falters;
- which in practice (subject to some exceptions) encourages creditors, especially secured creditors and key suppliers and customers, to exercise competitive self interest to secure or retrieve assets and terminate continuing contractual arrangements where possible, thus often assuring the inability of the corporation to regain 'going concern' status, as well as destabilising the prospect of a more orderly value optimisation for the general good;
- the primary outcome of which is to facilitate the shuttering of the business operations, the 'getting in' of receivables due and the sale of business assets, so that the net realisable proceeds may be shared amongst creditors once external administration expenses, and priority claims against the corporation, are first accounted for and paid.

3. Recent reform initiatives and director "safe harbour" protections

3.1 It was well argued by a number of leading legal, business and industry policy advocates that the rigour and outcome risks of Australia's traditional corporate insolvency regime is too draconian:

(a) rendering Australian corporations at a competitive disadvantage relative to their foreign counterparts; and

(b) as a consequence of (a), posing an impediment to the attractiveness of Australia as a destination for business investment from overseas investors.

3.2 Accordingly in recent years, including over the COVID-19 impacted era of 2020/2021, Australian legislation relating to corporate insolvency was amended with a view to mitigating a number of the aforementioned adverse consequences upon the Australian economy and society in "appropriate" circumstances.

3.3 Such legislative reforms include:

(a) options to legitimately restructure solvency problematic corporations, including through a debt restructuring process and a simplified liquidation pathway, primarily aimed at eligible incorporated small businesses with limited debt and liability levels [refer Corporations Amendment (Corporate Insolvency Reforms) Act 2020 now incorporated into the Corporations Act Part 5.3B – Restructuring of a company and Part 5.5 Division 3B – Simplified Liquidation Process];

(b) temporary safe-harbour relief from personal liability of directors for insolvent trading in certain qualifying circumstances during the period of the coronavirus pandemic [refer Coronavirus Economic Response Package Omnibus Act 2020 now incorporated CA s.588GAAA – refer later comments].

3.4 Australia's corporate insolvency laws have traditionally distinguished between three types of behaviour of corporations and those in charge of them:

(a) dishonesty and wilful disregard for the interests of the corporation and its stakeholders, which should not be tolerated and which warrants the full brunt of regulatory and legal criminal consequences;

(b) negligence or culpable ineptness, when the conduct of those in charge of the enterprise falls short of legitimate reasonable expectations, which warrants civil recourse in favour of those to whom the duty of care may have been owed; and

(c) mere corporate failure, where the commercial objectives, risks and rewards of the corporation's activities are assessed and a strategy is conceived and executed, based on rational "business judgements" made by those in charge of the corporation to deliver the desired outcome, but the impacts of the risks ultimately outweigh the corporation's ability to deliver the desired outcomes, and to financially survive.

3.5 These distinctions continue to manifest themselves in the current provisions of the Corporations Act.

3.6 Contraventions and Offences

As at April 2021 the following principal provisions apply:

(a) CA s.588G – general prohibition on directors for incurring debts and thereby allowing a company to trade while it is insolvent with:

- director civil liability for contravening the prohibition; and
- director criminal liability for dishonest contravention of the prohibition.

(b) CA s.588GAB and CA s.588GAC – general prohibition for directors and officers engaging in conduct which results in or procures, incites, induces or encourages a disposition of a company's assets with a view to avoiding the company's obligations to its creditors (including the practice commonly known as "phoenixing") with:

(i) director and officer civil liability for contravening the prohibition; and

(ii) director and officer criminal liability if they know or reasonably should have known that the disposition was a "creditor-defeating disposition".

(c) CA s.588V – for "holding companies" of subsidiaries, in certain circumstances, where the subsidiary company incurs a debt while it is insolvent or becomes insolvent by incurring that debt, including along with other debts.

3.7 Defences and Relief provisions available

As at April 2021 there are a myriad of detailed and prescriptive provisions which may or may not provide relief to a director (and in some cases officers) where the relevant corporation is insolvent, or is about to so become, depending upon the circumstances then applying. These include:

(a) CA s.588H(2) and (3) – where the person alleged to have contravened with respect to a civil liability under CA s.588G, CA s.588GAB or CA s.588GAC (or derivatively by virtue of CA s.588M) proves that at the "key time" (ie. when the relevant debt was incurred or the disposition committed to) they:

(i) had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent; OR

(ii) had reasonable grounds to believe and did believe:

- that a "competent and reliable person" was responsible for providing them with "adequate information" as to the company's solvency; AND
- that the "competent and reliable person" was fulfilling that responsibility,

AND that they expected on the basis of the information provided to them by the "competent and reliable person" that the company was solvent at that time and would remain solvent, despite all its debts incurred and dispositions of its property made at that time [subject to certain exceptions relating to some dispositions of property – refer S.588H(3A)].

