Australian Institute of Company Directors

BCA
Business Council of Australia

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Ms Genevieve Sexton
Panel Chair
Safe Harbour Review

via email: SafeHarbourReview@treasury.gov.au

Dear Chair

Joint AICD-BCA submission: Review of the Insolvent Trading Safe Harbour

Thank you for the opportunity to comment in response to the consultation paper **Review of the Insolvent Trading Safe Harbour** (the **Consultation Paper**).

The Australian Institute of Company Directors' (**AICD**) mission is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society. The AICD's membership of more than 47,000 reflects the diversity of Australia's director community, comprised of directors and leaders of not-for-profits (NFPs), large and small businesses and the government sector.

The Business Council of Australia (**BCA**) strives for a stronger Australia. Achieving this requires successful, well-run businesses that create meaningful jobs and inclusive work environments which reflect and are accountable to the broader Australian community. The Business Council actively collaborates with other business groups, political leaders at all levels of government and engages directly with the community to achieve our vision and purpose.

The AICD and BCA were supporters of the insolvency Safe Harbour reforms introduced in 2017 in section 555GA (the **Safe Harbour**) of the Corporations Act 2001 (Cth) (the **Corporations Act**) and continue to be. The AICD and BCA welcome the appointment of the Panel to review the Safe Harbour. The review is an important opportunity to comprehensively assess the effectiveness of the reforms and consider potential areas for improvement.

1. Executive Summary

Our strong view is that the Safe Harbour has been a successful insolvency policy reform that has driven changes in director behaviour to focus on restructuring businesses. This contrasts with directors being incentivised by threat of personal liability to place a business prematurely into administration. This has directly resulted in economic benefits through preserving employment, owner equity, providing greater returns to creditors and maintaining tax receipts. It has had broader economic benefits by helping to create a culture in which business preservation is encouraged and has enabled viable businesses to be saved which, without the option of Safe Harbour, would have been needlessly shut down.

The success of the Safe Harbour demonstrates the potential for further reform of Australia's insolvency laws and the benefits that can result from appropriately reducing the threat of personal liability faced by directors. Consistent with previously articulated policy positions of our organisations, we encourage the

Panel to consider whether lifting director insolvency liability settings to be in line with the United Kingdom would represent a further enhancement of Australia's insolvency laws.

We make the following observations about the operation of the Safe Harbour and COVID-19 insolvent trading moratorium:

- Based on engagement with directors and insolvency and restructuring experts by the AICD, our strong view is that the Safe Harbour has been effective in achieving its objectives. The Safe Harbour has promoted a culture of appropriate risk-taking by directors that has produced genuine benefits in restructuring businesses to the benefit of a wide range of stakeholders (including employees and creditors).

- It does not appear that the Safe Harbour is utilised in large numbers by directors of small and medium enterprises (**SMEs**). We believe that the Safe Harbour is fit for purpose for SMEs of a certain size and the current lack of access may be indicative of a lack of awareness and guidance on how to utilise the Safe Harbour amongst SME directors and their advisors. For very small businesses that do not meet the access conditions or have other characteristics that do not make the Safe Harbour suitable, the we encourage the Panel to consider whether other changes to insolvency law may be more appropriate to provide restructuring flexibility to these businesses.

- We caution against any amendments to the Safe Harbour provisions in the Corporations Act, when all indications are that it is working well. The greatest opportunity to resolve industry uncertainty around the provisions and to improve access is through comprehensive policy guidance from the Australian Securities and Investment Commission (**ASIC**) and potentially a joint awareness campaign between government and key industry bodies.

- The COVID-19 insolvent trading moratorium was effective, in conjunction with other Government assistance and lender support, in maintaining viable businesses that were temporarily threatened by virtue of the financial impact of COVID-19 public health measures. We consider the moratorium was a strong example of how lifting the threshold for director liability can result in tangible economic benefits.

The following sections broadly respond to each of the questions in the consultation paper with the exception of question 11, which is best addressed by practising Safe Harbour advisors.

