



Overview of the Australian insolvent trading prohibition and the safe harbour protections¹

Directors of Australian companies face significant *personal* monetary - and potential criminal and adverse professional - consequences if they allow the company to trade while insolvent.

Australian insolvent trading laws are harsher, and more frequently utilised to prosecute directors personally, than in many other jurisdictions including in the US and the UK.

Accordingly, frequent assessment of a company's solvency by its directors is crucial, particularly in financially difficult times, as are active steps to address any potential insolvency.

Elements of insolvent trading

A director will breach his or her duty to prevent insolvent trading under section 588G of the *Corporations Act 2001* (Cth) (**Corporations Act**) if:

- (a) they are a director of the company when the company incurs a debt; and
- (b) the debt was incurred while the company is insolvent or the company becomes insolvent by incurring the debt; and
- (c) at the time the debt was incurred there were reasonable grounds for suspecting that the company was insolvent or would become insolvent as a result of the debt being incurred, and
- (d) the director was aware that there are reasonable grounds for suspecting insolvency or a reasonable person in a like position in the company's circumstances would be aware that the company was or would become insolvent.

Who is liable?

The duty to prevent insolvent trading is imposed on any "director".

A "director" includes anyone who is formally appointed as a director (whether executive or non-executive), and also any 'shadow' or 'de facto' directors – being, broadly, any person who is not formally a director, but who acts in that position or on whose instructions or in accordance with whose wishes the directors or the company are accustomed to act.

In Australia, the holding company of a subsidiary may also be held liable for the insolvent trading of the subsidiary if there were reasonable grounds for the holding company to suspect that the subsidiary was insolvent at the time the relevant debts were incurred.

¹ This overview is current as at 1 January 2021. It is generic, and legal advice should be sought in relation to specific circumstances. This is a summary only and not an exhaustive statement of the law relating to insolvent trading or the potential liability of directors more broadly (including in respect of unpaid company tax and superannuation liabilities): legal advice should be obtained in respect of each individual set of circumstances. This overview only deals with potential director liability for insolvent trading: obviously potential insolvency of a company will also have ramifications for that company (including potentially in connection with covenants in its financing documents and otherwise in relation to its contractual arrangements).

Reasonable grounds to suspect insolvency

As noted above, in order for a director to breach the duty to prevent insolvent trading, the director must either actually know that the company was insolvent, or must have had reasonable grounds for suspecting that the company was insolvent or would become insolvent as a result of the relevant debt being incurred.

The requirement for reasonableness means the court will objectively consider whether a director of reasonable competence and diligence in the director's position, with knowledge of the company's circumstances, would have had a suspicion of insolvency.

Suspicion means a positive feeling of apprehension; it includes a tentative belief, without sufficient evidence to form a concluded opinion.

When is a company insolvent?

In Australia, a company is insolvent if it is unable to pay its debts as and when they fall due (in accordance with section 95A of the Corporations Act).

Solvency for the purpose of the insolvent trading provisions of the Corporations Act is determined on a *cash flow basis*. This involves considering whether or not the company can in fact pay its debts as and when they become due and payable, rather than by purely considering the company's balance sheet (i.e., its net asset) position.

Although the company's solvency position is determined on a cash flow basis, the balance sheet position of the company is an indicia of the general financial health of the company and may be relevant to determining whether the directors had, or ought to have had, a "suspicion" of insolvency (including, for example, insofar as the directors might have had recourse to the assets of the company to improve its solvency).

Whether or not a company is solvent on a cash flow basis is a question of fact and is determined as a matter of commercial reality in light of the circumstances.

External financial support available to the company (for example, from other group companies, investors and financiers) is relevant to determining solvency on a cash flow basis, as is the ability to realise assets or to refinance existing liabilities within an appropriate time frame. In this context, "temporary illiquidity" does not equate to insolvency if the position is likely to be remedied in the short term.

When assessing solvency directors must have regard to both debts which are currently due and payable as well as to future debts and their timeframes for payment.

