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Author: Dr Malcolm Quirey
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Safe harbours for startups and other directors

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On 7 December 2015, the Federal Government released the National Innovation and Science Agenda, delivering a range of new initiatives. Among the key focus areas, the Government highlighted insolvency law as a primary area overdue for reform. Whilst not introducing wholesale reforms to mimic the United States 'Chapter 11' framework, the targeted reforms seek to eliminate the stigma associated with business failure. ***Partner David Cornwell, Special Counsel Dr Malcolm Quirey*** *and* ***Law Clerk James Lowrey*** *explore the promise these measures hold for Australian startups and early stage companies.*

Background

The Government is actively pursuing insolvency law reform. On the morning of the National Innovation and Science Agenda announcement, the Productivity Commission released its Inquiry Report, *Business Set-up, Transfer and Closure*. Just days earlier (3 December) the Government had introduced into Parliament the Insolvency Law Reform Bill 2015. This Bill adopted many of the recommendations proposed in the November 2014 Financial Systems Inquiry Report. However, whereas these earlier reports and the Insolvency Law Reform Bill 2015 offer important procedural measures; the first promises of substantive reforms were within the National Innovation and Science Agenda. These provide:

1. the current default bankruptcy period will be reduced from three years to one
2. 'ipso facto' clauses will become unenforceable. These clauses allow contracts to be terminated solely due to an insolvency event. They often lead to a company's liquidation; if a company is undertaking a restructure
3. a 'safe harbour' defence to protect directors from personal liability for insolvent trading. This applies if the director appoints a restructuring adviser to develop a turnaround plan for the company.

This safe harbour reform was highlighted for consideration in the Financial Systems Inquiry Report 2014, and recommended in the Productivity Commission Report. Further detail in relation to the safe harbour reform is set out below.

The current regime

Australia boasts one of the strictest insolvent trading regimes of any nation. Section 588G of the *Corporations Act 2001* (Cth) imposes potential personal liability on directors for debts incurred by their company whilst it is insolvent. It provides a statutory basis for an action by a liquidator of an insolvent company to hold a director liable for the debts incurred by the company whilst it was insolvent. Because the attendant duty to prevent insolvent trading attracts the statute's civil penalty provisions, contrary directorial behaviour can also be policed by ASIC.

Where an Australian company is at risk of liquidation, the directors may pass a resolution that the company is insolvent (or is likely to become insolvent), placing the company into voluntary administration. Voluntary administration is the formal process for attempting to implement a formal restructure and continue operations. Under voluntary administration the business and property of the insolvent company is administered by a third party.

However, Australia's use of corporate restructure processes such as voluntary administration compares poorly to Canada and the United States. Almost 60% of companies entering voluntary administration are deregistered within three years, and there are few incentives to restructure. Further, these issues disproportionately affect small companies. Relevantly, as the Productivity Commission notes, around 80% of insolvencies relate to small companies.

The US Chapter 11 regime

Whereas directors of an insolvent company in Australia may elect to appoint an independent voluntary administrator, US Companies have the option to become ‘debtors in possession’. Under this scheme, the directors retain control of the company, however owe duties to creditors, and are supervised and scrutinised by the Bankruptcy Court. In this circumstance, the directors may then proceed to reorganise the company debt. Once this reorganisation is approved by either the Court or the creditors, the company may resume normal trading.

Following a detailed analysis and consideration of this US regime, the Productivity Commission labelled this process variously as ‘unnecessary’, ‘unjustified’, and ‘unsupported’ in Australia.

The ‘safe harbour’ defence to insolvent trading

The new safe harbour defence attempts to strike a balance between the status quo (where directors lose control of the company), and the US regime (where the directors retain control of the company).

The safe harbour defence thus provides that directors cannot be held liable for insolvent trading under the *Corporations Act 2001* (Cth). This has two primary impacts. The first is that instead of entering voluntary administration, and thereby relinquishing control of the company, directors of believed to be ‘solvent but struggling companies’ may instead formally restructure their company’s interests without risking personal liability for insolvent trading. The second is that to access the defence, directors must appoint a ‘registered restructuring advisor’ with at least five years of experience. These privately appointed advisors will be required to guarantee that a restructure is possible, or terminate the safe harbour period. In this regard, independent advisors will be able to be presented with the company’s books, records, and certification of solvency. Notably however, this appointment need not be publicly announced.

The safe harbour defence sits between solvency and voluntary administration and, significantly, offers a process by which directors can address financial issues before it is too late, whilst at the same time retaining confidentiality over the company’s affairs. A major attraction is the means of reducing the stigma and costs associated with responding to financial difficulties, which should see more companies staying afloat. Indeed, the Productivity Commission suggests the insolvency regime functions most effectively when commenced as early as possible, at times that can also be expected to enjoy greater optimism from directors wanting to turn around the prospects of a faltering company.

Conclusion

This safe harbour defence is part of a package of insolvency reforms. The defence is intended to provide company directors with scope to manage the company’s affairs without the need for a formal insolvency process, time to explore an informal restructure, and encouragement to seek professional restructuring advice sooner than later. This is likely to be particularly valuable for startup companies, where investors are reluctant to take directorships due to concerns over inadvertent breaches of insolvent trading laws.