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LAWYERS

Navigating Corporations through COVID-19 | Director's duties, insolvency and safe harbour protections

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1. Introduction

1.1 The COVID-19 pandemic has resulted in extraordinary challenges for many businesses and corporations. Not all businesses have been affected equally and tourism, restaurants, retail and airlines have been amongst those hardest hit. What to do next is unclear.

1.2 Firstly, much is out of the control of the actual business owners themselves, as state and federal governments take varying authoritarian measures to contain the spread of the virus, including mandatory closing or limiting of business. Secondly, the virus itself is unpredictable and a function of exponentiality, which makes it hard to anticipate how soon the virus will be contained, or how disruptive it will be. Thirdly, the free market is distorted by mandatory rent abatements and reductions for many affected small to medium enterprises (SMEs), Jobkeeper incentives and various grants and loans in an extremely low interest rate environment where credit is still available.

1.3 As a result, it is incredibly difficult for corporate officers of SME's to forecast whether this is a temporary impact requiring an injection of new capital (or restructure of existing liabilities) to trade out of the problem, or whether they are treading perilously close to insolvency. As the forecasting becomes more difficult and financial pressures mount, it is timely to revisit directors' duties and responsibilities.

2. Directors' Duties

2.1 Refresher on directors' duties generally

(a) Directors' duties are imposed by the *Corporations Act 2001* (Cth) (**the Act**). The Act prescribes the following general duties for directors:

(i) the duty to exercise powers and duties with the care and diligence that a reasonable person would have, which includes taking steps to ensure the director is properly informed about the financial position of the company and ensuring the company doesn't trade if it is insolvent;

(ii) the duty to exercise the director's powers and duties in good faith in the best interests of the company and for a proper purpose;

(iii) the duty not to improperly use the director's position to gain an advantage for the director or someone else, or to cause detriment to the company; and

(iv) the duty not to improperly use information obtained through the director's position to gain an advantage for the director or someone else, or to cause detriment to the company.

2.2 Director's duty not to trade while insolvent

(a) In addition to the general directors' duties, directors also have a duty to ensure that their company does not trade whilst insolvent or when they suspect it might be insolvent. A company is insolvent if it is unable to pay all its debts as and when they are due.

(b) Specifically, section 588G of the Act requires a director to prevent the company from incurring a debt if:

(i) the company is already insolvent at the time the debt is incurred; or

(ii) by incurring that debt (or that debt amongst others), the company becomes insolvent, and at the time of incurring the debt, there are reasonable grounds for suspecting the company is already insolvent, or would become insolvent by incurring the debt.

(c) You should ensure your clients are constantly aware of their company's financial position each time the company is considering incurring a debt. An understanding of the financial position of the company only at the time a director signs off on the annual financial statements is insufficient.

2.3 Penalties of Breaching Duty not to Trade while Insolvent

(a) There are two standards of liability in the event a director breaches his or her duty not to trade insolvently. One is a civil penalty standard in situations where there are grounds for suspecting insolvency. The second is a criminal penalty where a director suspects the company is insolvent at the time of incurring the debt (or would become insolvent upon incurring the debt) and the failure to prevent the company incurring the debt was dishonest.

(i) **Civil Offences** - If a director is found to have breached the civil penalty provisions under s588(2) of the Act, then the Court may order anyone, combination or all of the following penalties:

Type of Penalty	Description
1. Compensation Order	Director is personally liable to pay compensation to the company equal to the amount of the loss suffered as a result of the director failing to prevent the company from incurring debts while it was insolvent.
2. Pecuniary Penalty Order	Director to pay a pecuniary penalty to the Commonwealth of up to $200,000 if the Court finds that the director's failure to prevent insolvent trading is serious or materially prejudices the interests of the company or the company's ability to pay its creditors.
3. Disqualification	Court may disqualify the director from managing a corporation for a period of time considered appropriate in the specific circumstances.

(ii) **B. Criminal Offences -** If a director is found to have committed a criminal offence under s588G(3) of the Act, then the Court may make one or more of the following orders:

Type of Penalty	Description
1. Penalty Order	Director may be ordered to pay a penalty of up to $420,000.
2. Imprisonment	Director to be imprisoned for up to five years.

3. Safe Harbour Provisions

3.1 What are 'safe harbour' provisions?

(a) In September 2017, 'safe harbour' provisions were introduced to the Act, bringing some **conditional** relief for directors attempting to trade a company out of a difficult financial position.

(b) The 'safe harbour' provisions are contained in s 588GA of the Act and directors may now claim an exception for insolvent trading if:

(i) at a **particular** time after a director starts to suspect a company may become (or already is) insolvent, the director starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and

(ii) the **debt** is incurred directly or indirectly in connection with that course of action and during a specified time.