(b) CA s.588H(4) – where the person is a director of the company at the "key time" and they prove that "because of illness or some other good reason" they did not take part at that time in the management of the company;

(c) CA s.588H(5) – where the person "took all reasonable steps "to prevent the company" from incurring the debt or disposing of the property;

(d) CA s.588GAAA – for a person where the debt was incurred in the ordinary course of business of the corporation during what might colloquially be regarded as the corona-virus impacted period (as prescribed by regulations);

(e) CA s.588GAAB – for a person where the debt was incurred:

(i) during a "safe" harbour protected restructuring of the corporation under this section; AND

(ii) in the ordinary course of business of the corporation OR with the consent of the "restructuring practitioner" or pursuant to a Court order.

(f) CA s.588GAAC – for a person where the debt was incurred:

(i) at a time when the corporation was eligible for "safe harbour" protected temporary restructuring relief under this section; AND

(ii) in the ordinary course of business of the corporation; AND

(iii) the corporation had taken "all reasonably steps" to appoint a restructuring practitioner before the debt was incurred.

(g) CA s.588GA – for a person where the debt was incurred while the corporation was within "safe harbour" protection through a course of action being taken which is reasonably likely to lead to a "better outcome for the company". This particular "safe harbour" protection regime is addressed more fully in paragraph 4 following.

(h) CA s.588WA – relief from liability under CA s.588V, for holding companies of subsidiaries, in certain circumstances where the holding company can satisfy certain relief criteria along similar lines as those applicable under CA S.588H(2) – refer above. As the primary focus of this paper is on "director responsibilities and protections", relief under this heading will not be commented upon further.

4. "Safe Harbour" protection – course of action reasonably likely to lead to a "better outcome for the company" (CA s.588GA)

4.1 This safe harbour concession is the Australian Government's primary response to the concerns expressed earlier in this paper as to Australia's conservative attitude to corporate insolvency and to the advocacy mentioned in paragraph 3.1 of this paper concerning risks as to its impact on foreign investment and business competitiveness in Australia.

4.2 Primarily it is designed around the following constructs:

(a) the person seeking to rely upon this "safe harbour" protection must first have started to suspect the company may become or be insolvent;

(b) the person thereafter starts developing one or more "courses of action";

(c) the course(s) of action are "reasonably likely" to lead to a "better outcome" for the company;

(d) the debt is incurred or the property disposition is made "directly or indirectly" in connection with such a course of action;

(e) the debt is incurred or the disposition of property is made during a period:

(i) commencing following satisfaction of (a)-(d) above; and

(ii) ending on the earliest of:

- a reasonable period thereafter when the person fails to take such course of action;
- when the person ceases to take such a course of action;
- when such course of action ceases to be "reasonably likely" to lead to a "better outcome" for the company; or
- an administrator or liquidator being appointed to the company.

4.3 There are then a number of provisions to assist in the interpretation of this regime and in some cases to limit its application. These include the following:

(a) In considering whether a course of action is "reasonably likely" to lead to a "better outcome" for the company, "regard may be had" as to whether the person:

- is "properly informing" him or herself as to the company's financial position;
- is taking "appropriate steps" to:
  - prevent any misconduct by officers or employees of the company; and
  - ensure the company is keeping appropriate financial records (consistent with the size and nature of the company);
- is obtaining advice from an "appropriately qualified entity" who was given "sufficient information" to give "appropriate advice"; or
- is developing or implementing a plan for restructuring the company to improve its financial position.

(b) The "safe harbour" protection is NOT available to the person:

(i) unless a Court order specifies otherwise due to exceptional circumstances or reasons of justice – refer CA s.588GA(6), if when the debt is incurred or the disposition is made the company is failing to:

- pay employee entitlements by the time they fall due; or
- give returns, notices, statements, applications etc as required under taxation laws;

AND such failure:

- amounts to "less than substantial compliance" with the matter concerned; or
- is one of 2 or more failures to do those things in the preceding 12 month period before the debt was incurred; OR

(ii) in certain circumstances, if the person fails to comply with other provisions of the Corporations Act largely relating to a director's/officer's responsibility to assist an administrator/liquidator of the company (as may be applicable) – refer CA s.588GA(5).

