Insolvent trading: A safe harbour for reorganisation attempts outside of external administration

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Consultation process

Request for feedback and comments

The Government is seeking your feedback and comments on the options outlined in this paper, particularly any information about compliance costs, impacts on competition, existing business activities and any other impacts, costs and benefits. We also seek your advice on any potential unexpected consequences of these proposed changes.

The information will inform the Government's proposed approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 2 March 2010

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FOREWORD

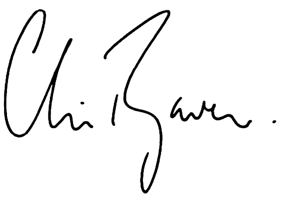
I am pleased to release this discussion paper outlining possible options for reform to the laws in relation to business rescue outside of external administration.

Australia possesses a modern, robust and efficient corporate reorganisation regime in the form of its voluntary administration procedures. However, placing a company into voluntary administration may not always represent the most appropriate method to effect a corporate rescue. Informal work-outs play an important role in preserving a troubled business and protecting the interests of its creditors, shareholders, employees.

Concerns have been raised that the laws directed at preventing businesses from trading while insolvent may negatively impact on genuine work-out attempts; in particular, where restrictions on the availability of credit impede the ability of businesses to temporarily maintain solvency while work-outs are attempted.

This discussion paper provides an overview of the current insolvent trading laws including the existing defences and relief provisions; the options available to companies facing insolvency; and the advantages and disadvantages of informal work-out attempts. The paper canvasses three possible options for reform: maintain the status quo; adopt a modified business judgement rule in respect of a director's duty to avoid insolvent trading; or adopt a mechanism for invoking a moratorium from the insolvent trading prohibition while work-outs are attempted.

The development of good law is dependent upon the active participation of interested stakeholders. I look forward to receiving your views on this important issue.



The Hon Chris Bowen MP
Minister for Human Services
Minister for Financial Services, Superannuation and Corporate Law

SUMMARY OF OPTIONS

Option 1: Status quo

There would be no change to the current law. Directors need to ensure that their company is solvent whilst attempting to reorganise outside of external administration.

Option 2: Modified business judgement rule

A director's duty not to trade whilst insolvent would be considered to be satisfied if, in addition to the requirements in the business judgement rule in section 180 of the *Corporations Act 2001*:

- the financial accounts and records of the company presented a true and fair picture of the company's financial circumstances;
- the director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remained solvent or that it was returned to a state of solvency within a reasonable period of time;
- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as of members, were best served by pursuing restructuring; and
- the restructuring was diligently pursued by the director.

Option 3: Moratorium

Directors would be able to openly and expressly invoke a moratorium from the duty not to trade whilst insolvent for the purpose of attempting a reorganisation of the company outside of external administration. The moratorium would apply for a limited period and would be subject to termination by creditors.

1 INTRODUCTION

1.1 Australia's corporate law has many features that aim to encourage company directors to conduct their business responsibly. Directors are subject to a number of common law and statutory duties that apply to all aspects of a company's business. They must act honestly, in good faith, and to the best of their ability, in the interests of the company. Directors are also subject to a duty to prevent insolvent trading by their company. Under Australian law, directors may incur civil or criminally liability if they permit their company to trade whilst insolvent.

1.2 The consequences of insolvency can affect many parties such as creditors, employees, taxation authorities, shareholders and customers. Insolvency law attempts to balance the interests of these diverse groups by protecting the interests of those transacting with companies in financial distress. Insolvency law also facilitates economic activity more generally by providing a deterrent to irresponsible risk taking by directors and contributing to reducing perceptions of counter-party risk in the economy.

1.3 Various concerns about the operation of Australia's insolvent trading laws have been raised in recent years by industry participants and stakeholder groups. In 2007, the previous government sought views on the introduction of a 'general defence' in the *Corporations Act 2001* to alleviate concerns that some corporate law sanctions were adversely affecting directors' willingness to engage in responsible risk taking. The 2007 paper, *Review of Sanctions in Corporate Law*, canvasses a general protection for directors which would relieve them of liability for decisions made where they acted: in a bona fide manner; within the scope of the corporation's business; reasonably and incidentally to the corporation's business; and for the corporation's benefit.

1.4 The 2007 paper sought to address the question of whether the introduction of a general defence would improve the balance between discouraging undesirable conduct and promoting responsible risk taking. The paper noted that the issue of applying a general defence to the duty to prevent insolvent trading needs to be considered in light of the possible unwillingness of directors to make business decisions as their company approaches insolvency. The paper also noted the contrary view that the early transfer of control of a company to an external administrator may best protect the interests of creditors in these circumstances.

1.5 In the wake of the global financial crisis (GFC) some commentators have argued that there have been significant negative impacts on the availability of credit, leading to both an increase in reorganisation attempts and increased difficulties for companies in maintaining solvency on a short-term basis while an informal work-out outside of external administration 'work-out' is attempted. It may be that the reduction in credit availability has precluded some companies from attempting a work-out at all when faced with the personal liability of directors for insolvent trading.

1.6 These impacts may be responsible for a shift post-GFC in stakeholder focus away from arguments for the application of a broad general defence for insolvent trading, toward exploring a solution to how the law impacts on informal work-outs outside of external administration. Concerns appear to now be more targeted to circumstances where the company is unable to maintain solvency while a work-out is attempted, particularly where the business is a large enterprise and/or a public company.

1.7 There are options open to a financially distressed company to avoid trading whilst insolvent.[1] Where a company is unable to avail itself of these options, directors are able to voluntarily place the company into external administration. External administration may take the form of a voluntary creditors' liquidation, under which the company may be wound up; or a voluntary administration, under which an attempt can be made to enter into an arrangement with the company's creditors.

1.8 Voluntary administration provides an efficient, non-court based, procedure to enable a company to come to a binding arrangement with its unsecured creditors. However, placing a company into external administration may not always be the most appropriate method to affect a business rescue or to otherwise realise value for the benefit of the company's creditors and members. Such objectives may more appropriately be effected through a work-out.