2. Insolvency law reform

The AICD and the BCA have long considered that Australia's insolvency laws are a key area of potential microeconomic reform with the opportunity to promote economic growth and employment. In our view, the insolvency regime should encourage entrepreneurialism, maintain employment and enable directors to save businesses that are fundamentally viable in the long-term. Insolvency laws prior to the introduction of the Safe Harbour often had the effect of 'railroading' otherwise viable companies into administration because there were seemingly no other lawful options available to directors that did not expose them to personal liability.

The Safe Harbour was an important step forward in modernising Australia's insolvency regime and, as discussed below, has been effective in certain circumstances in enabling directors to work flexibly to turnaround businesses. However, we believe that insolvency law continues to remain unduly punitive and excessively focused on the interests of creditors to the detriment of other key stakeholders, including owners, employees and directors.

Previous government reviews have identified how the threat of personal liability on directors under Australia's insolvency regime incentivises them to put a business into a formal insolvency process earlier than may be necessary. The Productivity Commission in its 2015 report on Business Set-up, Transfer and Closure found:

> *These incentives have contributed to a culture of risk aversion amongst directors of large companies — that is, those for whom the threat of personal liability outweighs any potential benefits from attempting to continue the business.*[1]

We also understand that it is typical for directors and officers insurance policies to contain an insolvency-related exclusion, meaning that any liability risk must be personally borne.

We further note that the AICD has continually found from the annual Director Sentiment Index that directors observe a risk averse decision-making culture on Australian boards.[2] As discussed below, the Safe Harbour has made inroads to the 'lack of a restructuring culture in the Australian corporate world' that was identified by the Productivity Commission.[3]

The case for "wrongful trading" reform

Australia's insolvent trading rules remain among the strictest in the world, according to comparative analysis by law firm Allens Linklaters.[4] The analysis found that Australia's insolvent trading laws take a punitive approach through both the potential for criminal and civil liability, which is out of step with settings in the United Kingdom (**UK**), New Zealand, Hong Kong, Canada and the United States.

We encourage the Panel to consider whether increasing the threshold of the insolvent trading director duty to 'wrongful trading' in line with the United Kingdom warrants further analysis. Under the relevant provisions of the UK's *Insolvency Act 1986*, the threshold for director liability requires *actual knowledge or negligence* that there was no reasonable prospect of the company avoiding liquidation and they did not take steps to minimise losses to creditors. By contrast, section 588G of the Corporations Act is based on a lower threshold of needing to prove only that there was *reasonable suspicion* in the mind of the director that the company was insolvent.

A lifting of the threshold would support all organisations, including SMEs in recovering from the COVID-19 crisis and encourage innovation and appropriate risk-taking to ensure long-term economic prosperity. A higher threshold would not blunt any incentive on directors to restructure businesses but rather provide greater comfort that they could take measured risks and seek innovative solutions to viability challenges without the threat of personal liability. Additionally, increasing the threshold will reduce the costs that are associated with obtaining advice on restructuring and insolvency, including utilising the Safe Harbour.

The experience with the COVID-19 moratorium and the effectiveness of the Safe Harbour both indicate the potential that exists for further reform. Additionally, increasing the threshold will reduce the costs that are associated with obtaining advice on restructuring and insolvency, including utilising the Safe Harbour.

We would be happy to provide the Panel with further information on this policy proposal.

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[1] Productivity Commission, *Inquiry Report: Business Set-up, Transfer and Closure*, 30 September 2015, page 367.

[2] AICD Director Sentiment Index results – first half 2021, available here: https://aicd.companydirectors.com.au/advocacy/research/directors-upbeat-about-economic-outlook-as-sentiment-soars

[3] Ibid.

[4] The research is available here: https://aicd.companydirectors.com.au/advocacy/research/summary-of-legal-research-commissioned-by-the-aicd

3. Effectiveness of the Safe Harbour

This section responds to questions 1-4 and 6 of the consultation paper. The AICD has engaged with directors, restructuring experts and academics in forming a view on the effectiveness of the Safe Harbour.

