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Trading in the time of pandemic – What directors need to know about the new "safe harbour" laws

On Tuesday 24 March 2020 the Commonwealth Parliament passed emergency laws responding to the COVID 19 Pandemic. [1]

Critically the Government has enacted amendments to the *Corporations Act 2001 (***Act***):*

- relaxing the insolvent trading rules under the current crisis;
- increasing the threshold debt levels for bankruptcy and liquidation proceedings to $20,000; and
- extending the time for responding to bankruptcy and liquidation demands to 6 months.

This is likely to be the first in a series of amendments to ameliorate the immediate economic impact of the current crisis in an endeavour to keep the doors of business open as long as possible.

Under Australian insolvency law a director of a company has a positive duty to prevent the company incurring a debt at a time it is insolvent or by virtue of which it would become insolvent[1]. It is both a civil penalty provision, and, if the failure to prevent the incurring of a debt is dishonest, it is an offence. Just as importantly however upon liquidation, the director can be made personally liable for all debts incurred in breach of that duty.

In 2017 the 'safe harbour" defence to "insolvent trading" was introduced into the Act[2]. In what has since been a developing area a specific defence to a claim to a breach of duty under section 588G(2) was created where the director, suspecting insolvency, embarks on developing one or more courses of action that is reasonably likely to lead to a better outcome for creditors and incurs debts in that process. In what is a prescriptive process that at its centre requires all employee entitlements to be met as they fall due, and all taxation lodgements to be up to date, the 2017 "safe harbour" defence is unlikely to provide immediate (if any) comfort to directors of companies that have had their business operations fundamentally altered over the past month by matters outside of their control.

While termed a 'safe harbour" from insolvent trading the COVID 19 Amendments simply suspend the operation of section 588G(2) for a period of 6 months commencing on Wednesday 25 March 2020[3] so long as the debts being incurred are "*in the ordinary course of the company's business*". The amendments also include a regulation making power to limit the suspension of section 588G(2) in specified cases (presumably to circumvent avoidance or other egregious and unintended behaviours). The amendments sensibly do not remove the offence of "dishonest" insolvent trading contained in sub-section 588G(3).

The term "ordinary course of business" has long been familiar to Australian insolvency law having its genesis in the earliest unfair preference provisions[4].

However care needs to be taken before blindly applying judicial consideration of the preference provisions, which entail questions as to whether payment of a creditor claim is preferential having been made other than in the "ordinary course of business" as opposed to a more general questions of whether a debt has been incurred "in the ordinary course of the compay's business".

Noting this limitation we can discern the following from the authorities:

1. Whether the incurring of a debt is in the ordinary course of business is a question of fact to be discerned from all the circumstances of the case[5];

2. The respective intentions of the parties is not relevant to a determination of whether a payment is made in the ordinary course of business. Rather the test is whether a reasonable observer would determine the transaction to be within the ordinary course of the company's business of that type and in all the given circumstances[6];
3. A court will likely have regard to the state of the economy when characterising the nature of the transaction. In *Hamilton* v *BHP Steel (JLA) Ltd* the transaction in question occurred during a recession, and the Court commented that it was important to take this into account as part of identifying the 'undistinguished common flow of business'. For example, certain transactions which may seem unusual and normally would not be considered part of the ordinary course of business may seem less unusual in a different economic climate.[7]
4. In characterising the transaction the courts have stated that general business and commercial practice must be taken into consideration as well as the particular course of business dealings between the parties[8].
5. *"The requirement that the transaction be in the ordinary course of the business excludes transactions which are made for purposes other than the carrying on of the business or to achieve ends disparate from those of the business activity"**[9]*** Thus a transaction such as a sale of business would not be in the ordinary course.

Notwithstanding the suspension of insolvent trading laws for debts incurred in the ordinary course of business directors continue to be at risk of personal liability in the current environment under a multitude of provisions by which the corporate veil has been shredded in recent years. Most relevantly:

1. The failure to pay employee entitlements remains a civil penalty for which directors can be held liable;
2. There has been no abrogation of the common law and statutory duties of directors including that owed to creditors upon insolvency; and
3. The lock down liability on directors for failing to lodge returns with the ATO

It has been suggested, while not being critical, that the decision to effect a suspension of insolvent trading laws is merely a case of "kicking the can down the road". Perhaps most importantly directors need to be conscious that the protections last only 6 months (unless later extended) and they need to plan for what happens next. And it is at that point the existing "safe harbour" protections will likely come to the fore for those with a business capable of being saved!

[1] Section 588G(1) and (2) of the Act

[2] Section 588FGA of the Act

[3] The period of 6 months may be extended to such later period as prescribed by Regulations

[4] Priestley JA of the New South Wales Court of Appeal in his scholarly judgement in *Harkness v Partnership Pacific Ltd* (1997) 41 NSWLR 204 provides a detailed history of the development of unfair preference laws in Australia and the term "ordinary course of business".

[5] *Downs Distributing Co Pty Ltd* v *Associated Blue Star Stores Pty Ltd (in liq)* (1948) 76 CLR 463

[6] *Harkness v Partnership Pacific Ltd* (1997) 41 NSWLR 204 per Preistley JA @ p 163

[7] *Hamilton* v *BHP Steel (JLA) Ltd* (1995) 13 ACLC 1,548

[8] *Sheahan v Fabienne Pty Ltd* (1999) 17 ACLC 1600

[9] Fairway *Estates Pty Limited v Federal Commissioner of Taxation (1970)* 123 CLR 153 Gibbs CJ in this case noted the limited application of preference law references to ordinary course of business references in the Income Tax Assessment Act