1.9 The purpose of this paper is to seek the views of stakeholders on issues that arise for companies and directors from the operation of the insolvent trading laws, in the context of attempts at business rescue outside of external administration.

1.10 There are pros and cons to any reform in this area and a careful analysis of the impact of any change to the law needs to be considered in the context of the impact on all stakeholders, not just a company and its directors. There are significant policy considerations for the rule against insolvent trading, including encouraging directors to be aware of their company's financial situation and improving the position of creditors by imposing post-liability debts on directors who are in breach of the law.

1.11 The paper examines the current law applying to directors including defences which directors may rely on to avoid liability and statutory mechanisms which can, at the discretion of the Court, excuse a director from the civil consequences of a breach. The impact of insolvent trading is considered from the perspective of a business and creditors, who in the absence of any significant deterrent can be severely disadvantaged from continued trading when a company is in danger of failing.

1.12 An individual company's response to current or imminent insolvency depends on a range of factors such as the severity of its illiquidity; the ability or willingness of creditors to delay or suspend payment of their claims; the effect on the company's assets of continuing to trade; and the sanctions which can result from a breach of the law. The paper discusses the advantages and disadvantages of work-outs outside external administration and presents two alternatives to the option of preserving the law as it currently applies. These options — a business judgement rule for insolvent trading or a moratorium on insolvent trading — would effectively provide a safe harbour for director of companies attempting a work-out outside of external administration.

1.13 The Government has not reached a position on the options or any of the issues raised in this paper, but will consider them in light of the submissions received.

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1 See below at Chapter 4.1.

2 AUSTRALIA'S INSOLVENT TRADING LAWS

2.1 WHAT IS INSOLVENCY?

2.1.1 Section 95A of the Corporations Act defines a person as 'insolvent' if they are 'not solvent'. A person is defined as solvent if they are able to pay all of their debts as and when they become due; that is, cash flow solvency, as opposed to balance sheet solvency.

2.1.2 In assessing the solvency of the company, the Court will not just look at the company's immediate cash resources but also at the company's ability to raise funds by realising its assets, borrowing or otherwise obtaining funds from third parties. Solvency is a question of fact to be decided as a matter of commercial reality in the light of all the circumstances. A mere temporary lack of liquidity does not amount to insolvency.[2]

2.1.3 ASIC's *Information Sheet 42: Insolvency: A Guide for Directors* sets out a range of indicia of corporate insolvency[3], such as creditors being paid outside usual terms; receipt of solicitors' letters, demands, summonses, judgments or warrants; or suppliers placing the company on cash-on-delivery terms.

2.1.4 Section 588E of the Corporations Act provides certain rebuttable presumptions in respect of a company's solvency, most notably where a company has failed to keep or retain financial records in relation to a period as required by section 286 of the Corporations Act.

2.2 LIABILITY OF DIRECTORS

2.2.1 A company director may be liable under Australia's insolvent trading provisions if:

- they are a director of a company at the time when the company incurs a debt;
- the company is insolvent at that time, or becomes insolvent by incurring that debt; and
- at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent.[4]

2.2.2 It should be noted that the duty to prevent insolvent trading is not a duty to prevent 'trading' per se. It is a duty not to incur debts when a company is insolvent.

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2 *Hymix Concrete Pty Limited v Garrity* (1977) 13 ALR 321.
3 http://www.asic.gov.au/insolvencyinfosheets.
4 Section 588G of the *Corporations Act 2001*.

2.2.3 For the purposes of the insolvent trading provisions, 'director' possesses its ordinary meaning under the Corporations Act, which includes both a shadow and a de facto director.[5]

2.2.4 There are various policy justifications for the rule against insolvent trading:[6]

- it encourages directors to be aware of their company's financial situation;
- it encourages directors to attempt to prevent the company continuing to trade if there are grounds for suspecting it is insolvent, for example, by relinquishing control so that the company's creditors can determine its future; and
- it improves the position of an insolvent company's creditors by imposing liability for post-insolvency debts on directors who breach their duty.
- It also provides an incentive for management to obtain competent professional advice when financial difficulties loom.

2.2.5 A director has several defences against liability if they can establish that they had reasonable grounds to expect that the company was solvent.[7] These defences are aimed at assisting directors who have acted diligently and actively participated in the management of the company, but have not been able to prevent incurring the debt. The defences are:

- *reasonable grounds to expect solvency*: use of the word 'expect' implies a measure of confidence that the company is solvent. A director must have reasonable grounds for regarding it as likely that the company would have been able to pay its debts when they fell due[8];
- *delegations and reliance on others*: a director must have had reasonable grounds to believe, and must have believed, that a competent and reliable person was responsible for providing them with information about the company's solvency, that the person was fulfilling their responsibility, and that the director expected on the basis of the information provided that the company was solvent and would remain so if the debt was incurred[9];
- *absence from management*: a director did not participate in the management of the company at the time the debt was incurred because of illness or some other good reason. A director will not have a good reason for being absent from management merely by not participating in the company's business[10]; and
- *all reasonable steps to prevent debt being incurred*: this may require unequivocal actions on the part of directors to exercise the powers and functions they possess

5 Section 9 of the *Corporations Act 2001*, definition of 'director'.
6 Austin et al. Company Directors — Principles of Law and Corporate Governance (2005) 408; Langford, R 'The New Statutory Business Rule: Should it Apply to the Duty to Prevent Insolvent Trading?' (1999) 16 CSLJ 533.
7 Subsection 588H(2) of the *Corporations Act 2001*.
8 *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.
9 ibid.
10 *Tourprint International Pty Ltd v Bott* (1999) 17 ACLC 1543.

to prevent the incurring of the debt directly or bring the matter to the attention of an officer or the board of directors.[11]

2.2.6 It is not a defence that the director was of the opinion that it was in the interests of the company or creditors that the company should trade whilst insolvent. However, this may be a relevant consideration taken into account by a Court when determining whether the director should be relieved from the civil consequences of a breach of the duty (see paragraphs 2.3.1 to 2.3.7).

