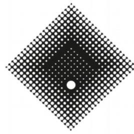

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Insolvency and the Australian Safe Harbour Reforms of 2017 – Do they Adequately Support all Australian Directors in Fulfilling their Role as a Fiduciary of their Company in 2021?

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Insolvency and the Australian Safe Harbour Reforms of 2017 – Do they Adequately Support all Australian Directors in Fulfilling their Role as a Fiduciary of their Company in 2021?

Abstract

As fiduciaries, Australian company directors will be acting in best interests of their company and for a proper purpose where they use their management powers to maximize profits for its shareholders, considering all of the interests of the corporation, including its continued existence and its interest in pursuing lawful activity. However, upholding these duties was negatively impacted by the apprehension of insolvency under the Australian insolvent trading laws as they were prior to the 2017 legislative reforms. The fear of associated personal liability that directors could face disincentivised them from taking appropriate business risks outside of formal insolvency situations. Following the temporary support measures implemented by the Australian Government in March 2020 to assist companies in financial distress due to the economic impact of the COVID-19 pandemic, additional legislative reforms were introduced to assist small company businesses experiencing financial distress in January 2021. Whilst these new reforms are welcome, this Article presents suggestions for further reform in order to provide additional support for all Australian company directors so that they can confidently fulfill their fiduciary duties to their companies, and to broaden much needed entrepreneurialism and innovation approaches for all Australian company businesses.

Key words: Corporate Insolvency, Fiduciary Duties and Reform

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Introduction

In September 2017, legislative reforms in Australia were introduced to its corporate insolvent trading laws under the Part 5.7B of the *Corporations Act 2001* (Cth) (CA). Section 588HA CA required the new reforms to be reviewed 2 years following their introduction, however as of May 2021, this has not formally occurred. It may be that the delay is due to 2 years not being an adequate time period for an effective review to be undertaken. However, there have been some legislative changes implemented in this area of the law in January 2021, which were introduced to assist small company businesses in financial distress, following the conclusion of the temporary measures that were introduced by the Australian government in March 2020 as part their response to the economic impact of the COVID-19 pandemic. Further, there are now some limited judicial determinations which have considered the 2017 reforms.[1] These new developments present Australian legislators with an opportunity to review the 2017 reforms, by focusing on their real and /or perceived shortcomings. This Article aims to assist Australian legislators by bringing together a critical analysis of the 2017 reforms as they stand in 2021 in order to determine if their objectives have thus far been met: to support all Australian company directors in fulfilling their fiduciary duty to act in the best interests of their company and for a proper purpose, during times of financial and operational restructuring outside of formal insolvency situations. Economic growth and efficiency in the Australian economy being the overall aim.[2]

In Part 1, the theoretical underpinning of the role of directors as fiduciaries in companies in the context of suspected insolvent trading is first canvassed. A brief overview of the corporate insolvent trading laws in Australian under the CA prior to the 2017 reforms is presented, and the various defences that were (and still are) available to directors in times of suspected insolvency under s 588H CA are examined. Judicial discretions available under ss 1317S and 1318 CA to excuse full or part liability for directors who have been subject to civil breaches of insolvency laws, together with their limitations are also explored. Why reform to the corporate insolvent trading laws in Australia was required is further elaborated on in Part 2. This historical focus provides the background rationales that drove the impetuses of the 2017 legislative changes, noting that the corporate insolvent trading laws in Australia prior to the

[1] *Re Balmz Pty Ltd (in liq)* [2020] VSC 652; *Habrok (Dalgaranga) Pty Ltd v Gascoyne Resources Ltd* [2020] FCA 1395.

[2] Australian Productivity Commission, *Business Set Up, Transfer and Closure. Productivity Commission Inquiry* (Report, No 75, 30 Sept. 2015) iv.

2017 legislative reforms arguably were having a negative effect on much needed entrepreneurialism in many Australian business sectors.[3] It is noted that the underpinning objectives of the 2017 legislative reforms were to encourage directors to make appropriate business decisions in times of corporate 'restructuring outside of formal insolvency',[4] and to '…promote a culture of entrepreneurship and innovation which will help drive business growth, local jobs and global success.'[5] Part 3 then evaluates a number of real and perceived shortcomings of the 2017 legislative reforms, in light of their performance over the last three years of operation. Most notably, given that the burden of proof to show that the safe harbour provisions do not apply, fall to a plaintiff (generally a creditor), this has still left directors unsure of what actions they should be taking with regard to restructuring activities in times of pre-insolvency. In addition, the time when insolvency is triggered and the period when the 'safe harbour' provisions are to apply are also still uncertain.

Part 4 then examines the temporary measures[6] that the Australian government introduced on 25 March 2020 in order to assist companies experiencing financial distress due to the economic impact of the COVID-19 pandemic. These temporary measures predominately ceased on 31 December 2020. An overview is also provided of the additional legislative reforms that were introduced to assist small company businesses experiencing financial distress in January 2021. To provide support for future reform to the Australian corporate insolvency laws, a concise international perspective is presented in Part 5 of this Article. Particular focus is made on the corporate insolvent trading laws as they apply in the United States (US), the United Kingdom (UK) and New Zealand (NZ).

The Australian 2017 legislative reforms to corporate insolvency laws have gone some way in addressing Australian insolvency law's previous limitations. The additional legislative reforms as introduced in January 2021 whose objective is to assist small businesses in financial distress have extended on this. Whilst these new reforms are welcome, this Article presents suggestions for further reform to Australian insolvency laws in order to provide additional support for all Australian company directors so that they can confidently fulfil their fiduciary duties to their

[3] Ibid 5.
[4] Jason Harris, 'Reforming insolvent trading to encourage restructuring: safe harbour or sleepy hollows?' (2016) 27 *Journal of Banking, Finance, Law & Practice* 294, 294.
[5] Australian Productivity Commission (n 2) 5.
[6] *Corporations Act 2001 (Cth)* s 588GAAA CA

companies, and to broaden much needed entrepreneurialism and innovation approaches for all Australian company businesses.

Part 1. The Role of Directors and the Company

The laws that govern companies in Australia are drawn upon the principles of the *Companies Act 1862* (UK), which adopted a *lassie faire* approach to company law, with its historical focus being on profit maximisation for the benefit of shareholders. These principles were predominately underpinned by the 'shareholder primacy' theory, as espoused by Adolf Berle.[7] This theory contends that directors, as agents of their company are in a position of trust, and thus owe a fiduciary responsibility to the company's shareholders. In the 1742 UK case of *Charitable Corp v Sutton*[8], Lord Hardwick LC noted '…by accepting a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence.'[9] The level of the standard of care for directors at that time was one of 'gross neglect' or '*crassa negligentia'*.[10] This duty found itself based in equity which limited directors free exercise of their corporate powers where such powers '...[were] necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.'[11] The 'invisible hand' doctrine reinforced this position which outlined that:

> Individuals should simply seek to maximise profits; profit seeking frees us from having to make controversial value judgements. The "invisible hand" doctrine assures us that profit seeking will invariably lead to the most economically efficient allocation of resources which, in turn, will produce the greatest utility for the world taken as a whole.[12]

This fiduciary duty also exists in Australian company law which requires directors to exercise their management powers only where they consider it is in the best interests of the company and not for an improper or collateral purpose.[13] While this seems to take on a subjective approach, some support for objectivity was provided for in *Charterbridge Corp Ltd v Lloyds Bank Ltd* where Pennycuick J applied the test as:

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[7] See generally Adolph Berle, 'Corporate Powers as Powers in Trust' (1931) 44 *Harvard Law Review* 1049.
[8] *Charitable Corporation v Sutton* (1742) 2 Atk 400, 406; 26 ER 642.
[9] Ibid.
[10] Joshua Getzler, 'Duty of Care' in Birks and Pretto (eds), *Breach of Trust* (Hart Publishing, 2002) 45, 47.
[11] Berle (n 7) 1049.
[12] See David Silverstein, 'Managing Corporate Social Responsibility in a Changing Legal Environment' (1987) 25 *American Business Law Journal* 525; *Charitable Corporation v Sutton* (1742) 2 Atk 400, 406; 26 ER 642; and Joseph Bishop, 'Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors' and Officers' (1968) 77 *Yale Law Journal* 1078, 1096 -1097.
[13] *Re Smith & Fawcett* (1942) Ch. 304, 306.

> ...whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.[14]

It followed then that directors had a primary duty to ensure that they maximise profits of the company for the benefit of its shareholders both in the short and long term. How long the long term is – is questionable however. As noted by Langton and Trotman,

> ...exactly how long remains unspecified. For that reason, it is submitted that the phrase 'best interests of the company' should be equated in Australia with ruthless profit maximisation over some unspecified period.[15]

As such, it was felt that directors were tasked to give primacy to the advancement of profit maximisation at all costs. Company law in Australia has however further progressed so that profit maximisation is not the only factor that is important when determining if they are acting in the best interests of the company. For example, ss 180 -183 CA provide that directors must exercise their powers by using due care and diligence, by acting in good faith, and not to use their position in the company or the company's information for personal gain.[16] In the recent appeal case of *Cassimatis v Australian Securities Investment Commission*[17] the Full Federal Court confirmed that directors have a duty to exercise a degree of care and diligence under s 180(1) CA while having regard to the company's best interests. In this case, the appellants, Mr and Mrs Cassimatis were directors and sole shareholders of the financial advice firm, Storm Financial Pty Ltd. The trial judge found that they had failed to exercise their powers and discharge their duties with care and diligence as required under s 180(1) CA particularly because they had caused the company to contravene s 945A CA as it appeared at the time[18] and this raised a risk to the company's continuation. The appeal court confirmed the primary judge's finding that the directors, Mr and Mrs Cassimatis, had breached these duties by exercising their powers in a way that caused inappropriate advice to be given to certain vulnerable investors by their company.[19] The appellants had argued that the alleged breach of their duties under s180(1) CA occurred while the Storm Pty Ltd was solvent, and at the time

[14] *Charterbridge Corp Ltd v Lloyds Bank Ltd* (1970) 1 Ch. 62, 74.

[15] Robert Langton and Lindsay Trotman, 'Defining the Best Interests of the Corporation: Some Australian Reform Proposals' (1999) 3 *Flinders Law Review Law Journal* 163, 176.

[16] *Corporations Act 2001* (Cth) ss 180-184.

[17] [2020] FCAFC 52.

[18] See *Corporations Act 2001* (Cth) previous s 945A (2)(a) which set out that in providing general advice to a retail client, the provider had an obligation to warn clients that the advice does not consider their objectives, financial situation or needs. This section has now been repealed and has been replaced with s 961A CA which sets out the obligation to act in the best interests of the client in relation to the provision of personal advice with regard to a financial product.