Future debts

In relation to future debts, generally:

- directors must have reasonable grounds to expect that the company will be able to pay all future debts as and when they fall due;
- directors can reasonably expect that the company is solvent if it can pay all its present and future debts (including those likely to be incurred) within about 90 days – although this is not a hard and fast rule, but a broad guideline only;
- the closer the time for payment, the more certain must the expectation be;
- if the capacity to pay future debts is dependent on particular events occurring (such as refinancing or asset sales) an assessment needs to be made – and revisited regularly with changing circumstances –

as to the likelihood of the event occurring; if the likelihood of the event occurring is anything less than probable or certain then the directors run the risk that in hindsight they may be regarded as not having reasonable grounds to expect that the company is solvent; and

- if assessment of the company's ability to pay the relevant future debt is dependent on more information being obtained, the directors must be satisfied that the information will be available before the debt falls due with sufficient time to enable relevant actions to occur to meet the relevant debt and enable the directors to make an assessment about the company's future solvency position.

Signs of insolvency

It can often be difficult to determine when a company is insolvent or likely to become insolvent, particularly with respect to debts falling due in the future. To assist directors, the courts have provided some guidance by referring to a number of key indicia which may create a "suspicion" of insolvency in the mind of a reasonable director. Those key "signs of insolvency" include the following:

- a serious deficiency of assets (notwithstanding that insolvency is a cash flow rather than balance sheet test);
- current liabilities significantly exceeding current assets (that is, a current ratio of less than one);
- serious cash flow deficiencies;
- continuing losses;
- overdue Commonwealth and/or State taxes;
- poor relationships with bankers, including an inability to borrow further funds;
- inability to raise further equity capital;
- suppliers placing the company on "COD", or otherwise demanding special payments before resuming supply;
- creditors unpaid outside standard trading terms;
- issuing of post-dated cheques;
- dishonoured cheques;
- special arrangements with selected creditors;
- solicitors' letters, statutory demands, summonses, judgments or warrants issued against the company;
- payments to creditors of rounded sums which are not reconcilable to specific invoices; and
- inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts.

In recent years, a frequently seen indicia of insolvency has been a simple inability to refinance existing loans when they become due.

What is a "debt" and when is it "incurred"?

The term 'debt' has been interpreted widely and includes contingent debts.

Transactions which have been held to give rise to a debt for insolvent trading purposes include supplying goods and services, lending money, entering into a lease, entering into a guarantee and certain transactions



giving rise to statutory obligations to pay tax (for example, by hiring additional employees, which then gives rise to payroll and other tax liabilities).

In addition, section 588G(1A) of the Corporations Act deems a company to incur a debt at various times when certain transactions are entered into. These include paying a dividend, making a capital reduction, redeeming redeemable preference shares, financially assisting a person to acquire shares or entering into an uncommercial transaction (within the voidable transaction provisions of the Corporations Act).

Generally, a company will incur a debt if, by its conduct or operations, the company subjects itself to a conditional, but unavoidable, obligation to pay a sum of money.

The words "debt" and "incur" are applied by Australian courts in a practical and common sense fashion, having regard to commercial realities and the statutory purpose of the insolvent trading provisions.

Defences and carve outs to insolvent trading

There are various statutory defences and carve outs available to directors against an insolvent claim, including by establishing that:

Reasonable grounds to expect solvency	At the time the debt was incurred, the director had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if it incurred that debt (the expectation must be reasonable – a director cannot rely on a complete ignorance of the facts or the law);
Reliance on competent and reliable person	The director expected that the company was solvent at the time the debt was incurred, and that expectation came as a result of relying on information provided by a competent and reliable person who was responsible for providing information as to the solvency of the company;
Illness or other good reason	Because of "illness" or for "some other good reason" the director did not take part in the management of the company at that time (complete ignorance of the facts or the fact that a director was a non-executive director does not constitute "some other good reason");
Reasonable steps to prevent incurring debt	The director took all reasonable steps to prevent the company from incurring the debt. Such actions include appointing an administrator to the company at the time when the directors resolved that the company was insolvent;
Safe Harbour	The debt was incurred on or after 19 September 2017 and was incurred directly or indirectly in connection with a qualifying " safe harbour " plan (see Annexure 1);
COVID Safe Harbour	The debt was incurred prior to the appointment of an administrator or liquidator and in the period between 25 March 2020 to 31 December 2020, being the period of the temporary COVID 19 safe harbour relief legislated in the <i>Coronavirus Economic Response Package Omnibus Act 2020</i> (Cth) (CERPO Act) ² ; and

² In response to the COVID 19 pandemic, the CERPO Act afforded directors temporary relief from their statutory duty to prevent insolvent trading (pursuant to s 588G), in respect of debts incurred in the ordinary course of the company's business in the period between 25 March 2020 and 31 December 2020. Directors were also relieved of their associated personal liability for these debts. As this COVID safe harbour expired on 31 December 2020, it is not discussed in any detail here



Restructuring Safe Harbour and Temporary pre-Restructuring Safe Harbour

The debt was incurred after the introduction of Part 5.3B of the Corporations Act from 1 January 2021³ in specified circumstances where the company was in *restructuring* or where the company is eligible for *temporary restructuring relief* (see [Annexure 2](#)).

Who can bring an insolvent trading claim?

The company's liquidator and the Australian Securities and Investments Commission (**ASIC**) can institute insolvent trading proceedings.

ASIC proceedings tend to seek criminal penalties and director banning orders, whilst liquidator proceedings generally seek civil compensation from the directors for breach of their duty (being the amount still owed by the company in relation to debts incurred in breach of the duty).

The liquidator may assign his or her claim to a third party. The company's creditors can also potentially bring proceedings against directors with the liquidator's consent.

If the liquidation of the company follows an administration of the company, potential insolvent trading claims will be discussed in the report by the administrator to the company's creditors pursuant to s 75-225 of the Insolvency Practice Schedule, including to compare potential returns pursuant to any deed of company arrangement that may be proposed (in which insolvent trading claims will generally not be available) and in liquidation (in which the liquidator will be able to pursue insolvent trading claims).

Ramifications for directors of insolvent trading

In a liquidation of the company, directors can be held personally liable for the unpaid debts incurred by the company whilst it was insolvent. Such amounts can be recovered as a debt due to the company (or to the relevant creditor if that creditor has brought the proceedings with the liquidator's consent).

Third party litigation funding is commonly available to allow a liquidator to pursue insolvent trading claims notwithstanding a lack of funds in the liquidation to do so.

Directors' and officers' insurance policies may not respond to insolvent trading claims.

In addition, directors could be liable to pay civil pecuniary penalties to the Crown, or, if they acted dishonestly, substantial fines and/or imprisonment may be imposed on a criminal conviction. ASIC can also seek director banning orders, with the effect that the director is disqualified from managing Australian corporations.

Finally, corporate insolvency gives rise to other potential personal liability on the part of directors, in addition to potential insolvent trading liability, including:

- pursuant to section 588FGA of the Corporations Act, in the event the Commissioner of Taxation is obliged to disgorge funds received by him or her from the company as an unfair preference on the application of the liquidator of the company, then the directors are liable to indemnify the Commissioner of Taxation in respect of any loss or damage resulting;

³ By the *Corporations Amendment (Corporate insolvency Reforms) Act 2020* (Cth).

- pursuant to Australian tax legislation, directors can be personally liable for certain unpaid company taxes in particular circumstances; and
- for breach of directors' duties: at a point where a company is insolvent or approaching insolvency, directors are obliged to consider the interests of the company's creditors in the discharge of their duties to the company.