2.2.7 The insolvent trading provisions are civil penalty provisions. In respect of a breach, the Court may order a director to pay a pecuniary penalty of up to $200,000, disqualify the director from managing companies, and/or order the director to pay compensation.[12]

2.2.8 Criminal liability may arise if it can also be established that the directors actually suspected at the time when the company incurred the debt that the company was insolvent or would become insolvent as a result of incurring that debt; and the director's failure to prevent the company incurring the debt was dishonest.[13] All elements of the breach must be established beyond reasonable doubt. A director can be liable to a maximum penalty of $220,000 or five years imprisonment, or both.

2.3 RELIEF FROM LIABILITY

2.3.1 Directors may potentially knowingly engage in insolvent trading and yet avoid civil liability. Sections 1317S and 1318 of the Corporations Act provide that, if a director has acted honestly and having regard to all the circumstances of the case ought fairly to be excused for a breach of a duty; the Court may relieve the person either wholly or partly from civil liability. This provision applies to civil breaches of the insolvent trading laws only and does not extend to criminal breaches.

2.3.2 These provisions do not strictly provide 'defences' to insolvent trading laws. For example, they do not appear to prevent a Court from making a finding that there was a breach, but instead empower the Court to relieve an officer of the civil consequences of a breach.[14] Although the Court may relieve an officer of the civil consequences of a breach, officers are still exposed to the reputational damage of such a finding.

2.3.3 Under these provisions, the onus is placed upon a director to apply to the Court for relief, and to establish that relief should be granted. The circumstances in which relief might be granted are uncertain. The provisions contain no criteria to be used by the Court in determining whether to exercise its discretion. Company officers are therefore reliant on case law in determining the extent to which the provisions may

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11 Lipton, P and Herzberg, A Understanding Company Law, Lawbook Co 2004 at page 370.
12 Part 9.4B of the *Corporations Act 2001*; see in particular, paragraph 1317E(1)(e) and sections 1317G and 1317H; for disqualification see Part 2D.6, in particular section 206C.
13 Subsections 588G(3)–(3B) of the *Corporations Act 2001*.
14 It should be noted that it has not been definitively settled whether the sections might operate to allow a Court to avoid making a declaration of a civil breach. See *ASIC v Plymin* (No 2) [2003] VSC 230 Mandie J at paragraph 7.

provide protection — and there is little case law in respect of the operation of the provisions in respect of insolvent trading.

2.3.4 The leading authority is the case of *Hall v Poolman*[15], where the Court held that:

> [I]n some cases, it is not commercially sensible to summon the administrators or to abandon a substantial trading enterprise to the liquidators as soon as any liquidity shortage occurs. In some cases a reasonable time must be allowed to a director to assess whether the company's difficulty is temporary and remediable or endemic and fatal.

2.3.5 In this case, the Court held that it was reasonable for the director to continue trading while he sought to determine whether the company could resolve a dispute with their main creditor, which would then have enabled an asset sale program and a restructuring to restore solvency. It is unclear from the judgment whether the company was attempting to reorganise its affairs during that time, or whether it was merely seeking to determine whether such a reorganisation would be possible.

2.3.6 The Court relieved the director of any possible civil liability in respect of insolvent trading taking place over a period of approximately five months — until it became clear that the problems of the company could not be resolved and solvency restored within a reasonable time. In doing so, the Court noted that the director sought and considered the advice of highly competent professionals; formed a view and exercised his commercial judgement as to the prospects of being able to resolve its dispute with a major creditor in time to restore solvency to the group; and although the director's commercial judgement proved erroneous, it was not made recklessly.

2.3.7 In some respects the Court's references to 'commercial judgement' based upon expert advice, and to the importance of the prospect of resolution of insolvency within a reasonable period, parallel some elements of the proposed modified business judgement rule discussed in Chapter 5.3 of this paper. Unlike that proposal, the relief provisions merely take these factors into consideration as part of the totality of the circumstances in which debts were incurred by an insolvent company, before the Court determines whether to grant a discretionary remedy.

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15 [2007] NSWSC 694.

3 THE EFFECTS OF INSOLVENT TRADING

3.1 Australia's insolvent trading laws are directed at protecting the interests of those transacting with companies in financial distress; and promoting economic activity generally. It has also been argued that the insolvent trading laws perform a valuable public function in contributing to maintaining and fostering ethical commercial behaviour and standards.

3.2 The non-transitory insolvency of a debtor — an inability of the debtor to pay its debts as they become due — is a strong indicator that a debtor will be unable to repay any fresh debts that it may incur. Insolvency is therefore an indicator that any persons entering into transactions that involve the provision of credit to the debtor may be exposing themselves to a markedly increased risk of loss.

3.3 Insolvent trading may also adversely affect existing stakeholders by contributing to a diminution of the assets available for distribution. Even where insolvent trading does not result in a loss of company value, it may have the effect of transferring losses from a company's existing shareholders and creditors, to new creditors arising from the company's continued trading.

3.4 In the absence of any real deterrent, directors, who owe very limited duties to creditors, can engage in activities that may benefit shareholders while disadvantaging existing creditors and those transacting with the company.

3.5 Where a company is in danger of failing, there may be an incentive for management to engage in behaviour that, while in the interests of shareholders, creates an unacceptably disproportional level of risk of loss to creditors. There may be no downside for shareholders associated with these actions as their shares may have no real value (or if there is some residual shareholder value, the potential downside may be very small), however, they will benefit from any success. A company may therefore undertake high-risk rescue attempts, or may attempt to maintain trading merely in the hope of an unlikely turnaround in conditions or some fortuitous event. The insolvent trading laws act to deter companies from such behaviour.

3.6 Other undesirable corporate conduct may involve insolvent trading. For example, the Cole Royal Commission into the Building and Construction Industry[16] concluded that 'phoenix' company behaviour in the building and construction industry was often associated with insolvent trading. As phoenix company behaviour involves the transfer of assets out of a company instead of applying them toward the payment of the company's liabilities, it commonly involves the company, at some point, carrying on business without the capacity to meet its liabilities as they become due. The laws against insolvent trading are therefore an important tool in addressing phoenix company behaviour.