3.2 Relying on Safe Harbour Provisions

(a) The protection of safe harbour provisions only apply to debt incurred directly or indirectly in connection to a course of action that is reasonably likely to lead to a better outcome for the company. Relevantly, it is important for a director to identify:

(i) where the **company** is currently situated;

(ii) the current trajectory of the company without altering its course or making changes to its operation; and

(iii) strategies and changes that may make the company <u>better</u>.

(b) In order for a director to implement the above steps and safely rely on the Safe Harbour provisions, he or she must:

(i) **acknowledge the financial position of the company and carefully document same**. In order to do this, directors must properly inform themselves of the company's financial position by, for instance, engaging an auditor to assess the company's solvency;

(ii) **ensure employee entitlements and taxation reporting obligations are being met at all times**;

(iii) **review internal processes to ensure the director is operating on correct data.** For example, if the director is heavily dependent on the collation and analysis of data presented by the company's employees, the director should check that the process is producing reliable data;

(iv) **implement measures to ensure the company is keeping appropriate financial records and be able to demonstrate such measures are in place.** It may also be necessary to reassess the regularity and degree of scrutiny that the director (or board of directors) gives to the financial status of the company;

(v) **clearly identify the course of action (if available) and obtain 'time stamped' third party professional advice on the probabilities of success.** Obtaining advices from experts will allow a director to rely on the advice to justify actions taken. A relevant expert may include an accountant, an insolvency or restructuring practitioners or a lawyer operating in the field. If your client approaches you for advice, you should inform them of your experience in the area and ensure you are comfortable in acting. For example, if you are an accountant and your client requests advice on whether restructuring the company is reasonably likely to lead to a better outcome than liquidation, and you have no experience in restructuring, it is best to refer your client to someone with the necessary expertise to provide that advice;

(vi) **continually review and assess the course of action and the status of the company.** Simply obtaining 'time-stamped' advice at the point a course of action is identified is not enough. Just because a course of action is reasonably likely to lead to a better outcome at one point in time does not mean the same course of action will remain reasonably likely to lead to a better outcome at some point in the future. The situation could be very fluid, the circumstances could change quickly and new information may arise, requiring a re-assessment of the suitability of the course of action. For this reason, you should encourage your clients to consider a continuing and regular engagement with relevant advisors to regularly review and confirm advice; and

(vii) **clearly document the rationale of any course of action embarked upon, including data to hand and professional advice relied upon**.

3.3 What is a ‘better outcome’

(a) A better outcome can be broadly construed, but essentially it is anything that staves off or defers insolvency. If the outcome is only a deferral of insolvency, it may simply be an improvement of the situation.

(b) A range of probabilities arise from any decision a director makes. It will rarely be certain that a ‘better outcome’ will be the result of a course of action at the point of undertaking that course of action. It is important not to judge decisions on outcome alone because it is possible some situations may present an attractive ‘heads I win, tails I lose less’ probability, for example where if the course of action:

(i) is successful, there is a **moderate probability of** the company returning to **solvency**;

(ii) is unsuccessful then there is a **moderate to high probability** the company’s **position** will have been **improved** despite entering insolvency (i.e. better cents in a dollar return for creditors; potential of return of some capital to shareholders); and

(iii) has a **low probability of worsening** the situation.

3.4 A director’s entitlement to Safe Harbour Protection - what is ‘reasonably likely’ in the eyes of a judge?

(a) If a company, despite implementing a course of action which a director believed was reasonably likely to lead to a better outcome, enters insolvency, then the director may need to rely on the protection afforded by the safe harbour provisions.

(b) A judge assessing the decisions of a director of an insolvent company does so with the benefit of hindsight. A judge is armed with the law and presented with evidence. The judge is not a financial expert. Consequently, a judge will receive and consider expert evidence to help the judge come to his or her decision. Relevant experts may include an insolvency practitioner, an experienced executive (to explain unique features of a particular industry) or a forensic accountant. It is then necessary to consider the process of an expert witness. The expert witness will typically be independent, and will be briefed in, and will opine on, the facts of the matter and primary information (for example, the financials for the company at a point in time).

(c) A course of action:

(i) must be judged by the information available and advice obtained by the director at the time; and

(ii) will evolve over time and space. It may be that a course of action is commenced, but unforeseen events overtake the company and the course of action must be stopped or altered.

(d) The director bears the evidential burden of demonstrating they are entitled to safe harbour protection. Accordingly, if your client is considering undertaking a course of action for a better outcome under the safe harbour provisions, ensure that they have considered each of the factors at 3.2 above when proceeding with any course of action.

4. Covid-19 Additional Safe Harbour Provisions

On 25 March 2020, the *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) (**COVID Act**) came into force.