Practical steps to take in the face of potential insolvency

Given potential insolvency, directors acting prudently would promptly do some or all of the following:

- ensure that they receive regular, up to date and reliable cash flow forecasts;
- regularly consider, and minute their consideration, as to whether the company is solvent and their reasons for concluding that it is solvent;
- ensure there is adequate evidence as to matters that enable the directors to conclude the company is solvent (for example, documenting forbearances by creditors);
- avoid incurring any significant liabilities;
- obtain appropriate professional advice including in relation to any potential "safe harbour" plan; and
- if they form the view that the company is insolvent or likely to become insolvent, take prompt steps to appoint an administrator to the company.

A word of caution for directors of subsidiaries of foreign companies

We often find that the Australian directors of companies that are part of a multi-national group, or who are being advised by American or European advisers, do not appreciate (or cannot make their offshore stakeholders appreciate) the personal risks presented by the Australian insolvent trading regime. This is because insolvent trading as a source of personal liability for directors in Australia does not exist in such a stringent form in other jurisdictions (including in that it does not require dishonesty), and/or is not enforced there, whereas insolvent trading claims are prosecuted in Australia, both by liquidators and by ASIC. There is, accordingly, often a need for education of foreign holding companies or advisers about the risks and the need to take prompt action.



Annexure 1 – 2017 Safe Harbour

Overview

The safe harbour reforms are a relative newcomer to the high seas of Australian corporations law. Commencing in September 2017 the reforms have the stated aim of encouraging entrepreneurship, and avoiding the stigma associated with insolvent trading.

The "safe harbour" is not a new or separate species of corporate insolvency regime: it is a carve out from a director's duty to avoid insolvent trading and the potential personal liability of the director if she or he fails to do so. It is not a defence more widely in respect of other breaches of duties or statutory obligations of directors, and directors wanting to enter the safe harbour need to be mindful of complying with those other duties and obligations.

What a director wanting to enter the safe harbour must do

Safe harbour looks at the actions taken by a particular director to develop and put into effect a plan at the time when a debt is incurred. The core requirements set by the Corporations Act⁴ in order for a director to have the benefit of the safe harbour are:

- the director starts to suspect that the company may become or be insolvent;
- the director starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and
- the debt is incurred directly or indirectly in connection with any such course of action.

The "better outcome for the company" is one that is better for the company than the immediate appointment of an administrator, or liquidator, of the company. Merely hoping for a better outcome is not enough - there needs to be some demonstrable action to develop and then implement a plan. The prospect that the plan will lead to a better outcome must be more than fanciful or remote. The test though does not require proof that there is a better than 50% chance of the outcome being better.

The safe harbour provisions provide a list of matters "to which regard may be had" in considering whether a course of action is reasonably likely to lead to a better outcome for the company. While, strictly, none of these matters must be satisfied, it would be prudent for directors to seek to satisfy as many of these matters as possible. We suggest that directors seeking to have the benefit of the safe harbour would ideally:

- inform themselves properly of the company's financial position;
- take 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;
- take appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company;
- obtain advice from an appropriately qualified entity who was given sufficient information to give appropriate advice;
- develop and implement a plan for restructuring the company to improve its financial position.

⁴ Sections 588GA and 588GB

The advisor chosen to assist needs to be appropriately qualified taking into account the particular problems facing the company, and the nature, size, complexity and financial position of the company. There is no particular required formal qualification for that person, but in the circumstances of a large complex business in financial difficulty, using legal and accounting advisors with experience in insolvency turnarounds is strongly recommended.

The safe harbour is entered from the time when the director starts to develop the required course of action. It applies in respect of debts which are incurred directly or indirectly in respect of that plan. Debts do not have to be solely associated with developing the plan or specific aspects of its implementation. Ordinary trading debts may also be protected.

A director will exit the safe harbour if the course of action is not followed within a "reasonable period", if that plan stops being followed, if that plan stops being reasonably likely to lead to a better outcome, or when a liquidator or administrator is appointed to the company.

What disqualifies a director from consideration for the safe harbour?