16 Volume 8 Reform — National Issues Part 2, page 161.

3.7 On 14 November 2009 the Assistant Treasurer, Senator the Hon Nick Sherry, announced the release of a proposals paper canvassing options to address fraudulent phoenix activity.[17] Reference is made in that paper to the relevance of insolvent trading laws in combating phoenix company behaviour.

3.8 There are unresolved arguments as to whether the insolvent trading prohibition has a negative impact on setting a responsible level of risk taking by market participants. It has been argued that the prohibition on insolvent trading promotes prudent behaviour when a company is in financial difficulties. However, it has also been argued that the prohibition on insolvent trading may have a broad negative effect on economic activity by reducing the willingness of directors to engage in entrepreneurial activity. In addition to the possibility of detrimental risk avoidance, imposition of directorial liability may contribute to increased demands for compensation by company officers in exchange for bearing risk.

3.9 Factors that adversely affect perceptions of credit risk within the market have the potential to also adversely affect levels of economic activity and employment. The prohibition on insolvent trading provides an assurance to those transacting with any company that the company is solvent and can meet the obligations it is incurring. A decrease in the general level of confidence that other market participants are solvent may lead to negative impacts on the perception of counter-party risk; the willingness to provide credit (through lending or providing goods and services on credit); the cost of credit; and the conditions upon which credit is provided.

3.10 There are significant obstacles and costs for creditors in making independent arrangements to protect or compensate themselves from the risk of a company trading while insolvent. Insolvent trading laws may, therefore, contribute to reducing transaction and monitoring costs. Even where self-protection measures are feasible, disparities in bargaining power may prevent some creditors from obtaining effective protection or fair bargaining outcomes.

3.11 The imposition of liability upon directors for breaches of their duties is partially aimed at minimising agency costs. It has been argued that insolvent trading laws encourage directors to proactively monitor and address their company's financial situation. In particular, it provides an incentive for directors to obtain competent professional advice when financial difficulties are looming for the company.

3.12 It has been asserted that the insolvent trading laws may have the effect of aiding in business rescue by inducing directors to place companies into external administration while there is still a possibility to reorganise and rescue the company (or at least its business). However, concerns have also been raised in respect of the insolvent trading laws' effects on work-outs. It has been asserted by some stakeholders that the laws may cause companies to be placed into external administration prematurely or in circumstances where external administration is not appropriate, by directors who fear personal liability if the company engages in insolvent trading while attempting some sort of informal work-out.

17 Available at: http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1647.

4 THE INSOLVENCY OF A COMPANY

4.1 RESPONDING TO INSOLVENCY

4.1.1 It is legally permissible for a company to continue to trade when insolvency is only transitory[18]. In light of their duty not to trade whilst insolvent, directors must seek to appropriately address any non-transitory insolvency by their companies. Companies may be able to address current or imminent insolvency in a number of ways.

Agreement of creditors

4.1.2 They may obtain the agreement of the current creditors of the company to delay or suspend payment of their claims. Agreement is required from sufficient creditors to enable the company to meet any claims against it as they become due. This option is dependent on the agreement of outside parties. There may be a large number of creditors whose agreement may need to be obtained, presenting a range of practical difficulties, costs and timing issues. Notwithstanding that the company might obtain agreement from most of its creditors, disagreement with a few creditors can obstruct attempts to avoid insolvency by this approach. This option is likely to be a more viable alternative where a large portion of the company's debts are owed to a few creditors, such as to the company's banking syndicate.

Debt or equity funding

4.1.3 A company may obtain fresh debt or equity funding to restore solvency. This ordinarily involves the state of the company being disclosed to the prospective funder who will then choose whether to lend to or invest in the insolvent (or imminently insolvent) entity. The new funder will generally seek a higher price for their funds to compensate them for the risk involved and may impose onerous conditions to secure repayment. A company may obtain fresh credit from existing creditors, either in the form of further goods or services on credit or as further funding advances.

4.1.4 The 'credit crunch' associated with the GFC presented a significant obstacle to companies seeking to obtain forbearance by creditors or fresh sources of funding to address liquidity problems. It is noted that while restrictions on credit have eased significantly[19], abnormal difficulties can remain in obtaining funding.

4.1.5 Under the above options, the requirement for some kind of agreement between the company and external parties provides an opportunity for the parties to negotiate appropriate allocations of risk. Generally, they involve persons who would benefit from the survival of the company choosing whether to bear the risk of funding the

18 See above at Chapter 2.1 in relation to the definition of 'insolvency'.
19 See http://www.bloomberg.com/apps/cbuilder?ticker1=.TEDSP%3AIND for a chart depicting historical TED spreads — a commonly used indicator of perceived credit risk in the general economy.

company in exchange for some benefit. Persons with existing exposure to the risk of a company's failure may choose to fund the company's activities in an attempt to mitigate that exposure. Persons without existing exposure may factor in the risk that they are adopted in determining the pricing of any funding they provide.

Other options

4.1.6 If an outside party is unwilling to provide assistance (ordinarily after conducting an assessment of the risk involved), some options still remain open to the company.

4.1.7 The company may stop incurring credit during the period of insolvency. Depending upon the severity of its illiquidity and the nature of its business, a company may not be able to avail itself of this option.

4.1.8 If the company is unable to obtain funding, the company may avoid trading whilst insolvent by the directors placing it into external administration. This may take the form of a voluntary winding up[20] or a voluntary administration[21]. Under the latter procedure, attempts are made to reorganise the company and establish some kind of arrangement between the company and its creditors to allow the company to continue trading.

4.1.9 It is not open to a company to respond to insolvency by continuing to trade whilst insolvent. While doing so is not a criminal offence in the absence of dishonesty; and a director may in some circumstances be relieved by the Court of the civil consequences of a breach, directors are still subject to a duty under the Corporations Act not to trade whilst insolvent.

4.1.10 Any concerns in respect of the effect of insolvent trading laws on work-outs may be considered in light of existing options to address insolvency to enable work-outs to occur. In particular, these concerns may be considered in light of whether the promotion of work-outs is appropriate in relation to companies which are unwilling or whose state is such that they are unable to avail themselves of existing non-external administration options to avoid insolvent trading.

