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Directors' guide to avoiding personal liability in circumstances of a company's financial distress or possible insolvency

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Introduction

Since the onset of the COVID-19 pandemic in 2020 and more recently with heightened geopolitical tensions, there has been a series of disruptions to the global economy. Evidence of this can be seen in supply chain interruptions, changes in consumer behaviour, inflation and heightened business risk. As Australia's Prime Minister recently observed: *"We're dealing with a world that has never been more unstable since the time of the Second World War."*

In Australia, the administrations of Virgin Australia Airlines and more recently the Probuild construction business are high profile examples of these shocks and their adverse effects on otherwise stable businesses.

It is important that directors are fully aware of their duties and responsibilities, particularly if their business is experiencing cash flow shortages, financial distress, or possible insolvency.

Specifically, directors should be aware of their obligations to avoid insolvent trading, and the consequences of failure to do so.

Directors have ongoing directors' duties as well as statutory duties to avoid "creditor-defeating dispositions" and duties to avoid transactions which would have the effect of reducing recovery of employee entitlements.

This is a guide to assist directors navigate the troubled waters of director liability in the face of financial distress and insolvency.

Insolvent trading liability

A company director has an obligation to prevent insolvent trading under section 588G of the *Corporations Act 2001* (Cth).

Insolvent trading occurs if, when incurring debts:

- the company is or will become insolvent by incurring the debts; and
- there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent by incurring the debts.

A director will be liable for insolvent trading if the director was aware or suspected that the company was or would become insolvent when it incurred the debts or a reasonable person standing in the director's shoes would have been so aware.

A breach of the duty to avoid insolvent trading can lead to the director being liable for:

- A financial claim equal to the amount of the creditors' loss arising from the insolvent trading. This is recoverable as a debt due to the company or as a compensation order;
- Civil penalties including pecuniary penalty orders arising from proceedings brought by the Australian Investments and Securities Commission; and
- In appropriate cases, criminal actions.

When is a company insolvent?

A company is insolvent when it is unable to pay all of its debts, as and when they become due and payable. A company's solvency is determined by reference to all of the company's circumstances and the commercial realities surrounding it.

Often, a company's ability to meet debts will depend upon a line of credit or other funding to meet the company's liabilities when they become payable. It is important to note:

- Establishing solvency does not require that the company to be able pay all of its debts from its own resources. If, as a matter of commercial reality, the company has a resource available to pay all its debts as they become payable, such as a loan or a voluntary extension of credit by another party, it may be solvent.
- Unsecured borrowings, debts placed on deferred payment terms or the support of directors or shareholders by unsecured loans may assist a company's solvency. However, where borrowed funds are available for a very short term, or the funds are repayable on demand, this may not enhance solvency, as it merely substitutes one form of immediate (or near immediate) obligation for another.
- A contractual agreement to subordinate the debt of one unsecured creditor (such as a director's loan or related-party loan) to the debts of other secured creditors can assist in establishing solvency.

Avoiding insolvent trading liability

Appointment of administrators (section 436A of the Corporations Act)

Company directors have the power to appoint an
external administrator if they form the view that the company is insolvent, or is *"likely to become insolvent at some future time."*

Directors who are aware or suspect that the company is, or would become, insolvent by incurring debts can cause the company to appoint administrators to avoid liability.

While company directors often view such a step as a last resort, administration can provide an opportunity to restructure a business' liabilities, capital structure and in some cases equity structure for the benefit of the business.

In the current business environment, creditors, suppliers, landlords, shareholders, customers and other key stakeholders are likely to show a greater degree of flexibility towards, and acceptance of, an administration process than might usually be the case, providing greater opportunities for successful administration outcomes.

There is already much flexibility in the voluntary administration process with Courts having a quasi-legislative power under section 447A of the *Corporations Act* to "re-write" the voluntary administration provisions of the *Corporations Act*. There are many examples where this power has been used to assist the administration process and ultimately enhance the prospects for a successful restructuring of the businesses in question.

Safe harbour (section 588GA of the Corporations Act)

The *Corporations Act* contains a mechanism to exclude the operation of insolvent trading provisions. That mechanism, commonly referred to as a *safe harbour*, is particularly relevant to a business attempting to conduct transactions outside the ordinary course of its business as an attempt to restructure a business in financial distress.