[19] *Australian Securities and Investments Commission v Cassimatis* (No 8) [2016] FCA 1023.

they were the only shareholders, thus Storm Pty Ltd' s interests were in line with its shareholders. Further, they argued that because they held all the issued shares in the company, they were therefore entitled to prioritise their own and the company's interests in operating the company's financial model (the Storm Model) over minimising other risks (including possible adverse actions taken by ASIC or dissatisfied investors). However, Thawley J dismissed this argument saying: '…it is step too far to say that 100% shareholders can approve their own contravention of s 180(1) as directors.'[20]

In Australia, these duties are owed to the company as a whole.[21] In Cassimatis the court noted that there is a balancing exercise required, where the duty to the company is not:

> … necessarily confined to commercial considerations or to a comparison of monetary consequences, but extends to considering all of the interests of the corporation, including its continued existence and its interest in pursuing lawful activity.[22]

It is arguable that such duties can also extend to the interests of a company's creditors in times of insolvency. This position was considered in the Australian context by Mason J in *Walker v Winborne*[23] where he said:

> …the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.[24]

Street CJ in *Kinsela v Russell Kinsela Pty Ltd* [25] supported this position noting:

> ...where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.[26]

This supports the view that where a company cannot continue trading without relying totally on creditor funds, 'the interests of the company are in reality the interests of existing creditors alone.'[27] However, the general view in times of insolvency is that this duty to creditors is an

[20] *Cassimatis v Australian Securities Investment Commission* [2020] FCAFC 52 at [472].
[21] See for example *Percival v Wright* [1902] UKLawRpCh 125;[1902] 2 Ch 421; *Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd* [1983] Ch 258 and *Grove v Flavel* (1986) 43 SASR 410, 417. Also see *Spies v R (*2000) 201 CLR 603, where the court suggested that the interests of 'the company' was to be viewed distinct from those of its creditors, and held that directors do not owe an enforceable duty to creditors.
[22] *Cassimatis v Australian Securities Investment Commission* [2020] FCAFC 52 at [459].
[23] (1976) 137 CLR 1.
[24] Ibid 7.
[25] (1986) 4 NSWLR 722.
[26] Ibid 730.
[27] *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50, 146.

indirect duty which is owed by the company to consider creditor interests overall.[28] The Australian position was set out in *Spies v R*[29] where the court confirmed that the 'duty' so far as creditors were concerned was an aspect of directors' duty to the company. It was not a direct duty owed to creditors or enforceable by them.[30]

More concerning are those times where a company is solvent but may be approaching insolvency, because this is the period when directors are faced with a number of tensions. In such times a company's shareholders, rather than risk further trading, may wish to extract what they can in the form of dividends. Creditors at the same time may want to ensure that the company preserves its funds, so that they can be paid their debts when due. Alternatively, shareholders may want the company to take appropriate business risks, to be entrepreneurial so as to maximise the prospect of making future profits. In such times, making dividend payments to shareholders or taking on risky business decisions can, in economic terms amount to a shift in value to a company's shareholders at the expense of its creditors.[31]

This is where tensions lie – in times of financial distress of a company, where restructuring activities may be undertaken (pre-insolvency) by directors in order to serve the best interests of the company:

- directors can find themselves taking actions which they believe are in the best interests of the company;
- creditors and shareholders having a subjective opinion whether these actions are indeed in the best interests of the company; and
- directors taking risk adverse actions, in order to protect themselves from personal liability.

Over time, these tensions have contributed to the development of the insolvent trading laws which we have in place in Australia today.[32]

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[28] *Mills v Northern Railway of Buenos Ayres Co* [1870] UKLawRpCh 73; (1870) 5 Ch App 62. In times of insolvency, this duty cannot be enforced by creditors directly, where they must rely on the appointment of a liquidator who will promote their interests.
[29] (2000) 201 CLR 603.
[30] Ibid.
[31] Edward M Iacobucci, 'Directors' Duties in Insolvency: Clarifying What is at Stake' (2003) *Canadian Business Law Journal* 398, 401.
[32] See generally Australian Law Reform Commission, *General Insolvency Inquiry* (Harmer Report), (Report No 45, 1988) where the history of the development of the *Corporations Act 2001* (Cth) s 588G is provided.

1.1 Why the Need for Insolvent Trading Laws?

It has been argued that the corporate insolvent trading laws in Australia prior to the 2017 reforms were necessarily strict because this could ensure that directors actively monitored the company's finances, which was in fact good business practice.[33] Indeed, the consequences of insolvency can negatively affect many parties, including shareholders, creditors, employees, the Australian Tax Office (ATO), suppliers and the general public. The laws as they were prior to the 2017 reforms attempted to balance the competing interests of all stakeholders. It was noted by the Australian Law Reform Commission's 1988 inquiry that 'the fundamental purpose of an insolvency law was to provide a fair and orderly process for dealing with the financial affairs of insolvent individuals and companies.'[34] This approach however did not always permit directors to adequately address their fiduciary duty to act in the best interests of the company and for a proper purpose, as they were burdened to take into account not only the maximisation of wealth of the company's shareholders, but to also consider other stakeholders interests (including creditors) and consider their own personal liabilities as well. These tensions inevitably impacted on directors' abilities or confidences to take on appropriate business risks and to be entrepreneurial in times when company debt restructuring was required.

As part of the company laws derived from the UK, corporate insolvent trading laws and associated liability for directors in Australia have been in place since 1961.[35] Initially, director liability was based on a director knowingly being a party to the incurring of a debt in those circumstances where there was no reasonable or probable expectation for the company being in a position to pay that debt.[36] The laws as they were in the 1960s however did not permit creditors to seek compensation directly from directors, or for liquidators to sue directors directly. Directors were nevertheless subject to criminal sanctions for a breach of the corporate insolvent trading laws, however no personal liabilities applied.[37] In the 1980s, the Australian Companies Code was introduced, which made provision for civil liabilities to be imposed on directors in those circumstances where they had permitted their company to trade where there

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[33] Harris (n 4) 297. Harris defines debt restructuring as '… a situation where a company has become over-leveraged with debt and needs to alter the nature of some or all of the debt obligations so as to facilitate the company to return to profitability at some point in the future.'
[34] Harmer Report (n 31) 3.
[35] *Companies Act 1961* (NSW) s 303(3).
[36] Harris (n 4) 295.
[37] See Andrew Keay and Michael Murray, 'Making Corporation Directors Liable: A Comparative Analysis of Wrongful Trading in the United Kingdom and Insolvent Trading in Australia' (2005) 14 *International Insolvency Review* 27, for a historical overview of the development for Australia's insolvent trading laws since 1961.

were 'reasonable grounds to expect that the company would not be able to pay all its debts when they become due.'[38] Following the passing of 1992 Corporate Law Reform Bill, both civil and criminal liability for directors for a breach of the corporate insolvent trading laws has applied.[39]

The current corporate insolvent trading laws in Australia are now contained in Part 5.7B, ss 588C – 588ZB CA. In particular, the current elements of s 588G CA set out:

- that the duty to prevent insolvent trading applies only to a person who was a director at the time when the company incurred a debt;[40] and
- the company 'was insolvent at the time, or becomes insolvent by incurring that debt by incurring at that time debts including that debts';[41] and
- at 'that time there were reasonable grounds for suspecting that the company is insolvent or would so become insolvent';[42] and
- the person was aware at the time that there are such grounds for suspecting insolvency or a 'reasonable person in a like position in a company in the company's circumstances would be so aware'.[43]

Civil liability can be imposed in circumstances where a company is insolvent and the director or a reasonable person in their position had grounds to suspect insolvency, and they fail to stop it from incurring debts at that time.[44] Notably, there is no definition of 'debt' under the CA. A debt can nevertheless be a deemed debt for the purposes of incurring a debt under s 588G(1) CA.[45] A deemed debt under s 588G(1A) CA includes: redeeming redeemable preference shares, buy back of shares, the payment or declaration of a dividend, making a reduction of share capital other than cancellation of shares for no consideration, financially assisting a person to acquire shares in itself or in a holding company, as well as entering into an uncommercial transaction within the meaning of s 588FB CA. Other debts are those defined at

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[38] Paul James, Ian Ramsay and Polat Siva, 'Insolvent Trading: An Empirical Study' (2004) 12 *Insolvency Law Journal* 210, 210.
[39] Jenny Schultz, 'Liability of Directors for Corporate Insolvency - The New Reforms' (1993) 5(2.4) *Bond Law Journal* 191,191.
[40] *Corporations Act 2001* (Cth) s 588G(1)(a).
[41] Ibid s 588G(1)(b).
[42] Ibid s 588G(1)(c).
[43] Ibid s 588G(2).
[44] *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266; 40 ALJR 13.
[45] *Corporations Act 2001* (Cth) s 588G(1A). Also see *Hawkins v Bank of China* (1992) 26 NSWLR 562.

common law.[46] Crucially, a director can be liable for corporate insolvent trading even where they are not responsible for or are unaware of a debt being allowed to be incurred. For example, in *Elliot v ASIC* [47] it was held that despite Mr Elliot holding a non-executive director position, where he had little to do with day to day operations of the companies, he nevertheless had a duty to protect the creditors from the inevitable insolvency of the companies. The court found that he had breached the insolvent trading provisions by 'not preventing' or 'failing to prevent' the companies from incurring a debt because there were reasonable grounds for suspecting insolvency when those debts were incurred.[48]

Today, the insolvency laws in Australia provide that in those situations where formal corporate insolvency applies, and a company has been placed into liquidation, the liquidator can sue directors personally for breaches of general law and statutory law duties under Part 2D.1 CA as well as for any breach of ss 588G-M(2) CA, where they are able to recover any damages or losses that the company may have incurred because of the breach. Creditors too may be in a position to sue directors personally.[49] Where a director is been found to be acting fraudulently, s 588G(3) CA will permit the regulator, the Australian Investment and Securities Commission (ASIC) to seek criminal sanctions.

