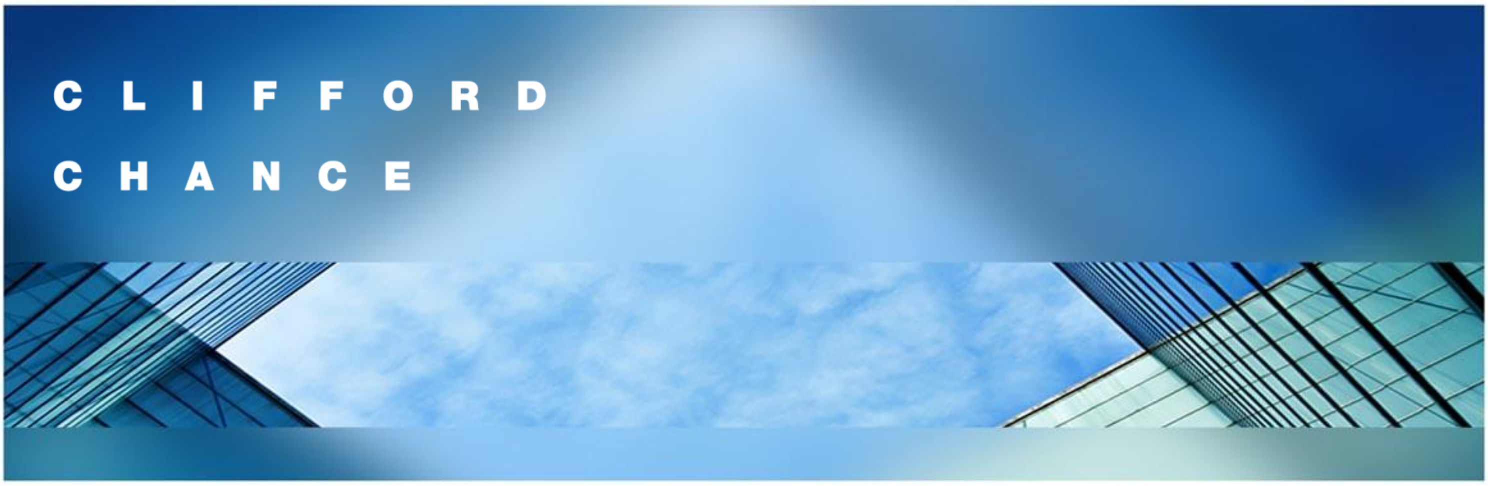

SAFE HARBOUR FROM INSOLVENT TRADING IN AUSTRALIA

The safe harbour regime was introduced in 2018 and since then it has allowed the successful turnaround of many Australian businesses that might have otherwise been forced to go into voluntary administration or liquidation. It has done so by providing company directors with a defence to personal liability for insolvent trading (while they develop and implement a restructuring plan for their company).

Almost four years later, in March 2022, the Review of the Insolvent Trading Safe Harbour Report noted that the Australian business community's awareness and understanding of the safe harbour regime was insufficient. And in August 2024, following a media leak, the board of Mosaic Brands Ltd was criticised for *"not disclosing"* that its directors had engaged the safe harbour regime (suggesting that the Australian business community continues to grapple with the safe harbour regime's place in corporate Australia). Helpfully, in December 2024, the Australian Securities & Investments Commission updated its regulatory guidance.

The Clifford Chance Restructuring & Insolvency Team has led many successful safe harbour engagements since 2018 (and provides some of their observations below).

BACKGROUND

With increased inflation, tightening monetary policy, the (relative) closing of traditional debt and equity markets, rising cost bases, labour shortages, tariffs and a more active pursuit of debts by the Australian Taxation Office over the last two years, many Australian businesses are now facing significant financial and operational pressure (which was not present in previous years).

In some cases, where a business is no longer viable and cannot be salvaged, voluntary administration or liquidation may be the only solution. However, for many businesses facing temporary financial difficulties, the safe harbour regime is an important alternative to the formal appointment of a voluntary administrator (or "handing over the keys" to the business to a company's lenders).

WHAT IS THE SAFE HARBOUR REGIME?

Broadly speaking, directors and officers have a duty to avoid incurring debts:

- while a company is insolvent; or

- which if incurred, would lead the company to become insolvent.

Personal liability for directors attaches to such debts incurred while there are (objective) reasonable grounds for suspecting that the company is insolvent.

Insolvent trading is a serious matter that can lead to personal liability for a director / officer as a result of breaches of directors duties, and a contravention of the Corporations Act.[1]

Safe harbour gives directors and officers a defence to insolvent trading liability, in respect of particular debts, if and only if:

- the company meets the *"eligibility criteria"* for safe harbour (i.e. it is: (1) meeting all of obligations to pay employee entitlements, including superannuation, as and when those entitlements become due and payable; and (2) meeting all of its tax filing obligations);
- the directors / officers start developing a plan or one or more courses of action that are reasonably likely to lead to a *"better outcome"* for the company than the immediate appointment of a voluntary administrator or liquidator; and
- debts are incurred directly or indirectly in furtherance of the courses of action referred to above (i.e. the debts are connected to the plan or courses of action referred to above).