4.2 Work-outs outside of external administration

4.2.1 Companies facing financial difficulties commonly seek to reorganise their affairs without recourse to the formal reorganisation procedures provided for in the Corporations Act. Generally, it is only in the most severe circumstances that directors will place a company into voluntary administration or, very rarely, seek to enter into a scheme of arrangement.

4.2.2 The insolvent trading laws can be seen as defining the point at which a company must seek to reorganise under external administration as opposed to under a work-out.

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20 Part 5.5 of the *Corporations Act 2001.*
21 Part 5.6 of the *Corporations Act 2001.*

4.2.3 If a company is insolvent and directors are unable to convince a sufficient number of its creditors to suspend or delay their claims against the company or to obtain funding to return the company to solvency whilst a work-out is attempted, then directors are generally forced to place the company into external administration in order to avoid liability for insolvent trading.

4.3 Advantages of a work-out

4.3.1 There are a number of advantages for debtors and significant creditors in pursuing a work-out solution, as opposed to formal external administration.

Retaining control and maintaining value

4.3.2 Generally, the existing management retains control of the enterprise. Although an external administrator may sometime engage previous management to aid in the management of a company under administration, retaining existing management in direct control may provide an efficient means of utilising their knowledge and skills.

4.3.3 Continuing the operations of the company in a 'business as usual' manner may be an effective way to preserve value. External administration may have a significant adverse effect on the value of a company.

4.3.4 The effects of external administration on a company's value are most pronounced where a company has high levels of intangible assets (for example, by causing goodwill to evaporate); and where market confidence in the enterprises' operations is necessary and persons transacting with the business are sensitive to counter-party risk (for example, finance companies).

4.3.5 External administration may result in a more pronounced loss of customers due to greater perceptions of uncertainty as to the company's future; in particular, for companies which provide goods in respect of which consumers place a high value on warranties or ongoing product servicing and support.

4.3.6 An informal work-out will avoid any possible termination, variation, and penalty clauses in contracts that might be triggered by the company entering external administration ('ipso facto' clauses). The circumstances in which such provisions are triggered depend upon the terms of the relevant contract. Contracts may provide for triggers for termination, variation or penalties in relation to events associated with reorganisation attempts other than external administrations. Any changes to the law to allow insolvent trading for work-outs may result in the standard terms of contracts being redrawn to refer to triggers associated with that process.

Cost effectiveness and flexibility

4.3.7 Work-outs may be less costly as they do not involve the appointment of an insolvency practitioner as an external administrator; and the law does not set out formal processes that need to be complied with for a work-out to occur. Generally, agreements are also negotiated only between key stakeholders, avoiding much of the costs associated with informing and dealing with all of the companies' creditors. However, an informal work-out is not necessarily less costly, as expert advice is still commonly required and the lack of a formal structure for the process may result in additional costs being incurred.

4.3.8 There is a high degree of flexibility in the rehabilitation solutions that may be achieved through informal work-outs; however, this is also the case with Deeds of Company Arrangement or Schemes of Arrangement.

4.3.9 It is sometimes suggested that perceptions of a ‘fire sale’ may sometimes be avoided, enabling realisation of assets or entry into other arrangements on more favourable terms. However, at least in respect of companies subject to continuous disclosure obligations, where the extent of a company’s financial difficulties should be disclosed to the market, it is questionable whether this is the case.

4.4 Disadvantages of a work-out

4.4.1 There are a number of disadvantages in pursuing informal work-out solutions.

Risk of director liability

4.4.2 The insolvent trading provisions continue to apply during any work-out attempt, exposing directors to the risk of personal liability for those cases where directors are unable to maintain solvency during the work-out period. It is unclear how commonly companies are in the situation where this is not possible but where there is still a reasonable prospect of a successful work-out occurring.

Transparency and accountability

4.4.3 There are no stays on enforcement by creditors during a work-out, increasing the risk that enforcement actions against a company’s assets will obstruct collective procedures that maximise value and that funds will not be distributed amongst creditors in a fair and proportional way.

4.4.4 There is a lack of transparency and accountability due to the absence of a mandated disclosure and supervisory regime, such as that which applies in respect of external administration. This can give rise to the risk of misconduct, or result in arrangements that, while they fall short of misconduct, may unfairly advantage influential stakeholders. Even in the absence of actual misconduct or unfair arrangements, a lack of transparency and accountability can still diminish market confidence.

4.4.5 Professionals that conduct informal work-outs are not required to be licensed and are not subject to supervision by a government regulator. These practitioners also have no power, or duty, to act independently from the company’s existing management (who appoint them and who determine the terms of their engagement, including the extent of their entitlements to remuneration).

4.4.6 In the absence of an independent and impartial investigation of the affairs of the company and with ultimate control of the process by company management there may be a failure to address any underlying governance concerns. Any breaches of the Corporations Act that might be identified will probably not be referred to the relevant regulator, in particular because any work-out specialist will have no statutory duty or authority to refer such matters or any protections from potential actions for defamation or breach of confidence.

4.4.7 There are no formal steps for commencing an informal work-out, which can result in it being unclear to persons dealing with the company whether such a process has commenced or ended.

4.4.8 The ability of market participants to assess the effectiveness of an informal work-out is also restricted. However, the continuous disclosure requirements for publicly listed companies may ensure that market participants are kept informed, to some degree, in respect of any informal work-outs by listed entities.

4.4.9 Normally, only significant creditors (such as, the primary financiers of the company) have their debts compromised and are parties to any work-out agreement. The debts of small creditors, trade creditors, and employees are generally not compromised. However, it is important to note that any arrangement may nonetheless adversely affect the assets available to meet their claims. Dissenting creditors cannot be bound by any arrangement put in place under an informal workout and therefore may take actions against the company that may frustrate any arrangement put in place to effect a business rescue.

4.4.10 There appears to be no published data available on how long informal work-out processes generally take to be concluded; or on how often companies are placed into external administration in circumstances where an informal work-out might have been a more appropriate solution.

5 REORGANISATION OUTSIDE OF EXTERNAL ADMINISTRATION

5.1 OPTION 1: MAINTAIN THE STATUS QUO

5.1.1 As discussed in the previous Chapter, the law currently requires a company to maintain solvency during any attempt at a work-out outside of external administration, unless it could do so without incurring credit.