1.1.1 Taking Appropriate Business Risks and the application of Judicial Relief

Relief from personal liability for directors for possible civil breaches may be available by an exercise of judicial discretion under ss 1317S CA and 1318 CA if the court considers there has been honest conduct, and in the circumstances, 'the person ought fairly be excused for the contravention.'[50]

Under s 1317S CA, if eligible civil penalty proceedings are bought before a court (which can include *inter alia* a contravention of s 588M CA and s 588W CA),[51] and the court finds that

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[46] For example, in *John Graham Reprographics Pty Ltd v Steffens* (1987) 5ACLC 904, the court considered whether or not an agreement to pay interest constitutes a debt. Connelly J held that interest payable under an agreement to pay, was incurred as a debt when the initial contract was entered into. The interest itself was not an independent debt however.
[47] (2004) VSCA 54.
[48] Ibid.
[49] *Equiticorp Finance Ltd (in liq) v Bank of New Zealand* (1993) 32 NSWLR 50, 146.
[50] *Hall v Poolman* (2007) 215 FLR 243; 65 ACSR 123.
[51] See *Corporations Act 2001* (Cth) s 588M which provides for recovery of compensation from directors for loss resulting from insolvent trading, by liquidators or creditors. Also see *Corporations Act 2001* (Cth) ss 588V and 588W which provide for similar recovery of compensation by liquidators in relation to holding companies.

the person acted honestly, having regard to all the circumstances, 'the court may relieve the person either wholly or partly from a liability to which the person would otherwise be subject, or that might otherwise be imposed on the person, because of the contravention.'[52] Olsson J in *Powell v Fryer*[53] noted that '[t]he authorities indicate that a director acts 'honestly'…when he acts bona fide in the interests of the company, including unsecured creditors of that entity.'[54]

Section 1318 CA is similar in operation to s 1317S CA and applies where civil proceedings have been taken against a person for negligence, default, breach of trust or breach of duty. It is open to the court, where it considers that the person acted honestly, having regard to all the circumstances, to 'relieve the person either wholly or partly from liability on such terms as the court thinks fit.'[55] This section applies to officers (including directors), auditors or experts in relation to the matter in question.[56]

Arguably both ss 1317S and 1318 CA give directors some comfort in times of debt restructuring. Both provisions' objective is to serve the public interest. They aim to balance the harm that can be done to companies where directors are found to not be acting in the companies' best interests, with the need to support directors when they are undertaking honest conduct.'[57] Without such discretions available, it is arguable that even fewer persons will undertake such roles.

Historically these provisions have rarely been used by the courts, and where they have been applied, their protection abilities for director liability have been limited. In earlier cases, the courts were reluctant to apply the discretions in relation to insolvent trading breaches by directors. For example, in *Commonwealth Bank of Australia v Friedrich,*[58] the court declined to apply the discretion under s 1318 CA as it did not consider a breach of the insolvent trading laws (as they were at that time) was a cause for proceedings to be bought under the section.

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[52] *Corporations Act 2001* (Cth) s 1317S(2).
[53] (2001) 159 FLR 433, 450 [111].
[54] *Powell v Fryer* (2001) 159 FLR 433, 450 [111]; *Marchesi v Barnes* [1970] VR 434; *Dominion Insurance Co of Australia Ltd (in Liq) v Finn* (1988) 7 ACLC 25 at 33-34.
[55] *Corporations Act 2001* (Cth) s 1318(1).
[56] Ibid s 1318(4)(1).
[57] *Powell v Fryer* (2001) 159 FLR 433, 450 [111]; *Marchesi v Barnes* [1970] VR 434; *Dominion Insurance Co of Australia Ltd (in Liq) v Finn* (1988) 7 ACLC 25 at 33-34.
[58] (1991) 5 ACSR 115.

That is, it was not a cause for 'negligence, default, breach of duty or breach of trust.'[59] In later cases the courts considered that because the insolvent trading laws imposed duties on directors to prevent insolvent trading, this was sufficient cause for proceedings for relief to be bought under s 1318 CA.[60] For example, in *Hall v Poolman,*[61] Palmer J ruled that s 1318 CA could apply in cases of insolvent trading breaches by directors under Part 5.7B CA, where a determination of 'honest conduct' supported the exercise of the court's discretion under s 1318 CA, with Palmer J noting:

> …the Court should be concerned only with the question whether the person has acted honestly in the ordinary meaning of the term, i.e. whether the person has acted without deceit or conscious impropriety, without intent to gain improper benefit or advantage for himself, herself or for another, and without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt has been [made] to carry out the duties and obligations of his or her office imposed by the Corporations Act or general law. A failure to consider the interests of the company as a whole, or more particularly the interests of creditors, may be of such a degree as to demonstrate failure to act honestly in this sense. However, if failure to consider the interests of the company as a whole, including the interests of creditors, does not rise to such a high degree but is the result of an error of judgment, no finding of failure to act honestly should be made.[62]

Palmer J found that while an error of commercial judgement had been made by the director in question, this did not amount to a failure to act honestly. To find otherwise would have been 'most hurtful, damaging and unfair to him and anyone in his position.'[63] In applying his discretion on whether the director 'ought to be fairly excused', Palmer J noted that decisions made by active and diligent directors, during times of financial difficulties, required careful evaluation. He was sympathetic in his understanding of what directors such as the director in question faced in times of a company's financial difficulties:

> It is sometimes a difficult decision for a director of a trading company suffering from liquidity problems to decide whether, and when, to abandon hope of a change in the company's fortunes and to summon the administrators. …When confronted with the necessity of making a decision involving these factors, a director cannot afford to procrastinate or to avoid confronting realities. He or she must ask and honestly answer [hard questions regarding how, and when, the company will be able to pay its debts.[64]

Palmer J exercised his discretion to partially relieve the director's breach of duty under s 1318 CA based on consideration of 'all of the circumstances to whether the action was commercially reasonable.'[65] In addition, the director was still liable for costs. Contrastingly, in *The Stake*

[59] *Corporations Act 2001* (Cth) s 1318.
[60] *Kenna & Brown Pty Ltd (in liq) v Kenna* (1999) 32 ACSR 430
[61] (2007) 215 FLR 243; 65 ACSR 123.
[62] Ibid 318; 193-194.
[63] Ibid 317; 193.
[64] Ibid 319; 195.
[65] Patrick J Lewis, 'Insolvent trading defences after *Hall v Poolman*' (2010) 28 *Company and Securities Law Journal* 396, 396.

Man Pty Ltd v Carroll[66], the Federal Court fully exonerated a director from liability for insolvent trading based, *inter alia* on honesty and fairness, under the judicial discretion provisions ss 1317 and1318 CA. In this case, the defences under s 588H CA were not able to be satisfied by the director. However, Goldberg J was nevertheless satisfied that the director did not act:

> …with deceit or conscious impropriety, [was] without intent to gain improper benefit or advantage for himself, herself or for another, and [was] without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been to carry out the duties and obligations of his or her office imposed by the Corporations Act or the general law.[67]

However, costs were once again imposed upon the director, who was ordered to pay the liquidators costs.

These outcomes highlight while the discretions under ss 1317S and 1318 CA can partially or fully exonerate directors for breaches of insolvent trading in certain circumstances, nonetheless they may not always be completely free from all financial impacts personally. As noted above, there have been very few cases that have applied the discretions available under ss 1317S and 1318 CA in order to absolve directors either fully or partially from liability. Empirical research published in 2009 illustrated that relief under these sections was refused in 8 out 23 cases examined because the courts found that directors had failed to 'act honestly'.[68] This position was illustrated in *Re Balmz*[69], where Randell AsJ did not exercise his discretion under s 1317S CA to relieve the defendants from liability for insolvent trading. He found that the defendants failed to act honestly, and did not act in the best interests of the company. Instead, by their actions, they had sought to minimise their own personal liabilities by not complying with their ATO reporting and taxation payment obligations. They also failed to consider putting forward a deed of company arrangement before resolving to appoint an administrator. This led the court to conclude that the defendants took this action to avoid an application by the ATO itself to wind up the company in insolvency, and to minimise their own personal liabilities.[70]

[66] [2009] FCA 1415.
[67] Ibid at [190].
[68] Steven Wong, *Forgiving a Director's Breach of Duty: A Review of Recent Decisions* (Centre for Corporate and Securities Regulation – Research Reports and Research Papers, 2009).
[69] *Re Balmz Pty Ltd (in liq)* [2020] VSC 652, 140-146.
[70] Ibid.

Further it has been argued that the test from *Hall v Poolman*[71] which was followed in *The Stake Man*[72] has confused the purpose of ss 1317S and s 1318 CA which find their basis in equity. It has been argued that these sections were designed to offer relief from oppression and not to provide a defence to protect directors in entrepreneurial risk taking.[73] It has been argued that sections do not provide:

> an appropriate mechanism for encouraging entrepreneurial risk-taking. There is no effective safe harbour for directors of companies attempting a work-out outside of external administration, or where they continue to operate with the reasonable belief that they can trade out of financial difficulty.[74]

Reliance on these two provisions therefore have limited relief possibilities even for those directors who may have acted honestly, while undertaking entrepreneurial risk-taking but nevertheless are found to be in breach of their duty to not permit their company to trade whilst insolvent.

1.1.2 The Defences under s 588H CA and Voluntary Administration

There are a number of statutory defences available for directors who may be subject to a breach of s 588G(2) CA, found under s 588H CA:

- That there are reasonable grounds to expect solvency;[75] and/or
- that there has been reasonable reliance on others who have provided relevant information;[76] and/or
- that they were absent from management for illness or for good reason;[77] and/or
- that they took reasonable steps to prevent the incurring of a debt.[78]

With respect to the defence available under s 588H(2) CA – reasonable ground to expect insolvency, an inquiry as to s 588G(1)(c) CA relies on not the conduct of the director in question but on the objectively formed state of mind of a person of ordinary competence.[79] In *Re Balmz*[80] it was noted that the expectation under s 588H(2) must be reasonable. In this case, the court held that a director could not rely on a complete ignorance of or neglect of his duty,

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[71] (2007) 215 FLR 243; 65 ACSR 123.
[72] [2009] FCA 1415 at [190].
[73] *Daniels v Anderson* (1995) 37 NSWLR 438, 525.
[74] Lewis (n 65) 410.
[75] *Corporations Act 2001* (Cth) s 588H(2).
[76] Ibid s 588H(3).
[77] Ibid s 588H(4).
[78] Ibid s 588H(5).
[79] *Trinick v Forgione* (2015)106ACSR 600; *Credit Corporation Australia Pty Ltd v Atkins* (1997) 17 ACLC 756.
[80] *Re Balmz Pty Ltd (in liq)* [2020] VSC 652 (7 October 2020).

[81] and a ‘sleeping director’ could not rely on their own ignorance of the company’s affairs which had been added to by his own lack to make further necessary inquiries.[82]

One option available to directors under s 588H(2) CA has been for them to resign from their position as soon as they have reason to suspect that a company is insolvent or is approaching insolvency. Most problematic however, is because it is difficult to pin point the exact time where there is a suspicion that the company is insolvent or would become insolvent by the incurring of a debt, directors can be liable even after they resign. Such an approach may also not be in the best interests of the company as a whole. This defence and its limitations continue to be in question even after the 2017 insolvency law reforms.

