Personal Liability for Insolvent Trading: Company Directors Find Berth in Safe Harbour - *Treasury Law Amendments (2017 Enterprise Incentive No 2)*

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Background

On 19 September 2017 the *Treasury Law Amendments (2017 Enterprise Incentive No 2) Act 2017* (the **Safe Harbour Reform Act**) came into effect.

The bill slated itself as amending the *Corporations Act 2001* to "create a safe harbour for company directors from personal liability for insolvent trading if the company is undertaking a restructure outside of formal insolvency [the safe harbour provisions]".

The safe harbour provisions

Australia's insolvent trading regime means that directors risk being found personally liable for debts incurred if they allow their company to trade whilst insolvent. While this regime is intended to dissuade directors from allowing their companies to incur debts which they will be unable to repay, in application, the regime often has the perverse effect of inducing company directors to prematurely engage in the formal insolvency process when they could otherwise have successfully turned around their struggling company.

The intention of the proposals contained in the reform legislation was to encourage honest company directors to remain at the helm of a company facing financial difficulties and to take reasonable steps to restructure and allow it to trade out of its difficulties.

In fact, the Productivity Commission report provided to the government on 30 September 2015, and publicly released on 7 December 2015, stated: 'A 'safe harbour' defence should be introduced to allow directors of a solvent company to explore, within guidelines, restructuring options without liability for insolvent trading.'[5]

The Safe Harbour Reform Act now legislates those intentions, with some key amendments having been made to the draft reform legislation as it passed through the Senate. This article discusses the effect of the amendments, and the practical application of the Safe Harbour Reform Act as passed.

[5] Productivity Commission, 2015, 'Business Set-up, Transfer and Closure, Final Report', 75 Canberra, p 2.

The effect: the safe harbour provisions

The Safe Harbour Reform Act provides that a director will no longer be personally liable for insolvent trading debts if, when they suspect the company is insolvent or likely to be insolvent, they develop one or more courses of action that are reasonably likely to lead to a better outcome for the company, as compared to the immediate appointment of an administrator or liquidator.

Claiming a berth in the safe harbour

For a director to claim the protection provided by the Safe Harbour Reform Act, several factors must be considered to assess whether the course of action being developed was reasonably likely to lead to a better outcome.

Relevantly, this assessment will include consideration of some or all of the following questions:

1. Did the director take reasonable steps to keep themselves informed about the financial position of the company?
2. Did the director take reasonable steps to ensure that the company's maintained appropriate financial records and met its reporting obligations, and were books and records handed over to any subsequent liquidator of administrator?
3. Did the director take reasonable steps to ensure that the company's other officers and employees were not guilty of any misconduct or fraud?
4. Did the director ensure that the company paid all employee entitlements when due?
5. Did the director seek advice from an appropriately qualified professional?
6. Did the director heed any such advice, and did the director develop or implement a restructuring or turnaround plan for the improvement of the company's financial position?

Therefore obtaining advice from an appropriately qualified professional and where appropriate, enacting that advice, remains a central pillar to utilising the safe harbour.

'Developing' a course of action

The Safe Harbour Reform Act provides that a director will be entitled to claim the protection of the safe harbour once he or she starts developing one or more courses of action (over a reasonable period) which are reasonably likely to lead to a better outcome.[6] This amends the Draft Reform Legislation, which proposed providing a safe harbour to a director only after they had actually commenced a particular course of action. The explanatory memorandum states: "*Developing requires more than merely thinking about the problem, but rather denotes actively taking steps to move towards a definite action.*"[7]

[6] Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017, Schedule 1, Part 1, item 2, 588GA 1(a).

[7] Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017, para. 1.45.

The Safe Harbour Reform Act appears to appreciate that generally directors will have a variety of potential turn around strategies which they could pursue, of which only some may be viable. The explanatory memorandum provides that a director who is genuinely intent on developing such a course of action will require a reasonable period of time to consider, and then enact, those options.[8]

What is the 'reasonable period'?