5.1.2 Retaining the law as it now applies may reflect that, while there may be costs arising from current insolvent trading laws in relation to how they affect informal workouts, such costs may be justified in light of the benefits of insolvent trading laws and the potential consequences of any weakening of the prohibition against insolvent trading.

5.1.3 Maintenance of the status quo would avoid the possibility that any safe harbour might be subject to abuse and might create additional difficulties in addressing undesirable behaviour, such as phoenix company activity.

5.1.4 If the status quo is maintained, companies would be required to rely on the options currently open to them to address insolvency. In particular, they may be dependent upon convincing existing creditors or new funders that any work-out attempt would be in their interests and is worthy of support.

5.1.5 Companies that could not maintain solvency would be required to attempt to reorganise under external administration.

Focus questions

Question 1 — Do Australia's insolvent trading laws unduly interfere with attempts at reorganisation outside of external administration? If so, how extensive and significant a problem do they pose?

Question 2 — Should the status quo (i.e. no safe harbour) be maintained?

Question 3 — If the status quo is maintained, are there any other actions or reforms that might be appropriate to assist companies to reorganise outside of external administration?

5.2 OPTIONS FOR A SAFE HARBOUR

5.2.1 A safe harbour from insolvent trading laws that applies to informal work-outs could assist directors (concerned about personal liability for insolvent trading) to avoid placing their companies into external administration, when a corporate rescue could be more appropriately achieved through an informal work-out. A safe harbour would realise many of the advantages discussed in the previous Chapter, such as maintaining existing company control and value and providing a cost effective and flexible mechanism to work through liquidity issues.

5.2.2 A safe harbour for informal work-outs may also increase the risk of the negative effects of insolvent trading or behaviours associated with it; and may increase the risks associated with companies engaging in an informal work-out. Of particular concern would be the adoption of a safe harbour by smaller companies and companies that are engaged in high risk ventures.

5.2.3 To the extent it may avoid costs and risks being borne by the company, directors might be expected to utilise a safe harbour in preference to other more appropriate methods of addressing a company's insolvency. Costs and risks that might more appropriately be borne by the company might therefore be borne by other parties. For example, a company may choose to trade whilst insolvent while attempting a work-out rather than restoring solvency during that period through obtaining fresh funds where the cost of those funds would include a significant risk premium.

5.2.4 The scope and application of a safe harbour, which would essentially relieve directors of their liability in relation to insolvent trading for a period of time, requires consideration within the broader remit of directors' duties at common law and under the Corporations Act. The purpose of these obligations is to ensure the highest standards for honesty and propriety — the duties in effect set the standard for directors' relationships at every level, including those with their company and the community in general, and set the norm for commercial activity. Relaxing or lifting these standards needs to be approached with caution to ensure that high standards of loyalty are maintained, and the basic proposition remains that when a person assumes a role whose performance involves the risk of injury to others, that person is under a duty to perform the role carefully and is subject to blame if the person fails to do so.

5.2.5 A safe harbour for work-outs could take the form of a statutory rule, modelled on the current business judgement rule in the Corporations Act, which would relieve a director of liability for insolvent trading where they have acted according to a particular formula to make a business judgement that the interests of the company's body of creditors as a whole would be best served by pursuing the work-out. Alternatively, a safe harbour for work-outs could be effected through the introduction of a mechanism under which a moratorium from the laws might be expressly and openly invoked.

Focus questions

Question 5 — What would be the costs and benefits if a safe harbour is applied to section 588G?

Question 6 — Would the introduction of a safe harbour for directors encourage insolvent trading?

– What mechanisms could be put in place to create an appropriate incentive to attempt to restore solvency, rather than simply relying on the rule?

Question 7 — Could the circumstances necessary for the application of a safe harbour be engineered to give insolvent trading other than for genuine attempts at restructuring the appearance of falling within the scope of any safe harbour?

Question 8 — Should the onus of proof for establishing that any safe harbour applies lie with the director or with the party seeking to hold the director liable?

Question 9 — If a safe harbour is applied to the insolvent trading provisions, is there a need to clarify its interaction with the existing defences for insolvent trading?

5.3 OPTION 2: A BUSINESS JUDGEMENT RULE FOR INSOLVENT TRADING

The current rule

5.3.1 The business judgement rule was introduced into the Corporations Act by the *Corporate Law Economic Reform Program Act 1999* (CLERP 9) and was introduced partly to address concerns that directors were becoming overly risk-averse. CLERP 9 was designed to promote optimal corporate governance structures without compromising directors' flexibility and innovation.

5.3.2 A fundamental purpose of the business judgement rule is to protect the authority of directors in the exercise of their duties and to clarify their liability. It was hoped the rule would facilitate legitimate business decisions and risk taking and therefore encourage entrepreneurialism.

5.3.3 The business judgement rule currently operates in relation to the statutory duty of care and diligence in section 180 of the Corporations Act and equivalent duties at common law and in equity. It does not apply generally to all duties imposed upon directors under the Corporations Act, including the duty not to trade whilst insolvent.

5.3.4 The rule provides that a director will be considered to satisfy their obligation to exercise their powers and discharge their duties with due care and diligence if they:

- make a business judgement in good faith for a proper purpose;
- in respect of a matter in which they do not have a material personal interest;
- after informing themselves about the subject matter of the judgement to the extent they reasonably believe to be appropriate; and

- rationally believed that the judgement was in the best interests of the corporation.

5.3.5 A director's belief that the judgement is in the best interests of the corporation will be considered to be 'rational' unless the belief is one that no reasonable person in their position would hold. A 'business judgement' means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.

A rule applying to insolvent trading

5.3.6 The rule would operate so that directors would be relieved of the duty not to trade whilst insolvent if the following elements are satisfied:

- the financial accounts and records of the company presented a true and fair picture of the company's financial circumstances at the time that the rule was invoked;

- the director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time;

- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring; and

- the restructuring was diligently pursued by the director.

5.3.7 This proposal would provide a high degree of protection for directors from the threat of personal liability for insolvent trading, while making bona fide attempts at company reorganisation outside of external administration.