The defence available under s 588H(3) CA requires evidence that there was reasonable reliance on others who have provided relevant information. This defence could be argued to support the operation of s 588GA(2)(d) where a safe harbour may apply in circumstances where a director has obtained ‘advice from an appropriately qualified entity who was given sufficient information to give appropriate advice.’[83]

The application of s 588H(5) CA and s 588H(6) CA provide that a defence may be supported if it can be shown that the director took reasonable steps to prevent the company from incurring the debt/s. Appointing an administrator as part of a Voluntary Administration (VA) process can be considered to constitute ‘reasonable steps’ under these sections, creating a type of ‘safe harbour’, which is still available to directors as a defence from corporate insolvent trading liability. This continues in addition to the safe harbour reforms of 2017.

By placing the company into VA, the director’s liability can be avoided, where:

- unsecured creditors can’t begin, continue or enforce their claims against the company without the administrator’s consent or the court’s permission;

[81] *Statewide Tobacco Services Ltd v Morely* (1990) 2 ACSR 405; *Morely v Statewide Tobacco Services Ltd* [1993] 1VR 423; *Metal Manufacturers Ltd v Lewis* (1986) 11 ACLR 122 at 129.
[82] *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405; *Morley v Statewide Tobacco Services Ltd* [1993] 1 VR 423; (1992) 8 ACSR 305; and *Tourprint International Pty Ltd (in liq) v Bott* [1999] NSWSC 581; (1999) 32 ACSR 201, 215 [67].
[83] *Corporations Act 2001* (Cth) s 588GA(2)(d).

- owners of property (other than perishable property) used or occupied by the company, or people who lease such property to the company, can't recover their property;
- except in limited circumstances, secured creditors can't enforce their security interest in the company's assets;
- a court application to put the company in liquidation can't be commenced; and
- a creditor holding a personal guarantee from the company's director or other person can't act under the personal guarantee without the court's consent.[84]

The voluntary administrator 'steps into the shoes' of the directors and has all their powers to manage the company. Arguably, VA action is risky as it can also be detrimental to the company as a whole, because it is the company's directors who are most familiar with the company's operations, and it is they who can best assist the company to trade out of its difficulties where this is a reasonable possibility. It has been found that once a company is put into a VA in Australia, it rarely trades out of its difficulties.[85] VAs in Australia have been considered to be an ineffective vehicle to encourage restructuring of businesses.[86] This is despite the operation of s 435A CA, which sets out the objective of a VA is to maximise the chances of the business (or part of it) to continue its existence or result in a better outcome for stakeholders when compared to a winding up.[87] These objectives in reality have rarely been met. For example, the Australian Productivity Commission noted in its 2015 Report that for those companies that enter into a VA, there are few incentives available to them to restructure, where 70% of them are deregistered within 4 years of the commencement of the VA.[88] These actions are therefore not always in the best interest of the company. One example concerned the Henry Walker Eltin group, where directors placed the company into a VA, based on their concerns of insolvent trading.[89] 'Ultimately, all creditors were paid 100 cents in the dollar but the shareholders experienced the destruction of the value of the business.'[90] Such an outcome illustrates that the directors did not find themselves in a position where they could uphold their fiduciary duty to

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[84] Australian Securities and Investments Commission (ASIC), 'ASIC INFO 74 - Voluntary administration: A guide for creditors', (Web Page, 1 September 2019) < https://asic.gov.au/regulatory-resources/insolvency/insolvency-for-creditors/voluntary-administration-a-guide-for-creditors/#purpose>.
[85] Australian Productivity Commission (n 2) 363.
[86] Ibid.
[87] *Corporations Act 2001* (Cth) s 435A.
[88] Australian Productivity Commission (n 2) 363.
[89] Lewis (n 65) 398.
[90] Ibid.

act in the best interests of the company, to take appropriate business risks or to be entrepreneurial.

Part 2. Why Reform was Required

A company as a separate legal entity[91] has its management vested in its board of directors.[92] Shareholders, creditors and other external parties generally are not involved in management decision making. Therefore, (as already noted above) in order to protect their interests against the possible risk of directors causing harm to the company including its assets, property and corporate and business reputation, directors as officers of a company[93] have a number of duties at common law, under equity and also under statute primarily in Part 2D.1 CA which they must abide by.

In addition to these duties, directors have a further positive duty under Part 5.7B, s 588G CA to prevent a company from trading while insolvent. This duty is owed to the company, its shareholders and its creditors.[94] As already noted, the duty does not relate to incurring a particular debt, or to creditors directly, but to maintaining the overall positive financial health of the company.[95] The Australian insolvent trading laws prior to the 2017 reforms also focused on the 'timing of when the debts [were] incurred by a company rather than the conduct of the directors in incurring that debt.'[96] This approach created a business risk averse culture for directors of companies in Australia, and any question of debt restructuring of a company by directors, even where they had the belief that they could assist it to trade out of its difficulties, was generally avoided.[97] The fear of personal liability was also felt to be disincentivising persons from taking on director roles.[98] It was recognised by many that this was an area that required reform.[99] For example, a survey of 600 directors from the largest public companies in Australia, conducted by the Australian Treasury and the Australian Institute of Company

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[91] *Corporations Act 2001* (Cth) s 124. Also see *Salomon v A Salomon And Co Ltd* [1897] AC 22.
[92] *Corporations Act 2001* (Cth) s 198A.
[93] Ibid s 9.
[94] Ibid s 588R.
[95] See *Mills v Northern Railway of Buenos Ayres Co* [1870] UKLawRpCh 73; (1870) 5 Ch App 621.
[96] Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) 7.
[97] Carmen Boothman, 'Safe Harbour or Shipwreck? Critical Analysis of the Proposed Safe Harbour for Insolvent Trading' (2016) 34 *Company and Securities Law Journal* 520, 520.
[98] See generally Andrew Keay,'Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective' (2005) 25 *Legal Studies* 431.
[99] Australian Productivity Commission (n 2) 10.

Directors in 2008[100] found that the fear of personal liability had an adverse impact on directors' business decision making.[101]

It was also argued that the corporate insolvent trading laws encouraged premature formal insolvency actions, where this may not have been in the best interests of the company, shareholders and creditors. Even where directors implemented a debt restructuring plan, where they had no reason to suspect that the company was trading while insolvent, there were significant risks and tensions under the insolvent trading laws under Part 5.7B CA prior to the introduction of the new reforms.[102] In such debt restructuring circumstances, there was much uncertainty around times when directors were undertaking negotiations with a number of stakeholders, including lenders. There was a risk that some of the company's creditors could lose faith in the actions that the directors were taking, and issue statutory demands, which could lead to a winding up of the company. Unless directors could enter into consensual restructuring agreements with major creditors (as occurred for Fitness First Ltd in 2012[103]) to avoid these risky situations, directors could find themselves either resigning or placing the company into premature voluntary administration, in order to avoid the risk of personal liability. Further, as discussed above, the defences under s 588H CA were not always available, and there were difficulties for directors solely relying on the exercise of judicial discretions under ss 1317S and 1318 CA for the exoneration of their liabilities associated with insolvent trading breaches under s 588G(2) CA. Arguably, the Australian insolvent trading laws prior to 2017 reforms thus presented directors with limited opportunities to take appropriate business risks, or to be entrepreneurial in their ventures.[104]

In the next part of this Article the legislative provisions as implemented in September 2017 which deal with insolvent trading laws under Part 5.7B CA, are discussed in greater detail together with a number of their perceived limitations and further considerations for reform.

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[100] The Australian Treasury, *Survey of Corporation Directors* (Web Page, 18 December 2008) < http://archive.treasury.gov.au/content/CorporationDirectorsSurvey/SurveySummary.html>.
[101] Ibid.
[102] Harris (n 4) 298.
[103] Pete Hayman, 'Fitness First to sell 67 UK clubs as part of restructuring process', *Health Club Management (HCM)* (Web Page, 1 June 2012) <https://www.healthclubmanagement.co.uk/health-club-management-news/Fitness-First-to-sell-67-UK-clubs-as-part-of-restructuring-process/301235?source=search>.
[104] Hon W Martin CJ, Official Opening Address, Speech delivered at the 2009 IPA Conference, Western Australia (May 28, 2009) <http://www.supremecourt.wa.gov.au>.

Part 3. The Australian Insolvent Trading Law Reforms of 2017 and Considerations for further Reform.

On 28th of March 2017, the Australian Treasury released a legislation exposure draft as part of the 2017 National Innovation and Science Agenda (NISA), which was aimed to creating the 'safe harbour' reforms.[105] Its objectives were to apply to directors of companies undertaking a restructure and to protect them from personal liability for insolvent trading in certain circumstances. On 19 September 2017, the proposed legislative reforms received Royal Assent. As a result, ss 588GA and 588GB were inserted into the CA. The objective of s 588GA CA is to provide a 'safe harbour' to directors who can show that they undertook a course of action reasonably likely to lead to a better outcome for the company and its creditors, in circumstances where they can illustrate that they had a genuine belief that they could turn around the fortunes of their company.[106] Rather than relying on when the debts were due, as was the case under the previous provisions, the new provisions now focus on the conduct of the directors.[107] Section 588GA CA also provides for a triggering event where 'a person starts to suspect the company may become or be insolvent.'[108]

The 2017 safe harbour reforms have already been subject to analysis by practitioners, professional associations and academics,[109] where some have argued that the Australian government may have missed the practicality of the provisions, because the legislators 'did not address the key issues to the challenges facing the companies and directors'[110] especially where support for directors to meet their fiduciary duty to act in the best interests of the company and its creditors was really what was required.

3.1 The Burden of Proof and the Limitations

Section 588GA(1) CA notes that s 588G(2) CA will not apply to a person where, 'at a particular time after they started to suspect that the company may became or be insolvent, they take a

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[105] Hon Kelly O'Dwyer MP, The Australian Treasury 'Government releases insolvency law reforms for consultation' (Media Release, 28 March 2017) <http://kmo.ministers.treasury.gov.au/media-release/025-2017/>.

[106] *Corporations Act 2001* (Cth) s 588GA.

[107] Explanatory Memorandum, Treasury Laws Amendment (2017 Enterprise Incentives No 2) Bill 2017 (Cth) 7.

[108] *Corporations Act 2001* (Cth) s 588GA(1)(a).