Consideration of a 'reasonable period' is to be defined on a case-by-case basis, but it is important to note that dallying is not considered acceptable, and after due consideration of the available turn around strategies the director must ensure steps are swiftly taken that are reasonably likely to lead to a better outcome for the company.[9] Examples of a reasonable period given include a few days for a small simple company, to perhaps weeks or even months for larger, more complex, entities.[10]

This means that directors will now have a reasonable period of time to consider, develop and enact appropriate turnaround strategies instead of being bound to immediately take and implement one specific turnaround strategy. This is balanced by directors needing to act swiftly and decisively once they have decided upon the appropriate course of action.

Temporal limits of the safe harbour

The Safe Harbour Reform Act provides that the safe harbour will be available from when the director suspects that their company is insolvent and starts to develop a course of action, and will cease if the course of action is not enacted in a reasonable period of time (as above), where the director stops taking the course of action — or when the course of action ceases to be — reasonably likely to achieve a better outcome.

The draft reform legislation proposed that a director should only be able to claim a safe harbour up to the point that the company entered into receivership, or a scheme of arrangement. The Safe Harbour Reform Act rather provides that, in addition to the above, the safe harbour protections will continue up until the point when the company enters administration or liquidation.[11]

This means as the insolvency situation evolves and develops, the director must continuously ensure that the course of action will lead to a better outcome, and if not, change to another course of action which will do so — or place the company in the hands of an administrator or liquidator.[12] It also means that directors are afforded a reasonable period of time to develop and enact the turnaround strategy most appropriate in the circumstances, and to allow that course of action time to progress and to turn the company around and remove it from insolvency.

How likely is 'reasonably likely'?

The explanatory memorandum provides that it is not necessary for 'reasonably likely' to mean the likelihood of achieving a better outcome is fifty percent or more, but instead that it must not merely be considered 'remote' or 'fanciful, and instead must be considered 'sufficient' or 'fair' (or more).[13]

8 *Ibid*, para 1.44.
9 *Ibid*, para 1.45
10 *Ibid*, para 1.46.

11 Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017, Schedule 1, Part 1, item 2, 588GA (1)(b)(i)–(iv).
12 Explanatory Memorandum, Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017, para 1.58.
13 *Ibid*, para 1.52

What is a 'better outcome'?

The draft reform legislation proposed that directors could claim the protection of the safe harbour if they were following a course of action which would lead to a better outcome for both the company and its creditors. The Safe Harbour Reform Act removes the director's duty to the company's creditors, and imposes a duty from the director to the company only.

The explanatory memorandum states that this means that a director can now allow their company to incur debts to creditors associated with the sale of assets which would help the company's overall financial position.[14]

The draft reform legislation proposed that a 'better outcome' be defined in relation to the company becoming a Chapter 5 body corporate (for example, the company going into administration or being wound up) over some unspecified time period.

The Safe Harbour Reform Act now provides that a 'better outcome' is to be defined on a case-by-case basis 'depending on the individual company and its circumstances at the time the decision is made',[15] and that it is to be a better outcome as opposed to the immediate appointment of a liquidator or administrator over the company.

This means that the director will be able to ascertain with more certainty if the turnaround strategy being considered or taken will pass the 'better outcome' test, as they can now be sure of the specific threshold which must be passed to class the action as providing a better outcome.

Who are 'appropriately qualified professionals'?

To utilise the safe harbour, a director should seek timely advice from an appropriately qualified professional. In assessing whether the insolvency professional is 'appropriately qualified', the explanatory memorandum states '[appropriately qualified professional] is used in the sense of 'fit for purpose' and is not limited merely to the possession of particular qualifications. It is for the person who appoints the adviser to determine whether the adviser is appropriate in the context'.[16]

The determination should have regard to the following:

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

[14] *Ibid*, para 1.49
[15] *Ibid*, para 1.18
[16] *Ibid*, para 1.69

The explanatory memorandum provides guidance and examples, such as a small business with a simple structure may require only the advice of an accountant, lawyer or other technical adviser with experience in insolvency.[17] A larger, more complex business may require the advice of a properly qualified, specialised insolvency or turnaround practitioner who is a member of a professional insolvency or turnaround association, or a specialist lawyer.[18] A very large complex business may need to retain an entire team of turnaround specialists, insolvency practitioners, and a law and accounting firm to advise on an appropriate course of action.[19]

This means that directors have the freedom to, and indeed must, ensure that the qualified professional has skills consummate with the case in hand.