The elements of the rule

Financial accounts and records

5.3.8 The requirement that the accounts and records of the company presented a true and fair picture of the company's financial circumstances is meant to ensure that any reorganisation would be attempted with the benefit of accurate information about the company's financial affairs.

5.3.9 It could be argued that this requirement may create uncertainty as to whether the protection applies in a given case. For example, questions may arise as to whether a company's financial accounts and records are sufficiently accurate for the protection to apply. Thus, persons seeking the protection of the rule or seeking to assert a breach may be required to engage in disputes as to the accuracy of financial records; with consequential costs, delay and uncertainty. It may be queried whether this requirement might detract significantly from any assurance that the rule is intended to provide; and whether it may add a significant additional obstacle to the enforcement of insolvent trading laws.

Director was informed

5.3.10 The requirement for a director to obtain expert advice in respect of a work-out attempt could be expected to have a positive impact of the prospects of success of a work-out attempt. The rule could require the advice to be reasonable and proper but this type of requirement may be more prone to being disputed; with consequential negative effects on complexity; cost and certainty. However, if the advice does not need to be reasonable and proper, then this requirement may add little extra protection against inappropriate insolvent trading.

5.3.11 The rule could require the director to be acting in reliance on the expert's advice. If there is no such requirement, it may be questioned whether a director wishing to obtain protection from insolvent trading might merely 'go through the motions' of satisfying the advice requirement in the rule. However, if directors do need to establish some connection between their actions and the advice, this may present another contestable issue that may add costs, complexity and detract from the certainty of any assurance of protection that the rule might provide. This might also fetter the ability of the directors to exercise their own judgement, expertise and knowledge, the utilisation of which is a primary reason for the use of work-outs outside of external administration.

Directors' business judgement

5.3.12 This element of the rule requires directors to make a business judgement that the interests of the company's body of creditors as a whole would be best served by pursuing the work-out. Under the current business judgement rule such a judgement is considered to be 'rational' unless the belief is one that no reasonable person in their position would hold. It may therefore be difficult to establish that a director had not formed a business judgement that a proposed course of action was in creditors' interests; and it may be queried whether this requirement would therefore provide adequate protection for creditors.

5.3.13 Application of this rule would require the resolution of whether the creditors' interests test refers to the interests of both unsecured and secured creditors. As the interests of any new creditors arising from any insolvent trading may vary significantly from those of existing creditors of a company, the issue may arise as to whether a test in respect of the interests of creditors as a whole would provide sufficient protection to new creditors; or whether separate tests for both classes would be required.

5.3.14 As this rule requires any work-out to be in the interests of members, it would not be available for relief in circumstances where members have no reasonable prospect of any interest in the outcome of a work-out. This would be consistent with director's primary function to act in the interests of members.

5.3.15 The rule has no requirement that persons exposed to the risks of insolvent trading should be informed of those risks, thereby providing them with an opportunity to seek the payment of risk premiums, to enter into arrangements to provide additional assurances of repayment, or to choose not to provide credit. Such an approach may therefore be subject to criticism that it permits companies which are unable to obtain credit from parties who are informed of the company's insolvency (such as the company's banking syndicate) to instead obtain goods and services on credit from parties who are not properly informed. A matter that may need to be resolved, if this option was to be adopted, is whether a director seeking to rely upon a modified business judgement rule should be required to disclose that they are trading whilst insolvent.

Restructuring to be diligently pursued

5.3.16 As the rule imposes no time limits on the application of the safe harbour, other than a requirement that restructuring be diligently pursued by directors, there may therefore be scope for extended insolvent trading to occur. The rule may be open to challenge on whether a director had been diligently pursuing a restructuring. A restructuring process may legitimately involve decisions by directors to delay certain actions in anticipation of certain events; or lengthy negotiations which may appear for some time to be unproductive (and may eventually turn out to be unproductive, although reasonably pursued). It is queried whether there is a real risk that such decisions may, in hindsight, appear to be unjustified and therefore a work-out attempt considered not to have been diligently pursued.

Other issues

5.3.17 While the creditors' and members' interests tests would appear to oblige directors to at least consider alternatives to an informal work-out, this option appears to place no obligation upon directors to consider the options available to the company to maintain solvency during a work-out and thereby avoid the need for insolvent trading. It is queried whether there would be a sufficient incentive for a company to maintain solvency during a work-out if this option was adopted; and whether this might lead to companies who are able to maintain solvency during a work-out to refrain from doing so in order to avoid any associated costs.

5.3.18 As with any possible safe harbour, it is queried whether there is a might potentially for it to be subject to abuse; and, if so, the degree to which that may occur. It should be noted, when assessing either safe harbour option, that phoenix company behaviour currently can occur under the pretext of 'attempts at reorganisation'; often with the assistance of expert advice as was the case in *ASIC v Somerville & Ors*[22].

Focus questions

Question 10 — What would be the costs and benefits of a business judgement rule applying to section 588G?

Question 11 — Should a business judgement rule for insolvent trading be adopted?

Question 12 — What elements should comprise the conditions of a business judgement rule for insolvent trading?

- Do you consider the proposed elements of the business judgement rule discussed above to be suitable?
- Are there any particular elements of the rule that may require further consideration or elaboration?

22 [2009] NSWSC 934.

5.4 OPTION 3: MORATORIUM

5.4.1 This option would provide that a moratorium from the laws might be expressly and openly invoked by a company. Such a moratorium would not apply to dishonest insolvent trading.

5.4.2 This option would require a company to inform the market, including existing creditors and potential new creditors, that the company was insolvent and intended to pursue a work-out outside of external administration.

5.4.3 From the perspective of a new creditor, this option would allow them to make an informed decision as to whether or not to provide credit to the company and to tailor credit terms to take into account any risks they choose to expose themselves to. It would, therefore, address a number of the 'creditor protection' arguments for the prohibition on insolvent trading.

5.4.4 Similarly, if existing creditors were provided with rights to bring the moratorium to an end if insolvent trading was collectively considered by them to be against their interests, this might largely address a number of the balance of the 'creditor protection' arguments for the prohibition on insolvent trading.