(c) Definitions of certain terms as follows may assist to some extent:

- "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;
- "evidentiary 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.

4.4 Importantly, the "evidentiary burden" of establishing each of the elements of this "safe harbour" protection lies with the person seeking to invoke its protection.

4.5 From February 2022 the Minister is obliged to cause an independent review to be undertaken of the impact of this safe harbour defence and thereafter to table a copy of the report arising from that review in Parliament, presumably for consideration as to its effectiveness and fitness for its intended purpose to address the mischief sought to be addressed by the provision (refer CA s.588HA).

5. The dilemma for corporations and their directors / officers approaching the Zone of Insolvency

5.1 The "zone of insolvency" is generally referred to as that period of a corporation's business operations between:

- business as usual cashflow viability; and
- material cashflow stress where, unless due and prudent attention is given to the financial affairs of the corporation to resolve that stress, the corporation may well become insolvent i.e. unable to pay all its debts as and when they become due and payable (refer CA S.95A).

5.2 It is well established that whether or not a corporation is solvent is primarily a cash-flow rather than a balance-sheet test, although the status of a corporation's balance sheet may be of evidentiary value in assessing a corporation's prospective ability, or otherwise, to generate cash-flow to meets its debts as and when they become due and payable.

5.3 This paper is not intended to be a treatise on corporate solvency.

5.4 Rather its focus is intended to be confined to how the directors of a corporation entering the zone of insolvency might act to best position:

(a) the corporation, to give the opportunity:

(i) for the prospect of the corporation's longer term survival through a work-out or other means; or

(ii) for a "better outcome" for the corporation than would be the case should an administrator / liquidator be immediately appointed due to the insolvent status of the corporation; and

(b) the directors discharging their duties to the corporation (including assisting te corporation to avail itself of the opportunity mentioned in paragraph (a) preceding), to also avail themselves of a statutory defence or "safe harbour" protection to a claim against them for allowing the corporation to continue trading and incurring debts while it was insolvent, or would become insolvent by reason of the debt being incurred (perhaps along with other debts).

5.5 By way of further focus, the paper concentrates on the relief available under the legislative regimes set out in CA ss.588GA ("safe harbour" protection relief where there is a course(s) of conduct reasonably likely to lead to a better outcome for the company) and 588H (insolvency related defences), without material consideration of CA s.588GAAA (temporary corona-virus relief) or CA ss.588GAAB and 588GAAC (relating to safe harbour protection relief pending or during a restructuring of the corporation) or CA s.588WA (relating to holding company relief).

5.6 Importantly to best avail the corporation and its directors of the opportunities mentioned in paragraph 5.4 above, strategies must be developed and actions taken well in advance of future critical events and decision points in order to ensure that the opportunities are not closed out due to such strategies and actions not having already been progressed in a timely manner and being available in evidentiary support of matters needing to be established.

5.7 The balance of this paper is therefore structured by way of a series of recommended actions by the corporation and its directors by certain times in order to ensure that those opportunities may remain open.

6. Recommended strategies and actions

When considering matters under this paragraph 6 it should be borne in mind that as insolvent trading defences, and claims for safe harbour protection relief, are "defences" to statutory causes of action (each element of which cause of action must be established to the appropriate standard of proof by the plaintiff or prosecutor), it is the director who carries the burden of establishing each element of any defence, or safe harbour protection claim, to the applicable evidentiary standard.

6.1

Recommendation 1

Ensure that the directors have reasonable grounds to expect, and do expect, that the corporation is at all relevant times solvent and will remain so.

[(CA s.588H(2))]

Actions Arising: The following actions should be addressed and constantly reviewed and updated from the earliest time that the corporation enters the zone of insolvency:

(a) Forward cash-flow forecasting and analysis for at least the following 18 month period (including to ensure at any time at least 12 months of expected solvency so as to satisfy "going concern" status for accounting standards and reporting purposes);

(b) Business analysis, revenue/expense projections, prudential profit and loss scenario planning, and complementary sensitivity analysis;

(c) Risk management outlook and treatments;

(d) Realistic business survival strategies having cash-flow management implications, with the following being the primary high-level strategies available:

(i) increase and/or accelerate money "in":

- raise equity;
- raise debt with deferred or longer term repayment obligations;
- increase sales revenue;
- accelerate receipt of receivables;
- liquidate assets (including non-cash generating assets as well as balance sheet restructure e.g. sale and leaseback);

(ii) decrease and/or delay money "out":

- restructure or reschedule shorter term debt to longer term repayment obligations;
- negotiate extended payment terms for trade creditors;
- delay or defer non-essential current expenses (e.g. longer term project development costs, capital works and asset maintenance expenses);
- reduce expenses (e.g. non-essential personnel, rental premises/equipment or corporate overheads).