As recognised by the consultation paper, the confidential nature of the use of Safe Harbour limits visibility on its use and effectiveness. However, the AICD's discussions with members and industry participants has revealed that the Safe Harbour has been a very effective insolvency policy reform. The Safe Harbour has provided flexibility to directors to successfully turnaround businesses and/or to provide a better outcome for creditors, employees and shareholders.

The discussions and examples provided to the AICD form a strong evidence base that the Safe Harbour is meeting its objectives to drive cultural change amongst directors to engage early with possible insolvency and take reasonable risks to facilitate the company's recovery, instead of simply placing it into voluntary administration. In our consultations with directors and advisers, we were told that the provision of Safe Harbour advice provided directors with "breathing space" to evaluate the various options facing a distressed business and seek out appropriate professional advice. The extra time not only afforded an opportunity to restructure businesses but provided a longer period of the business maintaining employment and meeting commitments with suppliers and customers than would have been the case under administration.

Examples provided to the AICD have demonstrated that the Safe Harbour is entirely consistent with an economic agenda that is seeking to promote entrepreneurism and employment. One indicative example was of a large agriculture business employing 200-300 people that was facing liquidity challenges. With the support from an experienced advisor, the directors received Safe Harbour advice and undertook a series of actions to maintain the business and sell it as a going concern. Crucially, the Safe Harbour was understood and supported by the main creditor, who provided further finance to complete the sale. Participants in this example are of the strong view that, absent Safe Harbour, the business would have been placed in voluntary administration, with significant loss of employment and shareholder equity, as well as poor returns to creditors.

Senior directors have noted that a key benefit of the Safe Harbour is that it empowers them to maintain control of the business and oversee the actions to address viability challenges. Importantly the Safe Harbour provides comfort to directors to make strategic decisions during the 'twilight of insolvency' where there is often significant uncertainty around the viability of the business and directors start to feel most exposed to the threat of personal liability. With appropriate advice and support, senior directors reported they were far more willing to take measured risks to turnaround businesses.

The AICD and BCA consider these positive outcomes as reflective of the benefits that can result when directors are freed from having only one effective option (voluntary administration) due the threat of personal liability.

Observations from directors with experience of the Safe Harbour include:

- it provides a form of comfort or protection that promotes director engagement with restructuring a business and limits the incentive to prematurely place it into administration;
- it often affords additional time or breathing space to reach a key hurdle or liquidity event, such as a sale of an asset or a capital raising;

- experienced expert advice is important, including in assisting with documenting compliance with ongoing obligations; and

- it is particularly useful for larger businesses that may be 'asset rich and cash poor', or are seeking to renegotiate with key suppliers or customers.

Any perception that the Safe Harbour provides an incentive or 'free kick' to directors to makes decisions that are reckless or lacking in due care and diligence is not supported by examples and practices shared with the AICD. The core director duties under sections 180-3 of the Corporations Act continue to apply to directors notwithstanding any Safe Harbour. In particular, case law confirms that directors are required to consider creditors in discharging their duty to act in the best interests of the corporation, in situations of potential insolvency. More generally, we are not aware of any instances of the Safe Harbour being misused by directors, businesses or advisors.

As discussed below, we do not consider there are shortcomings with the Safe Harbour that warrant amendments to section 555GA. Instead, the greatest opportunity to improve its impact would be through enhanced market education and guidance that would enable more businesses to avail themselves of it.

4. Small and medium enterprises

This section responds to question 10 of the consultation paper.

The complexity, rigidity and high barriers for use of Australia's insolvency regime for smaller businesses was recognised in the small business insolvency reforms introduced by the Government in 2020 via the *Corporations Amendment (Corporate Insolvency Reforms) Bill 2020* (**Small Business Restructuring reforms**).[5] The AICD supported these targeted reforms as a step forward, in addition to the Safe Harbour, in modernising Australia's insolvency laws.