5.4.5 In respect of a moratorium's effect on shareholder value, it can be argued that directors are already subject to duties to act in their interests, and any decision whether or not to invoke (and subsequently maintain) a moratorium would be made in the context of those duties.

Preconditions for commencement

5.4.6 The threshold test would not need to be as onerous as that required for the proposed business judgement rule to apply, given that creditors might have a role in determining for themselves whether the moratorium should continue or whether to deal with the company whilst insolvent. Any threshold test might therefore avoid the use of broad terms and subjective tests, and therefore give rise to greater certainty for stakeholders and for the purposes of enforcing insolvent trading laws.

5.4.7 For example, in order to declare a moratorium, directors might only be required to form a rational opinion that: (a) the company is currently or is in imminent danger of becoming insolvent (or its current or imminent solvency cannot reasonably be ascertained); and (b) it is in the interests of creditors as a whole that an attempt be made to reorganise the affairs of the company outside of rather than under external administration.

Term of the moratorium

5.4.8 A moratorium approach might enable limits to be placed upon the periods during which a company was permitted to trade whilst insolvent; thereby reducing any possible market distortions arising from extended insolvent trading by market participants.

5.4.9 Creditors might be given a primary role in determining whether a moratorium might be extended with, potentially, the Court being given a power to override creditor dissent to the continuation of a moratorium where the company is able to prove that the moratorium does not substantially increase the risk that creditors will suffer additional loss.

Termination of a moratorium

5.4.10 Under this option, whether insolvent trading could continue might depend upon the collective consent by the creditors to that trading (or at least a lack of dissent). Such a requirement would be capable of being objectively determined by, for example, a vote of creditors on whether a moratorium should continue (or the absence of a call for such a vote).

5.4.11 Any ability for creditors to bring a moratorium to an end might result in members' interests being unduly affected where they conflict with the interests of creditors. Any power of veto might be used as a bargaining chip by creditors. Although this may induce companies to behave in a manner that does not unduly affect the interests of creditors, it might also be subject to abuse.

5.4.12 As with decisions on whether a moratorium might be extended, the Court might be given a power to override creditor dissent to the continuation of a moratorium where the company is able to prove that the moratorium does not substantially increase the risk that creditors will suffer additional loss. As with any mechanism that relies upon Court intervention, this would involve associated costs and delays.

Other issues

5.4.13 The avoidance of any requirement for directors to meet the elements of the business judgement rule might also avoid any difficulties that may arise from the requirement under that rule for directors to have no material personal interest in the judgement being made (i.e. to attempt a work-out while insolvent). However, it might be queried whether a moratorium option should include a requirement to disclose any material personal interests.

5.4.14 As with the business judgement rule option, a moratorium procedure may not address the problem that persons with existing supply arrangements with the company (for example stock suppliers; employees and certain contractors) may be compelled to continue to provide goods and services on credit to an insolvent company. As disclosure is a key element of this option, some of these persons might be placed in a better position to take actions to protect their interests.

5.4.15 A moratorium approach may avoid the key criticism that may be levelled at the business judgement option; that it would permit companies who are unable to obtain credit from parties who are informed of the company's insolvency to instead obtain goods and services on credit from parties who are not properly informed. However, an expressly and openly invoked moratorium may damage the reputation of a company and therefore affect it value and may negatively affect attempts at reorganisation. In assessing this option, any benefit to the company from non-disclosure must be balanced against the risk of harm to third parties.

5.4.16 As with the Option 2, it may be queried whether a moratorium might be inappropriately utilised by companies that are able to maintain solvency during a work-out attempt but wish to avoid the costs associated with doing so. In this respect, the requirement for disclosure may constitute a significant disincentive for companies to rely upon a moratorium.

5.4.17 Permitting insolvent trading may increase perceptions of counter-party risk for those transacting in a troubled economy. A moratorium approach may act to minimise this effect by: clearly identifying those companies to which are seeking to rely on a safe harbour; and imposing clearly defined periods in which that safe harbour applies.

5.4.18 Disclosure of insolvency may be considered to be consistent with the continuous disclosure obligations of listed companies in respect of which the moratorium might apply. Many of the criticisms of the current insolvent trading laws on work-out attempts have focused on their effects on large, public and listed companies.

5.4.19 The extent of any possible arguments over whether any reorganisation efforts were 'diligently pursued' may be mitigated if this option is adopted. If creditors were granted the power to bring a moratorium to an end, creditors would decide for themselves whether to allow the moratorium to continue after considering a range of factors, such as how the work-out attempt is progressing. However, reliance upon the consent of creditors may result in rescues that are being diligently pursued being terminated due to perceptions that this was not the case.

5.4.20 A moratorium based upon disclosure might provide a higher degree of certainty for all stakeholders as to when directors would be liable for insolvent trading. Under a business judgement proposal whether the protection applies may be uncertain for directors and highly uncertain (or indeterminable) for persons outside of the company without knowledge of matters relevant to the elements of the rule.

5.4.21 A moratorium may impose costs on both a company and its creditors that would not arise under a modified business judgement rule. Costs would arise in respect of it being invoked, publicised or otherwise disclosed, extended and cancelled.

5.4.22 In particular, any power for creditors to call for a vote on whether a moratorium should be terminated or be extended might involve significant expense. Costs would arise in respect of the calling of meetings, the engagement of a nominee to convene and chair any meetings and in respect of any necessity to communicate with and seeking the support of creditors to allow a moratorium to continue.

5.4.23 The potential for a moratorium to be cancelled or for any extension to be refused may create uncertainties that might adversely affect the ability of directors to plan and execute reorganisation attempts.

Focus questions

Question 13 — What would be the costs and benefits of a moratorium in relation to the duty not to trade while insolvent?

Question 14 — Should a moratorium be adopted?

Question 15 — What form should a moratorium take? In particular:

- When should a moratorium be available?
- How long would a moratorium apply for? Would a moratorium's term be capable of being extended and by what process would an extension occur? Would a moratorium be capable of being terminated and by what process would a termination occur?
- What publication and disclosure requirements would apply in respect of a moratorium?