A carve-out rather than a defence and evidence

During the passage of the bill, amendments were tabled to enact the safe harbour provisions as a defence to insolvent trading in its own right, rather than to carve the insolvent trading provisions out of the existing legislation. These tabled amendments were not accepted, meaning the Safe Harbour Reform Act will provide directors with the safe harbour in the form of a carve out (that is, an exemption) of the insolvent trading provision contained in s 588G of the *Corporations Act 2001*, rather than as a stand-alone defence.

Therefore, a director who wishes to claim the safe harbour protection will merely have to adduce evidence which shows that the course of action was reasonably likely lead to a better outcome for the company and its creditors. Once this low evidential threshold is met, the onus of proof then shifts onto a liquidator to show, on the balance of probabilities, that the director did not develop a course of action reasonably likely to result in a better outcome for the company.[20]

Scope of debts covered

The draft reform legislation proposed covering only those debts which were directly incurred as a part of the turnaround action, for example, only further loan agreements or credits taken after the commencement of the turnaround action.

The Safe Harbour Reform Act now provides protection for directors against direct and indirect debts incurred during the turnaround action, for example, debts incurred during the day-to-day running of the company.[21]

This means that directors cannot now be found personally liable for the ongoing debts of the company 'through the back door', as would have been the case under the draft reform legislation.

[17] *Ibid*, para 1.71
[18] *Ibid*, para 1.72
[19] *Ibid*, para 1.73
[20] *Ibid*, para 3.5
[21] Treasury Laws Amendment (2017 Enterprise Incentives No 2) Act 2017, Schedule 1, Part 1, item 2, 588GA (1)(b)

Two-year review

The Safe Harbour Reform Act provides that it will be reviewed as soon as practicable two years from the date of commencement, being July 2019.

This means further amendments to the Safe Harbour Reform Act may be made in two years or more based upon the evidence and experience from the enacting of the Safe Harbour Reform Act. This review will consider the application and effect of the Safe Harbour Reform Act on companies, directors, and the interests of employees, and creditors.[22]

Conclusion

The enactment of the Safe Harbour Reform Act represents a steep change in the manner in which directors are able to address issues of their company's solvency.

Directors are now afforded additional protection to allow them the time and support necessary to turnaround a struggling company. The safe harbour protection comes with limits, and it is incumbent on directors to know how the new regime will affect them and their company during periods where solvency is in question.

The director can be reassured that they are protected by the safe harbour so long as they follow the correct procedures, including developing a sound turnaround plan, often with the advice of an appropriately qualified professional, and that they continued to evaluate that plan and changed tack where necessary.

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[22] *Ibid item 3*, 588HA

Aged Care Quality Reforms *Aged Care (Single Quality Framework) Reform Bill 2018 (Cth)*

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Review of National Aged Care Quality Regulatory Processes

An independent review of the National Aged Care Quality Regulatory Processes (the **Review**) was announced in response to the Oakden Report which detailed failures in the quality of care delivered at the Oakden Older Persons Mental Health Service in Australia.[23]

Following the publication of the Report into the Review of the National Aged Care Quality Regulatory Processes on 25 October 2017, which was led by Ms Kate Carnell AO in conjunction with Professor Ron Paterson, the Minister of Aged Care, Ken Wyatt announced several significant reforms to take place in the aged care community.[24]

The key impending changes are:

- the establishment of a new Independent Aged Care Quality and Safety Commission (**Commission**) from 1 January 2019 to centralise accreditation, compliance and complaints handling;
- enhanced risk profiling of aged care providers to determine the frequency and rigour of visits;
- the development of options, in consultation with the sector, for an efficient Serious Incident Response Scheme to ensure the right systems are in place to identify and prevent situations such as Oakden from occurring again;
- the introduction of a performance rating against the quality standards; and
- the development of a user-friendly provider comparison tool on the My Aged Care Website.

Improving effectiveness of accreditation and unannounced audits

To strengthen ongoing accreditation processes, all residential care services will be subject to unannounced re-accreditation audits for those services:

- applying for re-accreditation from 1 July 2018; and
- with an accreditation expiry date on or after 1 January 2019.

[23] Refer to the article on the Oakden Report in this publication.
[24] Review of National Aged Care Quality Regulatory Processes, Department of Health: https://agedcare.health.gov.au/quality/review-of-national-aged-care-quality-regulatory-processes.