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Licence to trade insolvent: The new safe harbour for directors

Marbury Chambers CLE
20 October 2018

Licence to trade insolvent

Direction of policy towards a safe harbour

Large businesses and professional directors

- Insolvent trading action is seen as a disincentive to restructuring – big business is driving reform
- Strictest insolvent trading regime in the world - mandates directors to move to external administration as soon as company is insolvent to avoid risk of personal liability
- Discourages taking sensible risks when considering an informal workout as an alternative to voluntary administration
- Strong consensus that professional directors may be putting companies to a premature end to avoid personal liability (i.e. through voluntary administration)

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Direction of policy towards a safe harbour

What about SMEs?

- Same law applied to the Ansett Administration as a voluntary administration of a fish and chip shop (i.e. Corporations Act 2001)
- Insolvent trading is not enforced much as a cause of action particularly for SMEs
- Directors of SMEs behave in stark contrast to professional directors because they have ‘skin in the game’
- SMEs and illegal phoenix activity is a significant concern for regulators
- A rescue culture is about allocative efficiency – voluntary administration does not preserve goodwill value

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Benefits of avoiding a liquidation fire sale

Rescue versus formal appointment scenarios

- New restructuring adviser – “appropriately qualified entity”
- Voluntary administration has the stigma of failure and is more than likely to ultimately end up in a liquidation anyway
- Liquidators close businesses rather than trade businesses resulting in a complete loss of goodwill and fire sale of assets
- Voluntary administration is expensive in professional costs
- One policy direction is to promote a rescue culture in Australia

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Insolvent trading: the claim and the penalties

What are the elements?

- A person is a director of a company
- The company is insolvent
- The company incurs a debt
- There are reasonable grounds to suspect insolvency

What are the penalties?

- Civil penalties up to $200,000
- Liability to compensate company or relevant creditors for the amount of the debt incurred as a result of the breach
- Also criminal prosecution potential

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The new safe harbour

New section 588GA of Corporations Act 2001 (Cth)
The duty to prevent insolvent trading does not apply when:

- At a particular time after the director suspects insolvency the director **starts** to develop a course of action that is reasonably likely to lead to a better outcome for the company; and
- The debt is incurred in connection with the course of action.

- For the purposes of finding that a course of action is likely to lead to a better outcome for the company regard is had to whether the director:
  - Informs themselves about the company's financial position
  - Takes steps to prevent misconduct by officers or employees
  - Keeps appropriate books and records
  - Obtains advice from appropriately qualified entity
  - Develops or implements a plan for restructuring the company

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The new safe harbour: the plan

What are the elements of the safe harbour?

- “Better outcome” for the company, means an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, over the company.
- Director is to be active not passive in the process
- No strict requirement to engage an “appropriately qualified entity”
- Directors are required to “develop” one or more courses of action that are “reasonably likely to lead to a better outcome for the **company**” (not the creditors, employees or the ATO)
- No essential requirement to have either a written plan or a plan that is actually executed

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The new safe harbour: Carve-out not a defence

Why a carve-out and not a defence?

- Formerly no specific defence where debts incurred in insolvency during an attempt to restructure or preserve trading value
- Carve-out means the principal claim cannot be made out (so a defence is not called upon)
- Director's duty to prevent insolvent trading is taken not to apply to an appropriate informal workout (in the safe harbour)
- A carve-out removes the element of wrong doing associated with insolvent trading (and therefore potential stigma)

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Safe harbour 101

What are some elements of a plan?

- The plan may ultimately lead to liquidation or a sale of assets
- Proper financial records are kept
- Cashflow projection and monitoring
- The plan is documented – explain why it is reasonably likely to lead to a better outcome
- It can be secret (and probably should be)
- TMA best practice: Assessment of solvency> Resolve to enter safe harbour> Turnaround planning> Implementation and monitoring> Leave safe harbour

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Hurdles to getting to the safe harbour

What must be done to obtain safe harbour?

- Pay entitlements of employees by the time they fall due
- Tax returns to be filed
- Key element of phoenix activity is likely to be non-remission of PAYG, GST and Income Tax – lodgement and not payment of taxes is essential
- But if entitlements are not paid or tax returns not filed Court may excuse in exceptional circumstances

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Law reform battles

When does the safe harbour end?

- Director fails to take action within a “reasonable time”
- The director ceases to take the course of action developed
- The course of action ceases to be reasonably likely to lead to a better outcome for the company
- A voluntary administrator or liquidator is appointed
- The directors don’t co-operate with a subsequently appointed liquidator (protection lost retrospectively) – new section 588GB

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Law reform battles

What didn't get included in safe harbour law?

- No honesty and diligence test (AICD Honest and Reasonable Director defence)
- No registered "Restructuring Advisor" (Productivity Commission)
- Fixed process of safe harbour rejected (Productivity Commission)
- No ban on pre-pack sales or restriction to advice provided by registered liquidators (ARITA)
- No moratorium on winding up applications or appointments of receivers during safe harbour
- No specific time limits to safe harbour

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What's next?

What to look out for

- Paucity of empirical research overall is problematic – do entrepreneurs care and who is actually doing pre-insolvency advice anyway?
- Review in 2 years mandated by section 588HA
- Look out for case law (maybe)
- See what the direction of regulation of phoenix activity will be (gov is threatening panel model)
- What about cultural change?
- Ultimate measure may be evidence of reduced numbers of formal appointments (voluntary administrations and liquidations)

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What value can you add in a safe harbour workout? Disaggregation of professional services

- Due diligence
- Financial analysis
- Project management
- Strategy development
- Legal research
- Template selection and bespoke drafting
- Negotiation
- Document management
- Legal Advice
- Risk assessment

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What we offer

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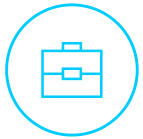

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We provide consulting services to clients faced with an insolvency challenge. We deliver pre-pack insolvency arrangements and act as restructuring advisers for our clients. We explore all avenues (both formal and informal) to protect and recovery value.

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Call us
+61 2 8251 0075

Email us
contact@sklawyers.com.au

Visit our website for information
sklawyers.com.au

Sydney Office

Sewell & Kettle Lawyers

Level 1, 299 Elizabeth Street

Sydney NSW 2000

Ph: +61 2 8251 0075

Melbourne Office

Sewell & Kettle Lawyers

Level 35, 600 Bourke St

Melbourne, VIC 3000

Ph: +61 3 8639 5775

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