The safe harbour will operate where a director *"at a particular time after he or she starts to suspect the company may become or be insolvent, starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company."*

A *"better outcome"* is defined as *"an outcome that is better for the company than the immediate appointment of an administrator, or liquidator, of the company."*

For an outcome to be better for the company than the immediate appointment of an administrator:

- It must, as a minimum, be an outcome which is superior to a liquidation outcome for all creditors. This requires consideration of the likely distribution to creditors in an immediate hypothetical winding up according to the order of priorities set out in the Corporations Act.
- To the extent that the outcome maximises the chances of the company, or its business, continuing in existence, this will be a factor which contributes to it being a better outcome.
- It may involve some reasonable speculation about the viability of a DOCA proposal, sale of the business or parts of the business or other aspects of how an administration might unfold – the process of administration means that there is inherent uncertainty as to its outcome. In certain situations, because of the creditor profile and the circumstances of the company's business, there may be greater predictability about a likely administration outcome than in other cases.
- It will protect the general body of creditors against a diminution of the company's assets by a transaction which confers an unfair or improper advantage on another party, in other words, it will exclude a transaction which would otherwise be a voidable transaction (in the hypothetical liquidation context).

Insofar as the *"better outcome"* must be *"reasonably likely"* the Explanatory Memorandum to the legislation enacting the safe harbour provisions explains that:

> *The phrase "reasonably likely" does not require a better than 50 per cent chance of a better outcome than the immediate appointment of an administrator or liquidator. "Reasonably likely" here requires that there is a chance of achieving a better outcome that is not fanciful or remote, but is "fair", "sufficient" or "worth noting".*

The safe harbour provisions give some guidance on what matters a director should consider when determining whether a course of action is reasonably likely to lead to a better outcome for the company, namely taking steps to:

- Properly inform him or herself of the company's financial position.
- Prevent any misconduct by the officers and employees of the company that could adversely affect the company's ability to pay all its debts.
- 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 which was given sufficient information to give appropriate advice.
- Develop or implement a plan for restructuring the company to improve its financial position.

The safe harbour provisions impose a time limit on the period during which a director can rely on the safe harbour protection. The protection starts from the point in time that the debt is incurred and will end on the earliest of:

- (if the course of action is not taken), a reasonable period after that time;
- when the company ceases to take the course of action;
- when the course of action ceases to be reasonably likely to lead to a better outcome; or
- when an administrator or liquidator is appointed to the company.

This requires the director to continually monitor the course of action proposed to be taken by the company to lead to a better outcome and continually assess and reassess whether the steps taken are reasonably likely lead to a better outcome.

For the safe harbour provisions to provide protection to a director of a company, the director must ensure that the company:

- pays all employee entitlements on or before the date when they are due to be paid; and
- gives all returns, notices, statements, applications or other documents as required by taxation laws within the meaning of the Income *Tax Assessment Act 1997* (Cth).

The Australian Government (Treasury) has recently completed a review of the insolvent trading safe harbour. The official report, *Review of the Insolvent Trading Safe Harbour Report, November 2021*, made a number of recommendations to further refine the legislative wording and operation of section 588GA and to facilitate further public guidance on the operation of the insolvent trading safe harbour. The Australian Government, in its official response, has accepted most of those recommendations. As at the date of this publication, no legislative proposals have been announced.

Defences (section 588H of the Corporations Act)

Aside from the safe harbour provisions a director will not be liable for insolvent trading if, at the time the debt was incurred:

- the director had reasonable grounds to expect that the company was solvent and would remain solvent even if the debt was incurred; or
- the director was relying on another person to provide information concerning the company's solvency and the director had reasonable grounds to believe that the person providing that information was competent, reliable and in a position to provide adequate and informed information.

Discretionary Relief (section 1318 of the Corporations Act)

The Corporations Act also gives the Court the power to excuse directors from liability for negligence, default, breach of trust or breach of duty.

If it appears to the Court that the person has acted honestly and that, having regard to all the circumstances of the case, the director ought fairly to be excused for the negligence, default or breach, the Court may relieve the person either wholly or partly from liability on such terms as the court thinks fit.

