PiperAlderman

Article Information

Authors: James Macdonald, Michael Lhuede
Service: Corporate & Commercial, Corporate Governance, Restructuring & Insolvency

---

Webinar Q&As: 2024 'The Dynamic Board' Series | Sailing close to the rocks: When is it time to look for a Safe Harbour? Board responsibilities when insolvency looms

Piper Alderman provides answers in response to the questions received during our 2024 'The Dynamic Board' Series | Sailing close to the rocks: When is it time to look for a Safe Harbour? Board responsibilities when insolvency looms event on 14 May 2024.

---

1. Is a letter of support from your immediate holding company sufficient to satisfy the solvency test?

Whilst a letter of support from your immediate holding company is likely to be of assistance in satisfying the solvency test in certain circumstances (for example, where that parent company is of substance and has the cash flow and assets necessary to support the subsidiary), it will not be sufficient where the parent company is itself in financial difficulty, faces difficulty being able to move funds to the subsidiary or faces a contingent liability which could lead it to having insufficient assets to be able to meet the debts of the subsidiary. Each case needs to be analysed on the merits.

2. What financial indicators suggest possible insolvency in say, the next five years?/ Wasn't there a recent case that reiterated the primary nature of the cashflow test?

There are many financial indicators that could suggest possible insolvency in the medium to long term (i.e. up to 5 years). These would normally include poor financial performance in the form of sustained losses which are neither showing sufficient signs of recovery nor leading to a milestone valuation event (such as clinical trial results) where a sale or other exit may become viable. Generally in that type of 5 year timeframe you would need to look at the balance sheet, the relationship between assets to liabilities, consider the company's operational and trading prospects and whether there are reasonable prospects for the company to raise additional capital, convert debt to equity or sell assets to pay down creditors.

Most boards when considering solvency if cashflow becomes tight, will be doing so from a shorter term perspective- namely over the next 2-12 months. Here the key elements to focus on will be the company's short term liabilities, when payments are due, what cash flows over that period will occur (including reasonably expected receipts from sales) and what can be done to bridge the gap between when receipts are expected and when payments fall due (such as raise capital, convert debt to equity, ask for extended payment terms from suppliers or shortened payment terms from key customers). In a recent decision, Anchorage Capital Master Offshore Ltd v Sparkes [2023] NSWCA 88 the NSW Court of Appeal affirmed the fact that the cashflow test was the most important when assessing near term solvency under section 95A of the Corporations Act, but that directors also need to turn their minds to other matters such as the balance sheet to assess the company's ability to pay future debts.

3. Can you explain how the s180 duties interact with the safe harbour regime?

The safe harbour protection only deals with a director's duty to prevent insolvent trading by a company. Accordingly directors are still required to act in accordance with their other statutory and common law duties. Under section 180 a director must exercise their powers and discharge their duties with the degree of care and diligence of a reasonable person in that position, noting that the business judgment defence is available under section 180 for directors acting in good faith, rationally in the best interests of the company, for a proper purpose, having informed themselves appropriately and not having a material personal interest in the subject matter of the action or judgment made.

Whilst the duties to prevent insolvent trading and to act with care and diligence are separate duties, acting in accordance with a safe harbour plan prepared by or with the assistance of an appropriately qualified entity in order to produce a better outcome than going straight into administration is likely to provide directors with good evidence of exercising either due care and diligence or an appropriate degree of business judgment to discharge their section 180 duties.

4. **Does an "appropriately qualified" advisor mean the advisor must be a registered administrator / liquidator?**

The term "appropriately qualified entity" used in section 588GA(2) is not defined in the Corporations Act. The factors listed in section 588GA(2) as those to which "regard may be had" in working out whether a course of action is reasonably likely to lead to a better outcome for the company. Accordingly whilst it is not a requirement that the appropriately qualified advisor is a registered insolvency practitioner, the need for someone of this level of skill will depend on the circumstances of the case and how complex the company's affairs are. This was acknowledged in the Explanatory Memorandum to the legislation which introduced the safe harbour defence where it stated that the "factors in subsection 588GA(2) therefore provide only a guide as to the steps a director may consider or take depending on the circumstances. For example, a small business may need only to seek the advice of an accountant, lawyer or other professional, while a large listed entity might retain an entire team of turnaround specialists, insolvency practitioners, and law and accounting firms to advise on a reasonable course of action."

5. Is there a time limit for which the safe harbour protection can apply?

The safe harbour protection only applies if, "after the person starts to suspect the company may become or be insolvent, the person starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company". But if the director fails to take any such course of action "within a reasonable period" or ceases to take that reasonable course of action then the safe harbour protection ceases automatically (see section 588GA(1)).

Therefore whilst the legislation does not prescribe a specific time for a director to act, (and what is reasonable will vary based on the circumstances) the time allowed is not limitless and directors are advised in this situation to act promptly and without delay to ensure that their safe harbour protection remains on foot.

Sign up and more details for further 2024 'The Dynamic Board' Series sessions, please see the Dynamic Board event page here.