[109] See generally, Australian Turnaround Management Association (ATMA), *Navigate your Way to a Safe Harbour* (2017) <https://turnaround.org.au/wp-content/uploads/_pda/2020/01/TMA-Australia-Safe-Harbour-Guidelines.pdf>

[110] Law Council of Australia (2010), Insolvency Practitioners Association of Australia, and Turnaround Management Association Australia, *Joint Submission in Relation to Insolvent Trading Safe Harbour Options,* (2 March 2010) 7-8

course of action that is reasonably likely to lead to a better outcome for the company and the company's creditors'[111] and 'the debt is incurred in connection with that course of action.'[112] This new section shifts the evidential burden of bringing an action for a contravention of s 588G(2) CA to those who wish to rely on the breach.[113]

A plaintiff liquidator who wishes to bring proceedings for a breach of s 588G(2) CA, is required to demonstrate that on 'the balance of probabilities, the course of action being taken was not one reasonably likely to lead to a better outcome for the company.'[114] It has been argued that this presents a 'forensic burden for liquidators in addition to requiring that they prove the already difficult factual issue of insolvency at the relevant time.'[115] This can lead to problems of illegal phoenix activity and affect the recovery of preferences.[116] Arguably, the 2017 provisions may lead to even more uncertainty for directors when deciding what actions they should or should not take in times of restructuring outside of formal corporate insolvency.

3.2 Insolvency Triggers and the Limitations

The definition of insolvency in s 95A CA in the context of determining whether a director is in breach of s 588G(2) CA is presumed to assist in determining whether the director or a reasonable person in a like position was aware at the time, that there were grounds for suspecting insolvency. Section 95A(1) CA defines insolvency as a situation where a company cannot pay its debts as and when they fall due and payable.[117] This definition has been tested judicially in complex cases. In *Sandell v Porter*[118] the High Court of Australia held that the debtor's entire financial position was to be considered, rather than sole reference to its liquidity circumstances.

This position was confirmed by Owen J in *The Bell Group Ltd (in liq) v Westpac Banking Corp* (No 9)[119] who noted that the cash flow test and the balance sheet test had their own deficiencies

[111] *Corporations Act 2001* (Cth) s 588GA (1).
[112] Ibid s 588GA(1)(b).
[113] Ibid s 588GA(3).
[114] Explanatory Memorandum (n 107) 20.
[115] Helen Anderson, 'Shelter from the Storm: Phoenix Activity and the Safe Harbour' (2018) 41 *Melbourne University Law Review* 999, 1033-1034.
[116] Ibid.
[117] *Corporations Act 2001* (Cth) s 95A.
[118] (1966) 115 CLR 666, 671 (Barwick CJ).
[119] [2008] WASC 239.

when considered separately. In this case, Owen J referred to both tests to make a determination on the solvency of the company, relying on an examination of the company's 'forecast of continuing cash flow deficiencies, the substantial disconformity in value of its assets, the deterioration in value of its assets, [and] ... the deficiency of assets to liabilities ... including the substantial deficiency of current assets to current liabilities.'[120] On appeal, the Western Australia (WA) Supreme Court of Appeal affirmed Owen J's decision and dismissed Westpac's appeal, also allowing for various cross-appeals made.[121] Importantly these cases illustrate that in complex cases, both tests are to be considered contemporaneously rather than in isolation. This approach can give the court a 'complete description of the company's affairs from the evidence adduced [as much] as possible.'[122]

Despite the judicial approaches taken by the courts on the scope of s 95A CA, the 2017 insolvency law reforms did not make any changes to its statutory definition. It is arguable that the new legislative provisions do not provide any further assistance for directors as would have been expected. Accordingly, a company can be taken to be actually insolvent under s 95A CA if it cannot pay its debts as and when they are due. Cash flows are therefore still very important in this determination.[123] It is argued that this area of actual insolvency requires further attention, as directors have no more guidance as to whether they may be in a state of insolvency or not, and to whom the duties are owed. For example, a company may have liquidity issues, but these may be short term, or a subsidiary company may no longer have the financial backing of its parent, or where shareholder backing is no longer available.[124]

The definition of deemed insolvency under s 588E(4) CA also remains unchanged following the 2017 reforms. The purpose of s 588E(4) CA for deemed insolvency upon the failure of maintain proper records is '…to assist a liquidator in bringing recovery actions (including recovery actions against former directors for insolvent trading) when it is necessary to prove insolvency and the company's financial records are not available.'[125] Black J in *Re Swan*

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[120] Ibid.
[121] *Westpac Banking Corporation v The Bell Group Ltd* (In Liq) [No 3] [2012] WASCA 157.
[122] David Morrison, 'To what extent does "The point of no return" impact on the notion of balance sheet insolvency, Editorial' (2014) 22 *Insolvency Law Journal* 95, 97.
[123] *Sutherland v Hanson Construction Materials Pty Ltd* (2009) 254 ALR 650, 652.
[124] Law Council of Australia (2010) (n 110).
[125] *Trinick v Forgione* (2015) 106 ACSR 600, 628 [209].

Services Pty Ltd (in liq)[126] noted that there is a presumption in the CA that insolvency will apply throughout the period in which the company has failed to maintain financial records under s 286(1) CA. Post 2017, directors may continue to find themselves falling foul of this provision, during times of financial distress where their focus may be on restructuring and not necessarily on the maintenance of the 'books'. The complexity of decision making in these circumstances for directors has not changed. This is an area that has arguably not been given sufficient consideration under the 2017 reforms.

3.3 Timing of Debts, the Safe Harbour and the Limitations

Further, the 2017 reforms do not give any guidance to directors in determining how long they have for the safe harbour to operate. 'Most problematic is that a safe harbour, which commences at the beginning of taking an action, will end at a time which is 'reasonable' for a particular company. Reasonable time' under the new provision s 588GA(1)(b) CA is not defined. 'Reasonable time' can differ depending on the nature of the company, and whether it is a large or small organisation. Again, this adds further uncertainly for directors who find themselves placed in such circumstances.

Considering the timing when the debts are incurred is still problematic under the new provisions. The 2017 reforms appear to require directors to examine each and every debt to determine whether to act where they start 'to suspect that the company is insolvent or may become insolvent.'[127] The safe harbour for directors in relation to debts will apply where those debts are connected directly or indirectly with the course of action they have undertaken that will be reasonably likely to offer a better return on the dollar. Once the safe harbour time period has lapsed – what then? There is no guidance given under the 2017 reforms. The Explanatory Memorandum did give some guidance noting that 'debts taken for the specific purpose of affecting a restructure as part of that course (for example paying a professional turnaround advisor to provide on the course of action)'[128] could be included under the safe harbour however this arguably does not go far enough to assist directors where other types of debt could be incurred. It is posited in this Article that a better approach would be to consider debts as a whole when taking a 'course of action that is reasonably likely to lead to a better outcome for

[126] [2016] NSWSC 1724.
[127] *Corporations Act 2001* (Cth) s 588GA(1)(a).
[128] Explanatory Memorandum (n 107) 13.

the company and the company's creditors.'[129] This would require consideration of all debts taken together, rather than by examining each one in isolation.

3.4 What is a 'Better Outcome?

The 2017 reforms also raise the question as to whether the new provisions adequately assist directors in choosing a course of action that is reasonably likely to lead to a 'better outcome' for the company. The 2017 reforms require that directors demonstrate that creditors, the company and its shareholders would be in a better position because of the course of action they have undertaken, when compared to putting the company into some form of administration. The Explanatory Memorandum to the 2017 legislative reforms indicated that a 'better outcome' rested on what was reasonably likely and 'require that there is a chance of achieving a better outcome that is not fanciful or remote, but is "fair", "sufficient" or "worth noting". '[130] While this goes someway in assisting directors, it is argued in this Article that it does not go far enough. The hope to take positive action is not included.[131] Thus for those directors who let things slide, they will not be able to utilise the new safe harbour provisions.[132]

Notably, there is a non-exhaustive list provided for under s 588GA(2) CA which sets out what is required to be considered when assessing whether a director is taking a course of action that will be likely to lead to a 'better outcome' for the company in these circumstances. To date, there have been limited cases which have considered the safe harbour provisions and what amounts to a course of action that can lead to a 'better outcome' under s 588GA CA. 'Better outcome' was considered in the recent case of *Re Balmz Pty Ltd (in liq)*[133] *(Re Balmz).* In *Re Balmz*, the liquidator sought compensation in his capacity as liquidator and on behalf of the company from the defendants Mr and Mrs Patch, the directors of the company, for not preventing the company from trading whilst insolvent. Mrs Patch's submissions *interalia* relied on the applicability of the safe harbour under s 588GA CA, in order to address the issue of insolvent trading. Her submission in this regard relied on the engagement of accountant and business consultants 'Your Business Angels' to demonstrate that a 'plan' had been put together that had a chance of placing the company in a 'better position'.[134] However, the court found no

[129] Ibid.
[130] Ibid 14.
[131] Ibid.
[132] Ibid 7.
[133] *Re Balmz Pty Ltd (in liq)* [2020] VSC 652 (7 October 2020).
[134] *Corporations Act 2001* (Cth) s 588GA(1)(a).

evidence which set out the terms of engagement of 'Your Business Angels", and further, the court found that s 588GA CA had no application as the debts in question owed to the Australian Tax Office (ATO) had been incurred prior to the engagement of 'Your Business Angels' or alternatively they were not incurred in connection with any relevant 'course of action'. Further the court noted that the company had failed to pay entitlements of the employees and they also failed to comply with the requirements from the ATO.[135] As such the criteria requirements of s 588GA CA were not supported.

Consideration of s 588GA CA was also raised in *Habrok (Dalgaranga) Pty Ltd v Gascoyne Resources Ltd* [136] (*Harbrok*). In *Harbrok* the plaintiff Habrok sought to terminate a Deed of Arrangement (DOCA) that had been executed on 26 June 2020 by the first to the seventh defendants (the GCY Group) plus the eighth defendant, the company's appointed administrators, seeking instead to appoint liquidators. The company's administrators had been appointed on 2 June 2019, where they investigated the options to either recapitalise the GCY Group or alternatively sell off the GCY Group's assets which included the Dalgaranga gold mine in Western Australia. The administrator's DOCA recommended a recapitalisation. At the second creditors meetings, the holding company of Harbrok, Habrok Mining Pty Ltd (Habrok Mining), put forward one of the two alternative DOCA proposals. At the time, Harbrok was not a creditor of any entity from the GCY Group, and only submitted the alternative DOCA on the day before the second creditors meetings. At this time, the creditors voted not to adjourn, but instead voted to execute the administrator's DOCA. Despite steps being taken to implement the administrator's DOCA, Harbrok sought its termination under s 445D CA, based on a number of factors which included, *interalia* the allegation that there was a risk that related to the future insolvency of the GCY Group, despite the proposed capital raising. This was based on the GCY Group previously seeking advice from the consulting group FTI (who were later the appointed administrators) in late December 2018 as to whether the safe harbour protection under s 588GA CA from insolvent trading claims was available to the board. Harbrok argued that this raised a conflict of interest between the administrators and the board. The court however dismissed this argument, noting that FTI's prior work with the GCY Group did not impair their independence or objectivity, where Beach J noted 'FTI did not provide advice on

[135] *Re Balmz Pty Ltd (in liq)* [2020] VSC 652 (7 October 2020) at 135.
[136] *Habrok (Dalgaranga) Pty Ltd v Gascoyne Resources Ltd* [2020] FCA 1395

safe harbour, on a turnaround plan or restructuring…'.[137] The outcomes of these two early cases which briefly consider the application of the 2017 safe harbour provisions of s 588GA CA have not added any further guidance however on what a 'better outcome' means in the context of restructuring activities under the 2017 reforms.