While the Safe Harbour is currently being predominantly utilised by larger businesses, discussions with industry indicate that the regime is also fit-for-purpose for SMEs of a certain size. There are a number of advisory and turnaround firms that focus on providing assistance to SMEs and that it represents an important option for directors of these businesses in assessing how to address viability challenges. These advisors have reported positive results from utilising the Safe Harbour to restructure businesses with turnover greater than $5 million per annum. In general, smaller businesses do not appear to have utilised the Safe Harbour in material numbers.

Based on stakeholder feedback, we understand that limited access to date by directors of SMEs of all sizes is partially due to a lack of awareness of the Safe Harbour's existence and/or concern around the cost of receiving expert restructuring advice, rather than any structural problem with the mechanism.

The AICD considers there are a number of factors or characteristics of SMEs that may be holding back use of the Safe Harbour, including:

- limited SME director and business advisor awareness of the Safe Harbour and understanding of how to access it and meet the ongoing obligations;

- the SME has existing tax and/or employee entitlement liabilities or record keeping issues that means it is not eligible to access the Safe Harbour;

[5] Explanatory Memorandum - Corporations Amendment (Corporate Insolvency Reforms) Bill 2020, page 9.

- existing director personal liability associated with the SME, such as a mortgage over a residential property, limits the incentive associated with the Safe Harbour; and

- limited resources that make it challenging for the SME to afford appropriate advice on utilising the Safe Harbour and meeting the associated obligations.

The AICD and BCA do not consider that the Safe Harbour needs to be specifically amended to address the above factors that may be limiting access by SMEs. Rather, our view is that comprehensive education and guidance on the Safe Harbour, including practical policy guidance from ASIC, has the potential to improve understanding of the reform and take-up by SME directors and advisors. This is discussed further below.

For very small businesses there are likely to be characteristics of these businesses, such as existing director personal liability or limited turnover, that no amendments to the Safe Harbour will ever be able to resolve to improve access.

We encourage the Panel to consider whether amendments to the new Small Business Restructuring reforms that commenced at the start of 2021 may be a more appropriate avenue to provide very small businesses with greater flexibility in the insolvency regime. While the AICD was supportive of the 'debtor in possession' model adopted under the reforms, we did note that the draft legislation was complex and may not be accessible for many SMEs.[6] The reforms have only been in operation for 10 months, however the take-up to date has been very limited and academic research has noted the relative complexity of obligations.[7]

5. Areas for improvement

This section responds to questions 7-10 and 12-13 of the consultation paper.

Our view is that the Safe Harbour does not need significant amendment, and that key elements are working as intended. However, it is important to note that there has not yet been case law considering the bounds of the Safe Harbour, so there is a risk that any such judgment may limit the Safe Harbour's accessibility if the law is interpreted more narrowly than current industry practice.

Based on feedback to date, and the short timeframe that it has been in place, we would caution against significant amendments to the Safe Harbour. Further, there is no evidence that the Safe Harbour has been misused or that there has been minimal take-up, that would warrant amendment. As detailed below, we consider the greatest potential for improvement in access, utilisation and understanding of the Safe Harbour is through education and guidance.

Appropriately qualified entity provides flexibility

An area of considerable industry discussion is whether 'appropriately qualified entity' should be limited under subsection 588GA(2) to a particular cohort of industry professionals. Consistent with our submission on the Exposure Draft, the AICD remains of the view that limiting who may provide advice would unnecessarily harm the flexibility of the Safe Harbour and further increase barriers to access, particularly for SMEs.[8]

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[6] AICD submission, Insolvency reforms to support small business, 12 October 2020

[7] Harris, J., Symes, C. (2021), The chimera of restructuring reform: An opportunity missed for MSMEs in pt 5.3B, Australian Journal of Corporate Law, 36, 182-193.

[8] AICD submission, Inquiry into the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017, 12 July 2017.