[**NOTE**: although attractive at face value, some of these strategies may even be cash-flow negative in the immediate term (e.g. leave/redundancy payment acceleration in reducing personnel numbers OR consultancy/adviser fees to be paid to assist in realisation of such strategies)].

(e) Plans being made and actions being taken on a priority basis to give effect to those of the strategies mentioned in (d) above which are appropriate for the circumstances of the corporation;

(f) Regular board, board committee and management meetings to ensure that these matters are pride of place in the organisation's deliberations and are receiving appropriate attention;

(g) Well documented audit trails via board and committee minutes and associated board and committee papers which support the likelihood of a continuing solvency outcome and expectation (unless such an outcome or expectation is not reasonably tenable);

(h) Skilled and experienced professional financial advice being taken including as appropriate from external advisers/consultants;

(i) Directors being sincere in their belief and expectation of the corporation's solvency;

(j) Prudential caution being taken so that "loose" or "careless" language or expression in relation to the corporation's solvency, or each director's and/or officers' belief and expectation in relation to its solvency, do not manifest themselves in any dialogue, correspondence, meeting notes, emails or social media commentary (most of which would be "discoverable" in any later legal proceedings);

(k) If the corporation be the subsidiary of a holding company or have a majority/dominant shareholder, and if the corporation be reliant on the ongoing financial support of its parent or holding company or majority/dominant shareholder in order to maintain its "going concern" and "solvent" status, and assuming the parent or holding company or majority/dominant shareholder has appropriate financial viability, then an appropriately worded "letter of comfort/support" from the parent or holding company or majority/dominant shareholder should be procured giving assurance of that support for at least a rolling 12 month period. It is noted that it is not uncommon for "start-up" enterprises or subsidiaries of holding companies to be in the "Zone of Insolvency" especially in their early days of operation where they are in what might be described as a "business development and growth stage" of evolution.

(l) Subject to the continued availability of other defences and/or safe-harbour protections mentioned in this paper:

(i) Immediately upon:

- there no longer being reasonable grounds to expect the corporation's solvency (an objective test for the corporation as a whole); or
- the directors no longer having the belief and expectation of the corporation's solvency (a subjective test for each director seeking to avail him or herself of the defence),

then the directors should resolve the insolvency or likely insolvency of the corporation and the appointment of an administrator or liquidator to the corporation.

(ii) On the failure of the directors to move in the terms of (i) above, and assuming there to be a minority of directors who no longer have the beliefs mentioned in (i) above that would otherwise cause them not to resolve as to the insolvency of the corporation, then each of those minority of directors should immediately resign from office (refer Corporations Act Part 2D.3 with caution as to CA s.203AB which denies a director the right to resign if there be no other directors in office at the time of that resignation, subject to certain exceptions).

6.2

Recommendation 2

Ensure that:

(i) a "competent and reliable person" is appointed with responsibility to provide the directors with "adequate information" as to the corporation's solvency;

(ii) such person fulfills that responsibility;

(iii) on the basis of that information provided, the directors expect that the corporation was solvent and will remain so.

[(CA s588H(3)]

Actions Arising: The following actions should be addressed and constantly reviewed and updated from the earliest time that the Recommendation may wish to be actioned:

(a) Importantly the evidentiary onus is on the director to prove all relevant elements of the defence;

(b) A "competent and reliable person" is appointed by the corporation with responsibility for the designated purpose. However:

(i) although the expression a "competent and reliable person" is not defined, one might reasonably assume it includes an accountant or other financially

skilled/qualified adviser with financial literacy, business acumen and experience in matters of corporate solvency stress;

(ii) if for any reason the person is not "competent and reliable" then the insolvent trading defence will not be available to the director even if they progressed with the appointment of the person in good faith believing they were "competent and reliable".