Additional uncertainties can also arise for directors who take actions that are reasonably likely to lead to a 'better outcome' for the company, but are not 'actions' that fall under the s 588GA(2) CA parameters. In order to address some of these additional uncertainties, guidelines have been developed by the Australian Turnaround Management Association (ATMA), which cover actions such as:

- Undertaking an initial assessment of financial position of the company;
- assessing the safe harbour options;
- entering a turnaround plan; and
- monitoring performance.[138]

Despite these guidelines, it is still unknown what emphasis courts will also place on factors that fall outside of the s 588GA(2) CA provisions.

3.5 Restructuring Advisors and the Risks

A further criticism of the 2017 insolvency law reforms has been that company directors are still 'more or less' in the same position as that they were before because there is no legislatively required 'formally appointed' restructuring advisor providing an accurate and rational assessment to directors of the company's solvency. For example, the 2017 reforms provide that directors can still be 'liable where it can be shown that they are not taking a course of action reasonably likely to lead to a better outcome for the company and its creditors as a whole rather than proceeding to immediate administration or liquidation.'[139] Section 588GA(2)(d) CA does set out that one consideration which could assist in determining whether a course of action is reasonably likely to lead to a better outcome for the company, is where directors obtain advice

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137 Ibid at 452.

138 See Australian Turnaround Management Association (ATMA), Best Practice Guidelines - Navigating Safe Harbour, *Turnaround Management* (16 June 2017) <http://www.turnaround.org.au/documents/TMA_BestPracticeGuIbidelines_16.6.2017.pdf>.

139 Treasury Laws Amendment (2017 Enterprise Incentives No. 2 Bill) (Cth) (Austl.) Bill No. X, 2017, 1.15, 9.

from 'an appropriately qualified entity.'[140] However such an entity is not defined nor is the appointment of one legislatively mandated.

While the Australian Turnaround Management Association (ATMA) provided guidelines which indicated that such a person should be appropriately qualified,[141] it has been argued that there may be an emergence of 'unregulated pre-insolvency advisors to sell themselves as experts who can work within the requirements of the new law.'[142] These persons acting as pre-insolvency advisors are to be distinguished from other professionals who provide legitimate advice about restructuring such as qualified accountants and lawyers, acting as experienced specialists. Arguably, under the 2017 insolvency law reforms, when engaging pre-insolvency advisors (who may or may not be professionally qualified), directors may incur even more debt and open themselves up to unscrupulous characters who may take advantage of their vulnerabilities, [143] where the advice provided could be 'intended to benefit directors over creditors, recommend hiding or stripping assets and, at best, skirts the law if not flagrantly violates it.'[144] It is argued that the 2017 insolvency law reforms (notwithstanding the 2021 legislative changes which were recently introduced that *interalia* addresses this issue to a degree for eligible small company businesses only – see discussion below) should be amended to ensure that all external advisors are appropriately qualified, that they operate under a regulated industry and act independently.[145] In 2019, the Australian Restructuring Insolvency and Turnaround Association (ARITA) conducted a survey of its members in order to gauge the impact of non-regulated pre-insolvency advisors on the industry at that time.[146] Over 300 respondents participated in the survey. Fifty percent of respondents felt that the influence of pre-insolvency advisors was greater or slightly increased compared to 2 years prior. Thirty percent of respondents felt that increased regulation was the single best way to reduce the

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[140] *Corporations Act 2001* (Cth) s 588GA(2)(d).
[141] ATMA (n 138).
[142] Leigh Prior, *Insolvency safe harbour reforms back on the agenda, but more work needed*, Smart Corporation, (5 April 2017) <http://www.smartcorporation.com.au/business-advice/legal/insolvency-safe-harbour-reforms-back-agenda-work-needed/>.
[143] John Winter, 'Pre-insolvency advisers: No-one's problem. Everyone's problem' (2019) 31(1) *Australian Restructuring Insolvency & Turnaround Association Journal* 12, 12.
[144] Ibid.
[145] Law Council of Australia (2010) (n 110).
[146]The Australian Restructuring Insolvency and Turnaround Association (ARITA) is an organisation for restructuring, insolvency and turnaround professionals. ARITA's objective is to lead and support appropriate and efficient means to expertly manage financial recovery See <https://www.arita.com.au/ARITA/About_Us/About-Us.aspx>.

influence of such advisers, while forty percent felt that stronger enforcement of existing laws was required.[147]

As one answer to addressing these concerns, in early 2020 the *Combatting Illegal Phoenixing Act* (2020) (Cth) (*CIPA*) and the *Registries Modernization & Other Measures Act 2020* (Cth) (*RMOMA*) were enacted. The *CIPA* was designed to *inter alia* address some of the concerns surrounding the existence and activities of non-regulated pre-insolvency advisors. Its objectives are to have laws dealing with the dispositions of company property that are designed to defeat creditor claims; to address the backdating of director resignations where they are designed to avoid director liability; to introduce Goods and Services Tax (GST) liability for directors in certain circumstances; to permit the ATO to withhold any tax refunds in certain circumstances; and to also prevent creditors from facilitating illegal phoenix activity through their voting powers at creditors meetings during external administration situations.[148] It was noted in the *CIPA*'s Bill's Explanatory Memorandum that Australian businesses, employees and the government incurred costs between AUD $2.85 billion and AUD $5.13 billion in previous years from such activities.[149] The *CIPA* consists of 4 chapters that addresses creditor defeating dispositions, director resignations, GST liabilities and retention of tax refunds. The *RMOMA* has introduced a Director Identification Number (DIN), which can provide regulatory bodies and potential creditors with the ability to examine a director's history and provide for greater transparency. It could be argued that the *CIPA* and *RMOMA* form part of the additional reforms to the corporate insolvent trading provisions under the CA. It is not for this Article however to explore these new Acts and their impact on the CA insolvency reforms.

3.6 *Ipso facto* Clauses Reform and the Limitations

Also referred to 'by the fact itself', *ipso facto* clauses in commercial contracts, in circumstances of an insolvency event, can cover the termination of the contract either automatically or at the discretion of an affected party; or for rights under the contract to be modified; or for the repossession of affected property.

An insolvency event generally will refer to the company entering into external administration.

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[147] Winter (n 143) 13.
[148] Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019 (Cth).
[149] Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2019 (Cth), 'Explanatory Memorandum', 5, 1.4.

Under the 2017 insolvency law reforms, the Australian government has provided for a stay on *ipso facto* clauses during the formal external administration process. These amendments negate the effect of *ipso facto* clauses on certain types of contracts and contractual rights. The intention of this legislative approach is to give companies more of an opportunity to optimize and stabilize the company after a restructure and to provide an increased chance of selling the business.[150] Section 588GA(1)(a) CA reflects this objective where it states 'one or more courses of action that are reasonably likely to lead to a better outcome for the company.'[151] As long as there is a suspicion of insolvency then this is adequate to trigger the section.

It is arguable that the treatment of *ipso facto* clauses under the 2017 insolvency law reforms do not go far enough. The moratorium does not assist in those circumstances where creditors and suppliers refuse to extend a new line of credit to companies in times of restructure. In addition, it has been noted 'the reforms do not go far enough, because the right of a secured creditor with a security interest over the whole - or substantially the whole - of the company's property to appoint a receiver in the decision period will still exist.'[152] Further attention to this area of the insolvent trading laws is therefore required.

3.7 Non-Applicability of the 2017 Safe Harbour Provisions

Directors/persons will not be able to rely on the safe harbour provisions in those circumstances where they do not comply with the requirements placed upon them by either an external administrator or liquidator. Under s 588GB(1) CA directors / persons cannot rely on books or information to support a safe harbour for their actions taken if they do not permit the inspection or delivery of those books or information by a relevant person.

This limiting provision will not apply if directors/persons can show under s 588GB(3) CA that they didn't possess those books or information or there were no reasonable steps that they could have taken to obtains the books or information. The provisions under s 588GB CA limit a director's/person's reliance on information that may have come to light or to the attention of the director after they were directed to provide such information. It is arguably a peculiar

[150] Ibid.
[151] *Corporations Law 2001* (Cth) s 588GA(1)(a).
[152] James Dunn, 'The Safe Harbour,' Australian Institute of Corporation Directors (Web Page, 1 July 2017) <http://aicd.corporationdirectors.com.au/membership/corporation-director-magazine/ 2017-back-editions/july/safe-harbour>.

provision, as it alludes to covering books or documents that may not actually exist. Further, the provision provides an exemption where the director/person is not provided with notice that a failure to provide such books or information when requested. Again, this is problematic because under s 530A(1) CA, liquidators are not obliged to notify directors that a failure to do so will prevent them from later relying on such evidence to support a safe harbour defence. These issues need further consideration to remove these additional uncertainties.

3.8 Disclosure under the CA and Continuous Disclosure under Australian Securities Exchange (ASX), Listing Rule 3.1

Disclosures to the market and to other stakeholders is also an issue that has not been dealt with adequately under the 2017 insolvency law reforms. It appears that this has been left to companies to decide when and if they should disclose to stakeholders those actions being taken under s 588GA(2) CA. Arguably, this could be considered an appropriate approach, as disclosure during a company's restructure could undermine stakeholders' confidence which would be more detrimental to the company at that critical time. However, for disclosing entities, the operation of the ASX Listing Rule 3.1 together with ss 674 and 675 CA, the continuous disclosure rules would nevertheless apply if actions taken under s 588GA(2) CA trigger continuous disclosure obligations. If continuous disclosure provisions for these disclosing entities are not complied with, liability can be imposed upon the company involved and this may also to extend to directors.[153] Disclosing entities, when undertaking actions under s 588GA(2) CA therefore may find themselves subject to investor class actions where they fail to keep the market informed of material information. [154] This could be avoided where they can make out the applicability of one or more of the 'carve out' provisions under the ASX Listing Rule 3.1A. If any one of the carve outs apply, then directors will avoid personal liability under s 674 CA. The carve outs include circumstances where information relates to an incomplete proposal or negotiation[155] which may or may not apply to actions under s 588GA(2) CA. However, if any information is leaked to the public, the carve out provisions no longer can operate to provide protections. Again, the company and/ or its directors may be in breaches of

[153] See *Corporations Act 2001* (Cth) ss 674(2A) and 674(2B) (the due diligence defence).
[154] See Australian Securities Exchange (ASX) Listing Rules (LR) Chapter 3, Continuous Disclosure. ASX LR 3.1 sets out: 'Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information' < https://www.asx.com.au/documents/rules/Chapter03.pdf>.
[155] Ibid ASX LR 3.1A.

the law and the ASX Listing Rules. It is posited in this Article that these issues have not been adequately dealt with under the 2017 insolvent trading legislative reforms.