A barrier for SMEs in utilising the Safe Harbour is the cost of advice. Prescribing who may provide advice to directors on Safe Harbour would likely increase costs through excluding individuals who are not a particular registered professional (e.g. liquidator) or a member of a particular industry body. We are of the view is that it should remain open for directors to use the advisor that is best suited to the size and complexity of the organisation. For SMEs, this may include a small business consultant, their accountant or an experienced lawyer.

Were the Panel to conclude that firmer parameters or guardrails around appropriately qualified entity are necessary, then this would be best achieved through ASIC guidance rather than legislation. The guidance would preserve flexibility, but importantly set clear expectations around who can provide Safe Harbour advice, such as being sufficiently independent and experienced in restructuring businesses.

Pre-conditions to access are important for Safe Harbour integrity

We support the maintenance of the taxation obligations and payment of employee entitlements as pre-conditions for accessing the Safe Harbour. These pre-conditions are important safeguards to prevent misuse of the regime and maintain its integrity for the benefit of all stakeholders.

An area that may warrant regulatory guidance is how an organisation is to interpret 'substantial compliance' with these pre-conditions under subsection 588GA(4). Advisors have shared with the AICD examples of clients making inadvertent errors in lodging tax statements or paying superannuation entitlements and uncertainty around whether this precludes access to the Safe Harbour. It does not appear to be the intent of the reform, as reflected in the Explanatory Memorandum, that minor, administrative non-compliance would preclude access.[9] .

Confidentiality is a key element of the Safe Harbour

We consider that the confidential nature of the Safe Harbour is a key element of the success of reform and does not warrant amendment.

We strongly support the existing ASX guidance note covering Safe Harbour and do not support any change to the current settings in respect of the confidential use of the Safe Harbour.[10] Disclosure would severely curtail the willingness of directors to access Safe Harbour and limit the ability of businesses to successfully negotiate with key suppliers and creditors ultimately limiting its effectiveness in successfully turning around businesses. Such a requirement would be particularly problematic, and potentially value destructive, for listed entities.

A register or some form of reporting requirement, even if is confidential, may serve to chill the use of the Safe Harbour by directors. Reporting would potentially reduce the flexibility associated with the regime and increase the administrative costs as directors and advisors sought to comply with reporting requirements for little to no benefit. Reporting would invariably have a degree of complexity, for instance determining when Safe Harbour is entered and exited, that would limit any hypothetical benefit that would come from visibility on use of the Safe Harbour. Directors would also be concerned about the reputational impact of being associated with the use of Safe Harbour, even on a confidential basis.

[9] Explanatory Memorandum - Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017, page 20.

[10] ASX Guidance Note 8 Continuous Disclosure: Listing Rules 3.1 – 3.1B

Uncertainty on application to NFP directors

The AICD has previously raised concerns with the Government about the uncertainty of the application of insolvency law reforms, including the Safe Harbour and the COVID moratorium, on the NFP sector.[11]

There is a patchwork of state and Commonwealth legislation that is relevant to governance of the NFP sector with application varying dependent on whether an NFP is an incorporated association under a state or territory or whether it is a company limited by guarantee and subject to the Corporations Act. In addition, the Australian Charities and Not-for-profits Commission (**ACNC**) has requirements via Governance Standard 5: Duties of Responsible Persons that place an obligation on a responsible person to not allow a charity to trade while insolvent.

The AICD has had feedback that it is unclear how the Safe Harbour applies to NFP directors due to differences in legislative regimes and ACNC requirements. The AICD considers this uncertainty could be resolved through joint guidance from the ACNC and ASIC making clear that, at least for entities incorporated under the Corporations Act, the Safe Harbour is a potential protection available to them.

Education and guidance can drive improved access and awareness

Experience so far demonstrates there is a significant gap in awareness and understanding of the Safe Harbour that is limiting its access and use by directors and advisors, especially in the SME sector.

Our view is that with greater awareness and support the Safe Harbour would be utilised by a broader range of organisations. Importantly any awareness campaign would be able to highlight the flexible, principles-based nature of the Safe Harbour and how it promotes directors retaining control of the organisation and proactively working to resolve financial challenges.