There are a number of obligations with which a company must be complying before its directors can rely on the safe harbour. The company must:

- pay the entitlements of its employees by the time they fall due (including wages, leave entitlements and superannuation); and
- file returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the *Income Tax Assessment Act 1997* (Cth)).

If the company fails to do so, and those failures involve less than substantial compliance, or are one of two or more failures during the 12 months before the debt is incurred, then directors cannot rely on the safe harbour.

There are also statutory obligations on directors to provide information on the appointment of receivers, administrators and liquidators. Failure to provide that information as required in the time limits set for a response may stop a director relying on the safe harbour. It may also stop the director relying on the information or records ultimately supplied when the director tries to rely on the safe harbour to defend insolvent trading claims made by a liquidator.

Whilst there is an ability for a Court to make an order which avoids these consequences, directors should be mindful of these obligations and comply with them if they wish to rely on the safe harbour.

Implications for a party dealing with a company whose directors are seeking to invoke the safe harbour

Disclosure and publicity

There are no notification requirements to the world at large when directors are taking steps intended to be relied upon at a later time to show entry into the safe harbour. Continuous disclosure rules applicable to listed companies, and the risk of engaging in misleading or deceptive conduct, are not suspended by the safe harbour.

The ASX has amended its listing rules to expressly reference the safe harbour reform. While the ASX's view is that no express reference or announcement needs to the effect that the directors of the company are

invoking the safe harbour, the company's financial circumstances and any plan it is implementing may of themselves may be matters in an appropriate case which would be expected to need to be disclosed. A supplier or other contractual counterparty may nevertheless not know that the directors of the company have invoked the safe harbour.

Potential impact for contractual arrangements

Directors seeking to rely on the safe harbour should also carefully consider whether their reliance on safe harbour would potentially constitute an event of default under contractual arrangements of the company, such as financing arrangements. If so, this possibility may require proactive management.

Dealing with a company whose directors are relying on the safe harbour

Safe harbour carries with it the assumption that a director suspects that the company may become or be insolvent. Where the company does communicate that its directors are attempting to rely on safe harbour, there may remain good commercial reasons to want to continue to deal with it. However there are also legal risks associated with transactions entered at that time in the event of a subsequent formal insolvency of the company.

Suppliers and other contractual counterparties should consider seeking advice about the best ways to manage those risks if they know or suspect the directors of a company are wanting to use the safe harbour.



Annexure 2 – Safe Harbours for companies under restructuring

On 1 January 2021, the Federal Government's small business restructuring reform package⁵ came into effect.⁶

This package introduced:

- a "debtor in possession" restructuring plan process (**restructuring**) for companies with liabilities of less than A\$1m that involves the appointment of a restructuring practitioner to the company. The restructuring procedure includes a **safe harbour**⁷, removing the application of the insolvent trading prohibition where a debt is incurred:
 - during the restructuring of a company; and
 - in the ordinary course of the company's business or with the consent of the restructuring practitioner or by order of the court; and
- temporary insolvency relief for companies (and their officers) that wish to enter the restructuring procedure, but cannot find a restructuring practitioner to undertake the restructuring during the period to 31 March 2021, including a temporary insolvent trading **safe harbour** for directors in respect debts incurred⁸ where:
 - the company is eligible for temporary restructuring relief when the debt is incurred⁹;
 - the debt is incurred in the ordinary course of the company's business; and
 - the company has taken all reasonable steps to appoint a restructuring practitioner before the debt was incurred.

⁵ *Corporations Amendment (Corporate insolvency Reforms) Act 2020 (Cth); Corporations Amendment (Corporate Insolvency Reforms) Regulations 2020 (Cth) and Insolvency Practice Rules (Corporations) Amendment (Corporate Insolvency Reforms) Rules 2020 (Cth)*

⁶ This document does contain a comprehensive discussion of these reforms and the operation of Part 5.3B - please see our separate publication.

⁷ In section 588GAAB of the Corporations Act.

⁸ In section 588GAAC of the Corporations Act.

⁹ See our separate publication for discussion of what this requires.

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