Part 4. COVID-19 2020 Temporary Measures and the 2021 Small Company Business Reforms

4.1 The 2020 Emergency Measures and their Shortcomings

In early 2020, the actual and potential economic impact of the COVID-19 pandemic provided the impetus for the Australian government to step in and provide temporary measures to further assist companies experiencing financial hardship. The *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) was introduced on 25 March 2020. As one measure of government assistance, temporary reliefs for companies experiencing financial distress due to the negative economic impacts of COVID-19 pandemic were provided for under the new s588GAAA CA. These included:

- a six month insolvent trading moratorium to address liability of directors for insolvent trading (not including those cases where insolvent trading falls under s 588G(3) CA)[156]
- An extension of the statutory demand period for compliance from 21 days to 6 months.[157]
- An increase in the threshold at which creditors could take action against the company under a statutory demand from $2, 000 to $20,000.[158]

There were some concerns however that the temporary measures did not go far enough to assist directors of Australian companies in these trying times. Directors could still be liable for breaches of their directors' duties under ss 180(1) and 181 CA in respect of debts being incurred which could fall under s588GAAA CA. For example, a breach of corporate insolvency laws could also be a breach of a director's duty to act with a degree of care and diligence that a reasonable person would do so in the circumstances under s 180(1) CA. Further, a breach of corporate insolvency laws could also be a breach of a director's duty to act in good faith and in the best interests of the corporation and for a proper purpose under s181 CA.[159] These risks

[156] *Corporations Act 2001* (Cth) s 588GAAA(1).
[157] *Corporations Regulations 2001* (Cth) Reg 5.4.01AA(1)
[158] Ibid Reg 5.4.01AA(2).
[159] See *Kinsela (1986)* 4 NSWLR &22, where directors allowed the company to trade whilst insolvent and *Bell Group (No 9)* (2008) 39 WAR 1 where directors allowed the company to trade while nearing insolvency. In both cases, directors were in breach of their statutory directors' duties.

continued for directors during the period of the insolvent trading moratorium. It was recommended by the Australian Law Council that this risk of exposure should have been also considered, where they noted that it 'undermine[d] the effectiveness of the new moratorium on insolvent trading claims in s 588GAAA CA… .'[160] They posited that further legislative changes were required as it was '…necessary to facilitate continuation of business in circumstances relating to the coronavirus known as COVID-19, and in order to mitigate the economic impact of COVID-19.'[161] They also noted that even if breaches of ss 180(1) and 181 CA were addressed, this would not address breaches of directors duties at common law.[162] Another concern related to the requirements of s 588GA(4) CA which continued to apply. This section requires that there is substantial compliance that all employee entitlements are paid when due, and that there is substantial compliance with all tax matters.[163] It was argued by the Law Council of Australia that s 588GA(4) CA requirements would hamper the operation and effectiveness of the temporary assistance measures under s 588GAAA CA. They argued that for a company to trade during the moratorium, they would need to incur trading debts, which would take priority over unsecured debts (including employee entitlements) so as to avoid being would up.[164]

Testing the effectiveness of the 2020 temporary moratorium provisions has yet to be determined. These temporary measures predominately concluded for most companies on 31 December 2020. From this date, the additional safe harbour protections for directors under s588GAAA CA reverted to those available under the 2017 reforms i.e. s 588GA CA, and with the minimum debt for creditor statutory demands reverting to the pre COVID-19 $2,000 statutory amount, and debtors again having the original 21 days to respond.

4.2 The 2021 Small Company Business Insolvency Law Reforms

While the temporary COVID-19 pandemic related statutory measures ceased on 31 December 2020, on 1 January 2021, the *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) (*IR Act*) and corresponding amendments made to other related Acts including the

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[160] Law Council of Australia (2020), Submission to the Australian Treasury, *Consequential corporate insolvency emergency measures,* 31 March 2020*, 12 <https://www.lawcouncil.asn.au/publicassets/60a186e5-a5a0-ea11-9434-005056be13b5/3803%20-%20Consequential%20corporate%20insolvency%20emergency%20measures.pdf>*.
[161] Ibid.
[162] Ibid. Also refer to *Corporations Act 2001* (Cth) s 185.
[163] *Corporations Act 2001* (Cth) s 588GA(4).
[164] Law Council of Australia (2020) (n 160) 14.

Corporations Act 2001 (Cth) were then introduced. These new legislative approaches were made in order to provide continuing restructuring support or for a simplified liquidation process, for small company businesses in times of financial difficulty.[165]

The 2021 reforms go some way to addressing some of the limitations of the 2017 insolvency law reforms as noted above. The *IR Act* and corresponding amendments made to other related Acts including the *Corporations Act 2001*(Cth) have been designed to provide more flexibility for small companies who are faced with two choices in times of financial difficulty. 1: In order to survive they must consider restructuring their operations; or 2: to alternatively liquidate their company but with less administrative difficulties and less costs.[166]

With respect to restructuring operations, the 2021 reforms under the *IR Act* have introduced a 'debtor in possession' process, similar to that described under the US Chapter 11 Bankruptcy provisions (see discussion on the US approach below). Unlike the VA process, where the voluntary administrator takes control of the company, the 2021 reforms permits an eligible small company business which is facing external administration, to be able to restructure existing debts while continuing to trade, under the control of its own directors.[167] This approach can support directors of eligible companies in financial distress to formulate a plan which permits them to pay off existing debts, to continue to trade and to ultimately avoid possible liquidation.

In order to access 2021 reforms for restructuring under the *IR Act*, and corresponding provisions of the *Corporations Act 2001* (Cth) eligibility criteria must however first be met. These include: total debts are less than the prescribed amount (currently at $1 million AUD); that all ATO lodgements and employee entitlements of the company are up to date; and that no directors or former directors of the company have been involved with a Small Business Debt Restructuring (SBDR) process in the last 7 years. [168]

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[165] *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) Sch 1.
[166] Ibid.
[167] *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) Sch 1 and *Corporations Act 2001* (Cth) s 453K.
[168] *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) Sch 1 and *Corporations Act 2001*(Cth) s 453C.

The 2021 reforms under the *IR Act* also provide for a simplified liquation process[169] where directors of a company can give a liquidator a declaration where they believe (on reasonable grounds) that the company can meet the eligibility criteria for the simplified liquidation process.[170] The eligibility criteria requirements for a simplified liquidation process to be adopted by a liquidator require: a triggering event;[171] the provision of reports on the company's business affairs and a declaration of eligibility for a simplified liquidation process under ss 497(4) and 498 CA; a declaration that the company will be unable to pay its debts in full within no more than twelve months from the date of the triggering event; or where the test for eligibility is based on the liabilities of the company – that test is determined on the day of the triggering event; that the company and its current directors and past directors within twelve months of the triggering event have not previously undergone a restructuring event or have been the subject of a simplified liquidation process within the last 7 years; and that the company is up to date with its tax returns and taxation reporting obligations.[172]

While the 2021 reforms under the *IR Act* and corresponding legislative updates to other related Acts, including the *Corporations Act 2001* (Cth) 2001 are a step forward to aiding small company businesses which are experiencing financial distress, is argued in this Article that they do not go far enough. Eligibility criteria for both restructuring and simplified liquidation processes should be broadened so that the 2021 reforms can apply to a wider range of Australian corporations. This could ensure that all directors of all Australian corporations are supported to meet their obligation to act in the best interests of their corporation. This approach could further encourage appropriate business risk taking under legislatively supported processes.

In the next and final part of this Article, international approaches taken in the areas of insolvency law are briefly canvassed. An overview is provided in order to further inform what

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[169] *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) Sch 3 and *Corporations Act 2001*(Cth) s 500AE.
[170] *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) Sch 3 and *Corporations Act 2001*(Cth) s 498.
[171] A triggering event under *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) Sch 3 and *Corporations Act 2001* (Cth) s 489F will include a number of situations, including a special resolution being passed under s 491 *Corporations Act 2001* (Cth) for the company to be voluntarily wound up.
[172] *Corporations Amendment (Corporate Insolvency Reforms) Act 2020* (Cth) Sch 3 and *Corporations Act 2001*(Cth) s 500AA.

additional reforms to the Australian corporate insolvent trading laws under the CA may be undertaken.

Part 5. International Corporate Insolvency Law Approaches

5.1 United States (US)

In this section a brief overview of the US approach to its corporate insolvent trading laws is provided. Historically in the US, debt restructuring of businesses that found themselves in financial distress was encouraged under the US federal law, and by the American courts.[173] For example, the early twentieth century in the US was a time for business growth,[174] however some firms were finding themselves in financial distress. Nevertheless, complex debt restructuring by managers and directors of such companies was still being encouraged at that time.[175] By the 1960s, legislative reforms were introduced in the US with a focus on restructuring of businesses within the protection of the law. In the 1980s de-regulation initiatives in the finance sector were introduced.[176] These initiatives had, for the next decade, an effect on corporate bankruptcy in the US where 'many of the deals of this era (the deal to take Macy's private, for example) were to be the bankruptcies of the next decade.'[177] By the 2000s Chapter 11 of the United States Bankruptcy Code (Code), was being relied on by many large organisations in the US, who found themselves in financial distress, to reorganise their affairs, rather than implementing an insolvency action under a Chapter 7 liquidation.[178]

In current times, under the Code, businesses that identify an inability to service their debt can file with the deferral bankruptcy court for protection under Chapter 7 of the Code. Under Chapter 7 of the Code, a process of liquidation applies, where operations cease, a trustee steps in to sell all of the business assets and then distribute the balance to creditors. Under Chapter 11 of the Code however, businesses will generally divest their operations to the debtor, as a

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[173] Rowena Olegario, *The Engine of Enterprise: Credit in America* (Harvard University Press, 2016) 73.

[174] Alfred D Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Harvard University Press, 1993) 298, 373.

[175] William D Cohan, *Money and Power: How Goldman Sachs Came to Rule the World* (Doubleday, 2011) 41.

[176] Sarah Paterson, 'Market organisations and institutions in America and England: Valuation in corporate bankruptcy' (2018) 93(3) *Chicago – Kent Law Review* 801, 818.