When considering whether a plan or course of action is reasonably likely to lead to a *"better outcome"*, the directors / officers should consider whether:

- they are appropriately informing themselves of the company's financial position;
- they are taking appropriate steps to prevent misconduct by officers or employees of the company that could adversely affect the company's ability to pay all of its debts;
- they are taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company;
- they are taking appropriate advice from appropriately qualified financial and legal advisors; and
- they are developing or implementing a plan for restructuring the company to improve its financial position.[2]

It is worth noting here that directors / officers bear the onus of proving that they are entitled to safe harbour protection.[3]

WHAT COURSES OF ACTION CAN BE PURSUED?

This will depend on the specific matters putting pressure on a company's liquidity and financial health. Continued trading, operational or strategic change, refinancing of debt, raising capital and selling or divesting assets are all examples of potential courses of action that might be pursued by directors / officers through safe harbour protection.

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1 *Corporations Act 2001* (Cth) ("**Corporations Act**") s 588G.
2 Corporations Act s 588GA(2).
3 Corporations Act s 588GA(3).

The *"better outcome"* test is potentially easier to establish for directors / officers who are developing and implementing a broader plan to restructure the company to improve its financial position. In other words, a plan that has broader, strategic elements aimed at restructure or turnaround might be preferrable to a plan that only deals with acute issues in the company's operations and financials from an evidentiary perspective.[4]

WHAT DOES SAFE HARBOUR SOLVE FOR?

Safe harbour protects directors / officers from statutory liability for insolvent trading, giving them confidence to lead a company through a restructure or better prepare for a more orderly insolvency.

Importantly, safe harbour protection:

- Is not advice, or protection, that the company obtains. It is advice, or protection, that the directors of the company obtain (without which, the directors would be more likely to place a company into immediate voluntary administration or liquidation).
- Does not absolve directors and officers from their other statutory, common law and fiduciary duties (i.e. to act in the best interests of the company, in good faith and for proper purposes).
- Is considered on a company-by-company basis, and in the case of corporate groups needs to be developed and monitored with careful thought as to the impact on each member of that group.

Further, as a company moves from solvency towards potential insolvency, it becomes increasingly important for directors and officers to be mindful of their duties to creditors.[5] In closely-held, private companies, where shareholders usually also sit on the board / have nominee directors, the importance of being mindful of these duties cannot be overstated (regardless of any safe harbour protection). In the twilight of insolvency, such directors need to be especially mindful of acting properly and prioritising the interests of creditors (rather than acting in self-interest / for their own benefit as shareholders). It is likely that any failures to do so will be examined carefully by creditors and external administrators.[6]

KEY INSIGHTS

In light of the above, directors / officers and their advisors should consider the following when developing or implementing a safe harbour plan or courses of action:

- **Eligibility Criteria:** The *"eligibility criteria"* are critical. Even the best laid restructuring plans could be derailed by a failure to meet employee entitlements or keep tax filings up to date. The same should be said for closely reviewing and monitoring the company's risk management and reporting lines (incl. to monitor for fraud by officers and employees).
- **Measuring the Impact of a Course of Action:** In the abstract, most courses of action might appear to meet the *"better outcome"* test. However, directors / officer should be mindful that they bear the onus of proving that. Accordingly, directors / officers should consider whether

4 Corporations Act s 588GA(2)(e).
5 *Walker v Wimborne* (1976) 137 CLR 1. See also *BTI 2014 LLC v Sequana SA & Ors* [2022] UKSC 25.
6 *Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017* (Cth) (**Explanatory Memorandum**) at [1.36] – [1.38].

there is operational or financial evidence that can be used to support a course of action (i.e. whether or not the course of action has been budgeted or cash-flow modelled as an obvious example).