(c) The performance of that person should be constantly monitored to ensure they are fulfilling that responsibility to provide "adequate information" because if they fail to do so, then the insolvent trading defence will not be available to the director even if the director was relying on that person's advice and information provided;

(d) Subject to the foregoing, the "Actions Arising" as listed in paragraph 6.1 (Recommendation 1) should generally apply with respect to the activities of the "competent and reliable person" and the corporation's and its directors' responses to the advices and "adequate information" provided by that person, although with Action Arising 6.1(i) the directors' expectation of solvency of the corporation may be on the basis of the information provided by that person.

(e) Essentially the effect of the insolvent trading defence in CA s.588H(3) is to allow the directors to rely on information provided by a "competent and reliable person" in forming their "expectation" as to the corporation's solvency at the relevant time, rather than that information having to be gathered directly by the corporation and/or its directors.

(f) However the following risks arise in relying on this insolvent trading defence:

(i) the person is not able to be established as "competent and reliable";

(ii) the information provided by that person is not able to be established as "adequate information";

(iii) as the critical time is when the relevant debt is incurred or relevant property disposition is made, whether or not the information provided by the person continues to remain "adequate" at that time or needs to be constantly updated at each critical time to ensure that at the relevant critical time there has been no material change that would deny the "adequacy" of the "information".

6.3

Recommendation 3

Take no part in the management of the corporation at the critical time of solvency test due to "illness or some other good cause".

[CA s.588H(4)]

Actions Arising: The following should be considered:

(a) The evidentiary onus is on the director to prove all relevant elements of the defence;

(b) Arguably there at least needs to be a plausible connection between the "illness or some other good reason" and not taking part at time in the management of the corporation;

(c) In a contemporary e-connected world, especially post COVID-19 computerised enabled meetings and information flow, that connection will probably require more than merely being quarantined or isolated from meetings, or being bed/home/hospital bound, provided that the director's health and mental state may otherwise not be so compromised so as to warrant non-engagement in the corporation's affairs over that period;

(d) The expression "or some other good reason" is of unknown interpretation and application although arguably its interpretation may be narrowed by its use in juxta position with the term "illness" to at least have a medical/health connotation;

(e) Suffice to say that reliance on this safe harbour defence is not a strategy to be planned for, but rather a default position, if unfortunately "illness" (or like) circumstances did arise and the corporation became insolvent at that time;

(f) Perhaps a better more assured liability protecting strategy to be deployed by a director, if their health did prevent them from taking part in the management of the corporation at a time of possible insolvency of the corporation, would be to resign from office (subject nevertheless to CA s.203AB, where there are no other directors then holding office).

6.4

Recommendation 4

"Take all reasonable steps" to prevent the corporation from incurring the relevant debt or making the property disposition.

[CA s.588H(5)]

Actions Arising: The following actions should be addressed:

(a) The "Actions Arising" as listed in paragraphs 6.1 and/or 6.2 generally should be applied at least up to the time when the relevant director no longer has the belief and expectation either:

- in the case of a defence relying on CA s.588H(2), that at the key time there are reasonable grounds to expect the corporation is solvent, including if the relevant debt is incurred or the relevant property disposition is made; or
- in the case of a defence relying on CA s.588H(3) that:
  - the person is "competent and reliable";
  - the information provided by that person is "adequate"; or
  - the corporation is solvent on the basis of that information;

(b) At that time the relevant director must take "all reasonable steps" to prevent the relevant debt being incurred or the relevant property disposition made. CA s.588H(6) states that regard may be had to the following in considering whether "reasonable steps" have been taken by the director:

- action by the director for the corporation to appoint an administrator or a restructuring practitioner;
- when that action was taken;
- the results of that action;

(c) Again the evidentiary onus is on the director to prove all the relevant elements of the insolvent trading defence. It is arguable that "all reasonable steps" could at least include the following:

(i) speaking and voting against any resolution to incur the relevant debt or make the relevant disposition of the property;

(ii) having that dissent formally noted in the board minutes, or at least insisting it is so noted;

(iii) moving a motion that the corporation is insolvent or likely to become insolvent and for an administrator and/or liquidator to be appointed, even if it is believed by

the director that the proposed resolution is unlikely to have the support of the majority of the board;

(iv) desirably, the director resigning from office as a director promptly thereafter(*).

[(*) This extra step has been proposed as a matter of pragmatism. The businesses of most operating corporations are continuing with debts being incurred on a daily, if not minute by minute, basis. In such circumstances it is not practicable for the director to take "all reasonably steps" to prevent the corporation from incurring a debt on a debt by debt repetitive basis other than to act generally in the terms of paragraph 6.4(c)(i)-(iii) above. To remain on the board thereafter and to acquiesce as a director (albeit perhaps reluctantly but still complicitly) in the corporation's ongoing business affairs, which of necessity includes debts being incurred (even in the ordinary course of business), may not be tolerable if this defence is to be relied upon.]