The AICD has released a director tool on use of the Safe Harbour and has published a series of articles from advisors on experience with the Safe Harbour.[12] Other industry participants have also published guides that provide useful information on the Safe Harbour. While the existing industry guidance is valuable, there is currently no guidance or information from ASIC on how organisations, directors and advisors are expected to meet the key Safe Harbour obligations. Such guidance would likely provide greater comfort to directors on the regulator's expectations, including approach to insolvent trading enforcement, while likely reducing the fees associated with professional advice (noting the latter would often cover what regulatory approach ASIC might take).

We consider that key areas for potential ASIC guidance include:

- what components or factors can be considered when assessing a 'better outcome', for example whether the preservation of employment or maintaining supply to key customers are relevant factors;
- approach to assessing the counterfactual(s) under the 'reasonably likely to lead to a better outcome' test, including clarifying how directors and advisors would be expected to interpret the guidance on 'reasonably likely' under paragraph 1.52 of the Explanatory Memorandum;

[11] AICD letter to Assistant Minister for Finance, Charities and Electoral Matters, COVID-19: Funding and regulatory support for not-for-profits (NFPs) and charities, 1 April 2020.

[12] AICD Director Tool available here: https://aicd.companydirectors.com.au/-/media/cd2/resources/director-resources/director-tools/pdf/06547-1-director-tools-insolvency-safe-harbour-a4-9pp-web.ashx

- expectations for documenting access to the Safe Harbour and meeting the obligations, including how frequently any documents should be updated;
- expectations for NFP directors in utilising the Safe Harbour and how it may interact with obligations on NFP directors under ACNC Governance Standard 5;
- parameters around what constitutes an 'appropriately qualified entity'; and
- meeting the pre-conditions on taxation obligations and employee entitlements.

We strongly encourage consultation with industry on developing guidance that will be fit for purpose and reflects existing best practice.

One potential model for an awareness or education campaign could be the Government working in conjunction with key industry bodies. The AICD would be pleased to work further with Treasury and ASIC on any campaigns to increase awareness and education on Safe Harbour amongst the director community.

6. COVID-19 insolvent trading moratorium

This section responds to question 5 of the consultation paper.

We strongly supported the Government's decision to provide insolvent trading relief to directors early in the COVID-19 crisis, as well as the decision to extend this relief until the end of the 2020 calendar year. An AICD member survey conducted in May 2020 indicated that the Government's relief had influenced 12% of respondents' decisions to trade through the pandemic, rising to 16% for SME directors.

Discussions with directors and stakeholders on this review have confirmed that the moratorium was effective, in conjunction with other Government assistance and lender support, in maintaining viable businesses that were temporarily threatened by virtue of COVID-19 public health measures.

We do not believe that a similar moratorium is currently necessary, notwithstanding ongoing economic and public health uncertainty. This position may need to change depending on how the nation recovers from the pandemic.

However, we are of the view the 2020 moratorium provides an informative case study of how the lifting of the threshold for director liability resulting from insolvent trading influenced director decision-making. Without the risk of personal liability, it appears that directors were more prepared to allow businesses to trade through a period of significant uncertainty and to take specific actions to support the financial viability of the business, such as capital raisings.

The success of the COVID moratorium is an important example of how greater flexibility in respect of director liability under Australia's insolvency laws can drive appropriate risk-taking with real-world benefits for business survival and employment.

Next steps

We hope our submission will be of assistance with this important consultation.

We would be pleased to facilitate access to the BCA's and AICD's network of directors, advisory committees and experts on governance and boardroom practice to reflect on the effectiveness of the Safe Harbour. This might include, for example, facilitating targeted roundtables between Treasury and/or ASIC and directors and insolvency advisors to discuss options for guidance and education opportunities.

If you would like to discuss any aspects further, please contact Christian Gergis (christian.gergis@aicd.com.au) and Ben Davies (ben.davies@bca.com.au).

Yours sincerely,

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