[177] Ibid.

[178] See Edward I Altman, Edith Hotchkiss and Wei Wang, *Corporate Financial Distress, Restructuring, and Bankruptcy: Analyse Leveraged Finance, Distressed Debt, and Bankruptcy* (Wiley Finance, 4th ed, 2019), for a discussion on Chapter 11 bankruptcy in the US over the past few decades.

'debtor in possession', within the oversight and jurisdiction of the court.[179] In this way, Chapter 11 of the Code can permit directors to 'retain control of the company subject to close court supervision.'[180] Chapter 11 bankruptcy provides for three outcomes for a business. This includes: reorganisation, conversion to a Chapter 7 bankruptcy, or dismissal.[181]

Reorganisation under Chapter 11 of the Code is possible where a debtor files with the court a plan of reorganisation. Under § 1129 of the Code, the bankruptcy court will generally approve the plan where it is satisfied that it complies with the applicable law, is feasible, is made in good faith and it is not likely to be followed by liquidation or further reorganisation.[182] Chapter 11 of the Code provides for a number of restructuring tools and options to the 'debtor in possession'. For example, the 'debtor in possession' can seek new financing options, and they are protected against other litigation by a "stay" under § 362 of the Code. The objective is for the business to eventually emerge as a going concern. This can take months or even years. It can lead to better outcomes for employees, debtors, creditors, shareholders, directors and the economy.

It is acknowledged that this Article has provided for only a brief overview of the US Code. Australia has already adopted a US Chapter 11 style approach of 'debtor in possession' under the Australian 2021 insolvency law reforms for eligible small company businesses (as discussed above). These 2021 reforms may demonstrate how some aspects of a US Code style approach can be a positive step forward for small Australian companies that may find themselves in financial distress. This new development can also provide support for further reforms to the Australian corporate insolvency laws which could apply to all Australian companies and for all Australian directors in the future. Broadening this approach so that it can apply to all Australian companies may also address the reputational damage for directors that that comes from placing their companies into voluntary administration in times of financial distress. In Australia it can be argued that the voluntary administration process leads to 'identity loss' and that an insider alternative to the current external administration approach for all

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[179] See generally Lyndon Norley, Joseph Swanson and Peter Marshall, *A Practitioner's Guide to Corporate Restructuring* (City and Financial Publishing, 1st ed, 2008).
[180] Lewis (n 65) 397.
[181] See generally US Courts, Chapter 11, Bankruptcy Basics < https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics>.
[182] Ibid.

Australian companies could be a beneficial policy change. This could provide directors of all Australian companies, in times of corporate restructuring, with more certainty in exercising their fiduciary duty to act in the best interests of their company.

5.2 New Zealand (NZ)

In New Zealand, under s 135 of the *Companies Act 1993* (NZ) (CANZ) the corporate insolvent trading laws refer to 'reckless trading' provisions which apply to directors:

> (a) who agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; (b) or cause or allow the business of the company to be carried on in a manner likely to create substantial risk of serious loss to the company's creditors.[183]

If directors are found to be in breach of s 135 CANZ, the corporate veil may be lifted where directors can be held personally liable for some or all of a liquidated company's losses. In *Mason v Lewis*[184] the NZ Court of Appeal commented that s 135 of the *Companies Act 1993* (NZ) provides that directors owe the duty to the company (not to any particular creditors). This duty is applied objectively and does not rest on the directors' belief. In particular the court has noted 'what is required when the company enters troubled financial waters is ... a "sober assessment" by the directors ... of an ongoing character, as to the company's likely future income and prospects.'[185] Under s 301 CANZ, on application by a liquidator, a creditor or a shareholder, the court can order directors to pay, by way of compensation, an amount that 'the court thinks just'.[186]

Two recent cases highlight two different approaches taken by NZ courts in determining when a breach of s135 CANZ has occurred and the remedies to be applied. In *Mainzeal Property and Construction Ltd (in liq) v Yan*[187], the directors of Mainzeal Construction were found to be liable for ongoing trading of the company while it was in a 'vulnerable state'. They were found to be liable for all of the company's trading losses on liquidation, of around $110 million NZ dollars. The directors were also imposed personally with a compensation award under s 301 CANZ of $36 million NZ dollars. In the latter case of *Cooper v Debut Homes Ltd (in liq)*[188], the NZ Court of Appeal however reaffirmed orthodox principles, finding that ongoing trading

[183] *Companies Act 1993* (NZ) s 135.
[184] [2006] 3 NZLR 225 [51].
[185] Ibid.
[186] *Companies Act 1993* (NZ) s 301.
[187] [2019] NZHC 255.
[188] [2019] NZCA 39.

by a director of a distressed residential property developer was not reckless, and that trading whilst insolvent did not automatically mean that director liability was made out. The court noted that risk is to be considered alongside potential advantage. In this case, the court found that the decision by the director to complete the houses was the better commercial decision when compared to not completing them and walking away.

The insolvency law in NZ is thus based not on the mere fact of insolvency and a reasonable suspicion of insolvency, but rather on legitimate and illegitimate business taking risks where the former can allow directors to continue to trade if they have 'realistic prospects of generating sufficient revenue to meet current and future liabilities.'[189] It can be argued that the Australian provisions with regards to insolvency can also benefit from such an approach, where the focus should not be on 'suspicion of insolvency' which can be difficult to gauge (as noted above) but rather on the taking of 'legitimate business' risks.

5.3 United Kingdom (UK)

In the UK, under s 214 of the *Insolvency Act 1986* (UK), a wrongful trading breach is somewhat similar in nature to the operation of s 588G(2) CA in Australia. The UK provisions also consider that a company is insolvent where it cannot meet its obligations, based on 'whether the state of the company's financial affairs are such that it can be said to be in a state of financial distress.'[190] The *Insolvency Act 1986* (UK) also encompasses fraudulent trading provisions[191] together with the wrongful trading provisions.[192] Fraudulent trading will apply where a business is carried on with the purpose to defraud creditors, with criminal sanctions applying. A breach of the wrongful trading provisions however, will occur where a director 'knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquation.'[193] There is however no definitive legislative definition of insolvency in the UK. A determination of insolvency relies on a number of tests as set out in various statutes, the main ones being the cash flow test and the balance sheet test.[194] Under s

[189] *Grant v Johnson* [2016] NZCA 157 [37].
[190] Winter (n 142) 97.
[191] *Insolvency Act 1986* (UK) s 214.
[192] Ibid s 213.
[193] Ibid s 214(2).
[194] See *Insolvency Act 1986* (UK), together with the *Insolvency Rules 1986* (UK) and the *Corporation Director Disqualification Act 1986* (UK). For example, s 6(2) of the *Corporation Director Disqualification Act 1986* (UK) provides that where the corporation fails the balance sheet test, one outcome is for the disqualification of a director of a corporation.

123(1) of the *Insolvency Act 1986 (UK),* a cash flow test rests on 'whether or not the company can pay its debts as and when they fall due'.[195] Section 123(2) of the *Insolvency Act 1986 (UK)* then refers to the balance sheet test, where a consideration of whether the assets of the company are sufficient to pay for the liabilities of the company applies. The application of the balance sheet test taken on its own has not been a precise matter however. In *Deiulemar Shipping SpA v Transfield ER Futures Ltd*[196] the High Court held that balance sheet insolvency could not be made out solely on the basis of fluctuations in the value of the defendant's assets which caused the company to be in an unfavourable financial position.[197]

In the *BNY Corporate Trustee Service Ltd v Eurosail*,[198] the UK Court of Appeal and the UK Supreme Court also considered the balance sheet test under s 123(2) of the *Insolvency Act 1986* (UK). Both courts rejected the view that the balance sheet test in s123(2) of the *Insolvency Act 1986* (UK) would only apply when the 'point of no return' had been reached. Following this case, directors of companies the UK now have some comfort in that their company's financial position will not be judged based on some mathematical determination of subtracting its liabilities from its assets. The balance sheet test is thus to be viewed as a supplementary approach when applying the cash flow test. The UK courts have also recently reaffirmed directors common law duty to consider the interests of creditors before actual insolvency, in those circumstances where they knew or should have known that insolvency was likely.[199] These approaches are very similar in approach to that taken by the courts in Australia (as discussed above).

The UK wrongful trading provisions are focused on 'a lack of reasonable prospects of saving the company from liquidation,'[200] and allow directors to restructure and continue to trade where there is a reasonable prospect that the company will not go into liquidation if they do so. These 'wrongful trading' provisions can allow for appropriate risk taking and entrepreneurial activity, and arguably go even further than the 2017 Australian insolvency law reforms permit.

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[195] *Insolvency Act 1986* (UK) s 123(1)(e).
[196] [2012] EWHC 928.
[197] Ibid.
[198] *BNY Corporate Trustee Service Ltd v Eurosail 2007-3BL Plc* [2013] UKSC 28; P*BNY Corporate Trustee Service Ltd v Eurosail 2007-3BL Plc* [2011] EWCA Civ 227.
[199] *BTI 2014 LLC v Sequana S.A. [2019] EWCA Civ 112*.
[200] Lewis (n 65) 398.

Conclusion

Prior to 2017, the corporate insolvent trading laws in Australia were in dire need for reform, as they affected directors' decision making, in those circumstances where they could/ should have taken appropriate business risks, but did not for fear of personal liability being imposed upon them. The defences under s 588H CA were and continue to be limited, and the judicial discretions provided for under ss1317S and 1318 CA cannot be relied upon to encourage entrepreneurial activity, nor are they appropriate restructuring tools that directors should rely on.

It has now been three years since the introduction of the 2017 reforms to the insolvency laws in Australia. Section 588HA CA required that the reforms be reviewed after 2 years of implementation, however to date this has not formally occurred. It could be argued that the delay was due to the two-year review period being too short for the laws to be effectively reviewed, together perhaps with the impact of COVID-19 in 2020. The 2017 reform provisions have only been judicially considered in a limited way to date and a number of the 2017 insolvency law reforms limitations do require further consideration. Notably, the recent reforms introduced in January 2021 under the *IR Act* and other associated Acts including the CA do go some way to further assist eligible small company businesses and their directors. These reforms appear to draw from the Chapter 11 Bankruptcy US Code. It is argued that as well as addressing many of the limitations associated with the 2017 insolvency law reforms as identified in this Article, consideration should also be given to broadening the 2021 *IR Act* approach to all directors of all Australian companies where it can provide a workable and adequately supported 'safe harbour' in times of corporate financial and operational restructuring (outside of formal insolvency) for all Australian directors. To do so will more effectively promote entrepreneurship and innovation in Australia, and one which supports directors of all Australian companies to take actions that are in the best interests of their companies.