6.5

Recommendation 5

Ensure that the corporation and its directors do all things necessary, in a timely and prudential manner within any applicable timeframes, so that the safe harbour protection of "taking one or more courses of action reasonably likely to lead to a better outcome for the company" may be availed of.

[CA s.588GA]

Actions Arising: Paragraph 4.2 of this paper teases out the essential elements of this "safe harbour" protection and the defence it accords to a claim of insolvent trading. Importantly it is the directors who bear the "evidentiary burden" to come within the protection of the "safe harbour" of the defence i.e. the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist. The following necessary actions should be considered in order to take advantage of this protection:

(a) As these relevant actions are quite specific, and some quite temporally sensitive, it would be best for the entirety of the process, and actions arising, to be closely documented with a clear audit trail of actions, beliefs and outcomes for ease of discharging the evidentiary burden of the safe harbour defence should ever the need arise;

(b) Further, as much of the terminology used in CA s.588GA is relatively unique, untested and undefined, and as many of the various elements are quite prescriptive, in the documentation referred to in paragraph (a) above, care should be taken to replicate the language and terminology used in CA s.588GA as closely as possible to better assure alignment and consistency;

(c) Against these cautions, the following are the key actions:

(i) As a preliminary threshold, and before the critical time of a relevant debt being incurred or relevant property disposition being made which may trigger the insolvency of the corporation, the director must start "to suspect the company may become or be insolvent". This suspicion should be documented to create the audit trail, with care being taken that it is the mere start of a suspicion, without the outcome of the suspicion having been established, with care being taken to ensure that the wording is not evidentiary of a pending insolvency per se;

(ii) The director, probably with the other members of the board, should then start "developing one or more courses of action that are reasonably likely to lead to a better outcome" for the corporation. Based on this:

- there could be a single or an array of prospective course(s) of action;

- however to be a qualifying "course(s) of action" for the purposes of the safe harbour defence, it must, or each of them must, satisfy both the "reasonably likely" and "better outcome" tests;

- the "course(s) of action" need not be complete or final before they are relied upon, and may be in a dynamic state of evolution;

- wisely the "course(s) of action" should be documented (with version control tracking noted for temporal currency purposes) and each specifically referred to as "CA s.588GA Course of Action (#[ ])" for cross-verification and alignment with the legislation;

- the "course(s) of action" desirably should include within them self-justifying validation as to:

  - its/their prospective outcome(s);

  - why such outcome(s) would be "reasonably likely" to lead to a relatively "better outcome" for the corporation, implying the need to compare or benchmark the same against the outcome should an administrator or liquidator immediately be appointed;

  - what is the "reasonable likelihood" of that "better outcome" being delivered.

(iii) Any relevant critical debt incurred, or relevant property disposition made, is incurred or made "directly or indirectly in connection with such course(s) of action". Accordingly the stronger the link between the relevant debt being incurred or relevant property disposition being made and the course(s) of action, then the better the prospect of satisfying and being able to prove this element. Accordingly the wording of the breadth and specificity of the "course(s) of action" needs to be appropriate. As the corporation, especially if it has an operating business, will be likely to at least be incurring debts on a daily, if not more frequent basis, then the wording of the "course(s) of action" will need to bear this in mind;

(iv) The relevant "protected" debt or property disposition must be one which occurs after having satisfied the aforementioned elements (and desirably the recommended actions arising) and prior to the earliest to occur of the following:

- the expiry of a reasonable period (if the corporation fails to pursue a course(s) of action within a reasonably period);

- upon the cessation of taking such a course(s) of action;

- upon the course(s) of action ceasing to be reasonably likely to lead to a "better outcome" (*);

- the appointment of an administrator or liquidator of the company.

[**(*) Note**: this implies that the course(s) of action should continue to be monitored and reviewed on an ongoing basis to assure its/their continuing fitness for purpose i.e. it/they will reasonably likely lead to a "better outcome" for the corporation notwithstanding any changed circumstances or events that may have arisen since the course(s) of action was first originally agreed upon.]