Such relief is not commonly granted by the Courts and should generally be considered as an option of last resort.

Interaction with directors' other duties

Because the safe harbour provisions only prevent the operation of the insolvent trading provisions, they will not prevent the operation of other provisions of the Corporations Act and directors' other duties under common law, which will continue to apply. This means that directors must comply with all their other legal obligations and in particular:

Director's duties

A director must:

- exercise the due degree of care and diligence (section 180 of the Corporations Act);
- act in good faith in the best interests of the company and for a proper purpose (section 181 of the Corporations Act);[1]
- avoid improper use of his or her position or information to gain an advantage for him- or herself or someone else or to cause detriment (sections 182 & 183 of the Corporations Act);[2] and
- provide a declaration as to solvency and that the company's financial statements comply with accounting standards and give a true and fair view of the company's financial position and performance (s344 of the Corporations Act).

In a situation of financial instability or near insolvency, these duties mean that a director must prevent the company from embarking on a course of action which an honest and intelligent person in the position of the directors of the company could not have reasonably believed was in the interests of the company, having in mind the interests of the company's creditors.

Duty to prevent the company entering into *"creditor-defeating dispositions"* (section 588GAB of the Corporations Act)

These are transactions which involve a disposal or transfer of company property:

- the consideration for which was less than either the market value of the property or the best price that was reasonably obtainable for the property, having regard to the circumstances existing at that time; and
- which has the effect of preventing, hindering, or significantly delaying, the process of making the property available for the benefit of the company's creditors in the winding-up of the company.

A director can be personally liable if:

- the company is insolvent at the time of the disposition, the disposition makes the company insolvent or the disposition directly or indirectly leads to the appointment of an external administrator within 12 months of the transaction taking place; and
- the director knows, or a reasonable person in the position of the director would know, that the disposition is a creditor-defeating disposition.

This duty became law in February 2020 with the enactment of the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* (Cth) which amended the Corporations Act to include this duty.

Under this legislation, the safe harbour provisions also apply to a director's duty to prevent the company entering into *"creditor-defeating dispositions."*

1 Section 184 imposes criminal liability where the breaches are reckless or dishonest.

2 Section 184 imposes criminal liability where the breaches are reckless or dishonest.

Duty to prevent the company entering into transactions likely to lead to employees being worse off in a liquidation scenario (Part 5.8A of the Corporations Act).

These are transactions which would have the effect of avoiding, preventing or significantly reducing the amount of the entitlements that employees of a company could recover if the company were to enter liquidation.

Directors can be liable for loss or damage for any transactions that led to employees being worse off in a liquidation scenario.

Directors are required to actively form a view that the transactions will enhance employee recoveries, or, at least, are not likely to have the effect of avoiding, preventing, or significantly reducing recovery of employee entitlements in all scenarios, and in particular a potential liquidation scenario.

Directors need to take particular care about employee liabilities that might crystallise in a liquidation context but which are not presently due and payable (for example, redundancy or long service leave entitlement).

This duty became law in April 2019 with the enactment of the *Corporations Amendment (Strengthening Protections for Employee Entitlements) Act 2019* (Cth).

There is no safe harbour from this obligation, so it is important that, if a company is in distress or facing possible insolvency, directors are actively monitoring employee entitlements and making decisions taking this duty into account. The *Review of the Insolvent Trading Safe Harbour Report, November 2021* recommended that there be a safe harbour from this obligation. However, the Australian Government's official response noted (rather than accepted) this recommendation, indicating it will undertake further consultation before considering whether to implement this recommendation.

Conclusion

As custodians of their businesses and to protect themselves from personal liability, directors should be taking pro-active steps to guide their companies through the troubled waters of financial distress and possible insolvency.

In particular, they should heed early warning signs and address them head-on when there remains time and breathing space to do so.

As provided for under the legislative safe harbour, directors should be seeking the advice of appropriately qualified advisers who can provide specialist and objective assistance in achieving better outcomes for a company's business.

Taking this approach, directors will often be able to lead their businesses to better outcomes for creditors, employees, shareholders and other key stake holders.

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