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Directors' "safe harbour" – How to Steer the Ship in Uncertain Financial Times

In challenging financial times, a company director's role is fraught with difficult decisions regarding continued operations and the preservation of the business. These decisions may be influenced by the risk of personal liability to the director.

This Legal Alert revisits the existing legislative mechanism to protect directors who may engage in insolvent trading in order to lead the company to a better outcome. This is in addition to the temporary relief measures for company directors which have been introduced as a result of the COVID-19 crisis.

Introduction

In our Legal Alert on Directors' Duties in Uncertain Financial Times, we canvassed the issues facing a director when the company's financial viability comes into question.

In particular, the penalties for directors trading the company whilst insolvent put directors at personal risk for debts incurred by an insolvent company and can result in the company being placed prematurely into administration or liquidation.

In order to allow company directors an opportunity to explore alternatives to a formal external administration, the "safe harbour" provisions were introduced in 2017 to provide directors with a "safe harbour" from insolvent trading offences when deciding on a course of action at a time when they suspect the company is insolvent.

The safe harbour provisions pre-existed the coronavirus (COVID-19) health crisis, and have been supplemented by the temporary reforms introduced by the *Coronavirus Economic Response Package Omnibus Act 2020* (Cth). As set out in our alert regarding the temporary relief in insolvency laws, the Government has introduced temporary measures to incentivise continued trade through the COVID-19 health crisis, with the aim of returning to viability when the crisis has passed. This includes a moratorium on directors' personal liability for insolvent trading.

What is the duty to prevent the company trading while insolvent?

Company directors have a duty to prevent the company from trading while insolvent. A company becomes insolvent at the point in which it cannot pay its debts when they become due and payable.

A director may be personally liable to the company for an amount equal to the loss or damage suffered by unsecured creditors if:

(a) they were a director (or alternate, de facto, or shadow director) when a debt was incurred;
(b) the company was insolvent (or became insolvent) by incurring that debt;
(c) there were reasonable grounds to suspect the director knew of the insolvency, or a reasonable person in the director's position would have known; and
(d) the director did not stop the company from trading.

The safe harbour provisions

Under section 588GA of the *Corporations Act 2001* (Cth), a director will not be liable for the company's insolvent trading where the director starts developing and implements a course of action that is reasonably likely to lead to a better outcome for the company and the debt is incurred directly or indirectly in connection with the course of action.

This allows directors to 'engage early with possible insolvency',[1] and seek out a better outcome for the company and its creditors.

Before being able to avail himself or herself of the safe harbour provisions, a director must ensure that the company has paid all outstanding employee entitlements and that all tax reporting obligations have been met.

The protection of the safe harbour only applies to those directors who are otherwise operating the company in compliance with these important obligations, rather than those derelict in their duties.

What is a reasonably likely to lead to a better outcome for the company?

The course of action decided upon as an alternative to liquidation or administration need not be guaranteed to lead to a better outcome for the company, however it must be reasonably likely to do so.

In assessing whether the proposed course is reasonably likely to lead to a better outcome, regard is had to the following:

- Are the directors properly informed of the company's financial position?
- Are steps being taken to prevent misconduct by employees or officers that could adversely affect the company's ability to pay its debts?
- Are appropriate financial records being maintained, consistent with the size and nature of the company?
- Is advice been sought by the directors from an appropriately qualified person, who has been given sufficient information to provide such advice?
- Is the developing and implementing of a plan for restructuring the company to improve its financial position?

Again, company directors must ensure that they are operating the company appropriately and in line with their duties as directors. Directors must be actively engaged and importantly, should seek advice from an insolvency and restructuring expert.

How long does a director have the benefit of the safe harbour?

The protection of the safe harbour will end on the earlier of:

- if the director fails to take any course of action within a reasonable period, the end of that reasonable period;
- when the director ceases to take the course of action;
- when the course of action is no longer reasonably likely to lead to a better outcome; or
- when an administrator or liquidator is appointed.

Accordingly, any course of action decided on by the company directors should be implemented immediately, continuously monitored and assessed, and if necessary, altered.

The protection from personal liability will not necessarily continue to apply if the course of action is not adequately pursued or it becomes apparent that it is unlikely to improve the prospects of the company and its creditors.

COVID-19 (Coronavirus) temporary relief from directors' personal liability for trading while insolvent

The *Coronavirus Economic Response Package Omnibus Act 2020* provides a special and additional safe harbour to relieve company directors from their duty to prevent insolvent trading. This only applies in relation to debts incurred in the ordinary course of the company's business and during the six month period from 25 March 2020 to 25 September 2020, unless extended by the Government.

For further information on these and other temporary measures introduced in an attempt to reduce the devastating impact of COVID-19 on Australia's economy, please visit our website.

Conclusion

While it is possible for directors to protect themselves from potential personal liability at the same time as trying to revive the fortunes of a struggling company, directors should seek appropriate advice to ensure that the protections are available and that the best possible outcome for the company and its creditors is achieved.

[1] Explanatory Memorandum, Treasury Laws Amendment (2017) Enterprise Incentives No. 2) Bill 2017 (Cth) 3.

Contact details

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This content is current as at 1 April 2020. The speed with which COVID-19 is spreading and the varied responses both internally within Australia and externally change on a daily basis. It is important that you regularly keep up to date with all relevant information and be prepared to respond as the landscape in which the virus is moving changes.