(v) But what is a "better outcome"?. CA s.588GA(7) defines it as "an outcome that is better for the company than the immediate appointment of an administrator or liquidator of the company". CA s.588GA(2) also gives guidance in this respect by stating that in considering this aspect, regard may be had to whether the person (i.e. director/officer as applicable):

- is properly informing him/her self as to the corporation's financial position (in this context the action steps referred to in paragraph 6.1 are relevant)(*) – but what constitutes "properly informing" may be a relatively high standard, so err on the side of caution;
- is taking appropriate steps to prevent any misconduct by officers or employees that may impact upon the company's ability to pay its debts (*) – but what constitutes taking "appropriate steps" may be a relatively high standard, so err on the side of caution;
- is taking appropriate steps to ensure the company is keeping appropriate financial records consistent with the company's size and nature (*) - but what constitutes taking "appropriate steps" may be a relatively high standard, so err on the side of caution;
- is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice(*) – but what constitutes "appropriately qualified entity" and what constitutes "sufficient information" may both be relatively high standards, no err on the side of caution;
- is developing or implementing a plan for restructuring the corporation to improve its financial position (*).

[**(*) Note:** it is anticipated that these considerations are likely to be critical collateral threshold requirements in assessing whether or not a proposed course(s) of action is "reasonably likely to lead to a better outcome" the absence of any of which may be a fatal defeasance to the anticipated protection otherwise sought to be availed of.]

(vi) Finally, neither of the defeasance provisions referred to in paragraph 4.3(b) must exist i.e:

- employee entitlements must be paid on time; and
- taxation laws must be complied with.

(d) Provided that all elements of the CA s.588GA "safe harbour" can be established, then the director is "protected" and relieved from either not incurring debts or having to appoint an administrator or liquidator of the corporation even if the relevant corporation may otherwise be insolvent at that time.

(e) Notwithstanding paragraph (d) above, the focus of which is solely on CA s.588GA, if the corporation is a continuously disclosing entity (including an entity listed on the ASX) then consideration also needs to be given as to whether or not disclosure under CA s.674 or ASX Listing Rule 3.1 (as applicable) if the corporation is insolvent but is continuing to trade in reliance of the insolvent trading safe harbour protection of CA s.588GA. There may be no clear answer to this conundrum pending judicial determination and clarification, and even then the outcome is likely to largely be dependent on the unique circumstances of the corporation and the case in hand.

7. Proposal for simplified more generic safe harbour relief for directors of corporations in the Zone of Insolvency

7.1 As alluded to in the introduction to paragraph 6.2 of this paper, the provisions that offer directors either defences and/or "safe harbour" relief from insolvent trading risks:

- are many in response to various disparate reform initiatives over the years;
- are detailed, prescriptive and in many cases administratively costly and burdensome;
- have uncertainty as to the interpretation of many of their key elements;
- are not necessarily consistent in their application to address the substantive concerns they seek to resolve;
- in some cases may encourage the "gaming" of processes in order for a director to come within their scope;
- pose distinct evidentiary challenges for a director who may seek to avail him/herself of them; and
- in varying degrees, do not necessarily give sufficient encouragement to directors to continue to apply their energies and endeavours for the benefit of the corporation and its stakeholders generally, given the ever present personal liability for insolvent trading risks that they continue to carry.

7.2 Directors need to have the support of not being at material or inadvertent risk of incurring personal liability where they act in a proper, prudential and professional manner in all the circumstances of the corporation during periods of corporate financial stress.

What is commonly known as the 'business judgment rule' (**BJR**) is effectively codified in CA ss 180(2) and (3) of the Corporations Act. In appropriate cases the BJR can give relief to directors where their conduct might otherwise have constituted a breach of their obligation of care and diligence under s 180(1) of the Corporations Act, or its equivalent provisions at common law and at equity. However, it is clear that at present the BJR does not extend to the obligations of a director to prevent insolvent trading under CA s.588G.

This proposed initiative for reform is designed to create a rule comparable to the existing CA ss 180(2) and (3) BJR but so that it more extensively applies to insolvent trading risks.