- **Continued Trading:** As set out above, continuing to trade as a going concern will almost certainly feature in a restructuring plan. It might even be characterised as a broad course of action to be pursued by the directors / officers. If cast in those broad terms, steps should be taken to ensure that each of its component parts meets the *"better outcome"* test (see *"Measuring the Impact of a Course of Action"*).
- **"Directly or Indirectly":** Directors / officers will only have safe harbour protection in respect of debts incurred that are directly or indirectly in connection with the course(s) of action that form part of the restructuring plan. If in doubt, the directors / officers should take advice. A safe harbour plan to trade the business in the ordinary cousrse and raise capital, for instance, would not automatically protect a new plan to sell a division unless that additional course of action was considered and adopted as a new *"course of action"* forming part of a revised plan.
- **Critical vs Less Critical Initiatives:** Even if a debt can be said to be incurred *"directly or indirectly"* in furtherance of an approved course of action, directors / officers still need to consider whether the course of action would be in the best interests of the company and its creditors (in the context of the *"better outcome"* test). For example, if a course of action involves an initiative that: (1) will have a low or uncertain impact on the company's financial improvement (for instance, launching a new product); but (2) will significantly increase the company's operating costs or debt load, the directors / officers might consider postponing such initiatives until the company is returned to financial health and focus on other more critical and certain restructuring initiatives.
- **Monitoring / Updating the Restructuring Plan:** In responding to situations of financial distress, directors / officers will need to respond to changing (daily, even hourly) pressures and events. Restructuring plans need to be as adaptable and dynamic as their surrounding circumstances. Directors / officers need to consider the frequency of their monitoring, planning and implementation meetings and whether a course(s) of action should be prioritised or de-prioritised as matters progress (and any decisions in respect of the same should be carefully considered, minuted and monitored for their effectiveness). In some circumstances, it may be necessary to review or revise a plan to respond to changing market conditions, challenges in implementing a current plan or *"black swan"* events.
- **Holding Company Liability:** Holding companies are also exposed to insolvent trading liability.[7] Safe harbour protection can be sought by holding companies, however, to be obtained, reasonable steps must be taken by the holding company to ensure that safe harbour protection applies in relation to each of the directors of the relevant subsidiary and the debts they incur.[8] This can be difficult in the case of large corporate groups, or where safe harbour advice is being sought or obtained on behalf of some but not all directors.

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[7] Corporations Act s 588V.
[8] Corporations Act s 588WA.

OTHER CONSIDERATIONS

By its very nature, a successful safe harbour plan that enables a company to avoid entering an insolvency process is unlikely to be publicly disclosed.[9]

There are a few points to note here:

- A director's reliance on the safe harbour regime, in and of itself, is not something the ASX typically require an entity to disclose under Listing Rule 3.1.[10]

  ASX Guidance Note 8 gives a useful summary (**emphasis added**):

  > *ASX has been asked whether the fact that the entity's directors are relying on the insolvent trading safe harbour in section s 588FA of the Corporations Act requires disclosure to the market. Section 588GA is a conditional carve-out from a director's potential liability for insolvency trading that does not affect an entity's continuous disclosure obligations or reduce the entity's obligation to disclose the extent of its financial difficulties.* ***The fact that an entity's directors are relying on the insolvent trading safe harbour to develop a course of action that may lead to a better outcome for the entity than an insolvent administration, in and of itself, is not something that ASX would generally require an entity to disclose under Listing Rule 3.1. most investors would expect directors of an entity in financial difficulty to be considering whether there is a better alternative or the entity and its stakeholders than an insolvent administration. The fact that they are doing so is not likely to require disclosure unless it ceases to be confidential or a definitive course of action has been determined.***

- The safe harbour regime does not detract from directors' statutory, common law and fiduciary duties in favour of the company and its stakeholders. Nor does it detract from directors' obligations to work with auditors in providing fair and true financial statements, to disclose any material uncertainties or to emphasise matters concerning the company's ability to trade as a going concern.
- If trade creditors learn that a company's directors have utilised the safe harbour regime, they may be less inclined to continue trading with the company. Consequently, a company that might have otherwise navigated through financial distress could find itself in a worse situation due to the disclosure of its directors' engagement with the safe harbour regime, potentially resulting in a less favourable outcome for both creditors and shareholders.
- In the absence of the safe harbour regime, directors of a financially distressed company that could potentially secure a "*better outcome*" for creditors and shareholders through restructuring and continued trading would be compelled to initiate a formal insolvency process, such as voluntary administration or liquidation, immediately. In other words, for safe harbour protection to apply, the plan or strategy implemented by the company's directors must be reasonably likely to result in a "*better outcome*" for the company's stakeholders, compared to the near-certain

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9 Review of the Insolvent Trading Safe Harbour Report (March 2022) at 7.3 (*"Success Stories"*).
10 ASX Listing Rules Guidance Note 8 (27 May 2024) at 43.

value destruction that would occur through voluntary administration or liquidation.

FURTHER GUIDANCE ON THE SAFE HARBOUR REGIME

In due course, we expect that case authorities involving safe harbour plans will arise (e.g. where eligibility criteria were not met or the likelihood of a *"better outcome"* was in dispute). However, as matters stand, there are no detailed case authorities involving an analysis of the safe harbour regime.

In the meantime, outside of their advisors, directors instead need to look to: (1) the *Corporations Act*; (2) the Explanatory Memorandum; (3) the Review of the Insolvent Trading Safe Harbour Report (March 2022); and (4) the Australian Securities & Investment Commission's Regulatory Guide 217, for guidance on how the safe harbour regime can and should be used.

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