7.3 The proposed rule (Solvency Business Judgment Rule of **SBJR**) might be crafted in the following terms:

"A director or officer is only liable for debts and liabilities incurred by a company while the company is insolvent, or for debts and liabilities incurred which cause the company to become insolvent, if:

(1) it is shown:

(a) the company was insolvent at the relevant time the debt or liability was incurred, or becomes insolvent as a consequence thereof:

AND

(b) the director or officer:

(i) exercised a Solvency Business Judgment which led to the relevant debt or liability being incurred; or

(ii) refrained from exercising a Solvency Business Judgment, which the director or officer reasonably should otherwise have exercised, to prevent, or try to prevent, the debt or liability being incurred;

AND

(c) no reasonable person acting in the position of the director or officer in the circumstances of the company at the time of the exercise of the Solvency Business Judgment or at the time of refraining to exercise the Solvency Business Judgment (as applicable), with the benefit of the information and knowledge actually known to, or which reasonably should have been known to, the director or officer at the relevant time, could rationally have formed the judgment that the company was then solvent;

AND

(d) the director or officer is not able to show that in exercising, or refraining from exercising, the relevant Solvency Business Judgment, he or she:

(i) acted in good faith, for proper purpose and without material conflict of interest; and

(ii) took reasonable steps to seek to understand or inform him or herself of matters reasonably relevant to the exercise, or refraining from exercising, the Solvency Business Judgment, including as appropriate and reasonable, information and/or advice provided by a company officer or other person whom the director or officer should reasonably be able to place reliance upon as being competent and knowledgeable, or having relevant expertise, in such matters,

BUT with the rebuttable presumption that the director or officer does satisfy the criteria in subclauses (d)(i) and (ii) unless it is shown to the contrary.

(2) For the purposes of subclause (1), the term "**Solvency Business Judgement"** means any decision to take or not to take action in respect of a matter which may have relevance to the solvency or insolvency of the company.

7.4 It is submitted that a SBJR in the terms of paragraph 7.3 would materially remove the untoward risk to a prudent and engaged director or officer from continuing to work for the benefit of the corporation and all stakeholders of the corporation in seeking to preserve value within the corporation and assist the corporation in either trading out of its difficulties, or undertaking a reconstruction which may have a similar outcome.

Of particular note, by the inclusion of the rebuttable presumption at the end of subclause (1)(d) of the SBJR, prima facie the onus of challenging the various elements of reliance by a director or officer on the SBJR resides with the plaintiff or person seeking to prosecute a claim against the director or officer, at least until sufficient evidence is adduced to counter the rebuttable presumption, rather than the entire onus of proof being with the director or officer ab initio in having to establish the existence of those elements of the SBJR defence referred to in subclause (1)(d) of the proposed SBJR.

7.5 This proposed SBJR should be in augmentation of the existing safe harbour protections and defences available under the Corporations Act.

7.6 It might be noted that a SBJR in substantially the same terms as proposed in paragraph 7.3 was proposed by the author in 2011, as part of other insolvency reform initiatives, in the IPA Australian Insolvency Journal 2011 Vol 23 Number 2 in a feature article headed "Arresting Value Destruction – Insolvency Agenda Reform". Hopefully one decade on it may again be considered for adoption.

8. Conclusion

Especially having regard to the economic and social benefits that flow from productive business activity, the termination and insolvent liquidation of business activity can have profound impacts on the prosperity and social well being of the community in which the relevant business enterprise operates.

Including on account of legislative responses to circumstances driven by the risk of profound economic and social impacts arising from the COVID-19 global pandemic, the Australian Government has displayed some appetite for reform of Australia's insolvency laws by extending "safe harbour" protections and insolvent trading defences to directors and officers of corporations in certain circumstances. Recent commentary on behalf of the Federal Government around the time of the announcement of the 2021 Budget indicates a continuing preparedness to support reform with respect to Australia's corporate restructuring and insolvency regimes.

This paper seeks to summarise the current state of prospective liabilities and safe harbour protections available for directors and officers when a relevant corporation enters the Zone of Insolvency. It also gives guidance as to the various action steps, safe-guards and evidentiary assurances, as well as their timing, if the currently available "safe harbour" protections and insolvent trading defences are to be availed of.

The paper then questions the pragmatic efficacy for their intended purposes and outcomes of many of those protections and defences by analysing in detail all the elements that need to be satisfied, the uncertainty of interpretation of such elements, and the evidentiary burden upon the director or officer seeking to establish the same.

Finally, it proposes a reasonably simplified and pragmatic relief for directors and officers of corporations in the Zone of Insolvency in the form of a Solvency Business Judgment Rule.

It is hoped that the guidance given in this paper may be of use to company directors and officers, and to insolvency practitioners and others who may support companies in the Zone of Insolvency. Finally, it is also hoped that the proposed SBJR may be taken up as part of the Government's ongoing reform agenda on such matters.