4.1 COVID Act Amendments

(a) The COVID Act is relevant to a director's duty in relation to insolvent trading because, in addition to the current safe harbour provisions, the COVID Act inserts a new section 588GAAA to the *Corporations Act* which provides further temporary safe harbour provisions, namely:

(i) temporary relief to directors from personal liability for insolvent trading where the debts are incurred in the ordinary course of business for six months (being up to and including 24 September 2020) prior to the appointment of an administrator or liquidator;

(ii) a raise in the minimum threshold for a creditor to issue a statutory demand from a debt of $2,000 to $20,000; and

(iii) a company has six months to respond to a creditor's statutory demand rather than the usual 21 days.

(b) In effect, the COVID Act has 'paused' some of the usual insolvent trading rules with a view to allowing directors the necessary time and space to make decisions about the company without the added pressure of personal liability during what has been (and still is) a tough economic climate. This is not to say that the COVID Act simply gives directors 'get-out-of-jail free' card. Cases of insolvent trading which involve dishonesty and fraud will certainly still be subject to criminal penalties.

4.2 A coming storm?

(a) It is extremely difficult to forecast at date of writing:

(i) the continuing impact of COVID-19 in terms of public health, and whether there is more than one wave of infection;

(ii) actions taken by government to reduce the spread of COVID-19;

(iii) actions taken by government to stimulate the economy; and

(iv) the overall degradation of the economy. Economies are not a wholly mechanical function. Rather, they are an example of a complex system largely driven by the psychology of sentiment and confidence. We live in a globalised economy, and volatility and risk spread rapidly across the globe. It is not known, for example, what the status of the credit market will be (and willingness of lenders to lend) in September 2020 onwards.

(b) It is therefore important to bear in mind the current stressors on businesses, particularly small or medium-sized businesses, and to consider the impact on directors. Moving forward it seems very likely that directors will increasingly require timely and accurate advice as to their duties and obligations.

5. Workshop

5.1 Considerations for ASIC investigations into actions taken whilst in 'safe harbour'

(a) The Australian Securities & Investments Commission (**ASIC**) is charged with investigating and prosecuting breaches of director's duties. This workshop is aimed at criminal prosecutions, but many of the considerations are also largely relevant to civil prosecutions too.

(b) It is rare that ASIC will initiate a prosecution against an individual without engaging in a dialogue first. It is a well enshrined principle of any enforcing authority that it will offer an opportunity for the subject of the investigation to justify and explain his or her actions.

(c) The following are relevant factors for ASIC in how it conducts its investigations:

(i) limited resources. Investigations and prosecutions are very resource intensive and expensive to conduct. At any point in time ASIC will have a limited amount of suitably qualified personnel to investigate potential breaches of director's duties. Consequently, ASIC will generally try to apply its resources to matters:

I. of high profile, so that it can be clearly seen to be discharging its duties to deter flagrant breaches;
II. of significant value and worth;
III. where there is a sufficiency of evidence to proceed, and a successful outcome for ASIC is likely; and
IV. where it is in the public interest to proceed;

(ii) the antecedents of the investigated person. Is this a person who has a history of non-compliance? What is the level of sophistication of this person? Are they an ASX 300 listed director, or are they a 'mum and dad' small business owner attempting to use a sophisticated corporate structure they may not fully understand; and

(iii) alternatives to prosecution. It is far quicker and more cost effective to achieve a negotiated resolution. The principles of sentencing are fundamentally targeted at correcting behaviour. Punishment is a traditional sentencing tool in the event ASIC are successful in their prosecution but is only one of many considerations. ASIC has the discretion to resolve matters without prosecution and will be more likely to do so when an investigated party cooperates (reasonably, avoiding unnecessary self-incrimination) and expresses contrition and a willingness to remedy a shortfall in knowledge.

5.2 How active are ASIC?

(a) In 2018-2019 ASIC:

(i) reported the existence of 2.7 million companies, of which 223,661 were registered in that time period;

(ii) commenced 151 investigations;

(iii) completed 103 investigations;

(iv) conducted 369 prosecutions for strict liability offences;

(v) commenced 14 criminal prosecutions;

(vi) commenced 55 civil prosecutions;

(vii) took on average 39 months to investigate and achieve a court outcome in civil prosecutions; and

(viii) took on average 52 months to investigate and achieve a court outcome in criminal prosecutions.

(b) The key takeaways are that:

(i) ASIC are very targeted in their use of resources; and

(ii) there appear to be many opportunities to resolve investigations prior to prosecution.

5.3 How do ASIC become aware of breaches of director's duties?

(a) While a company officer is appointed a director, he or she will have fairly small oversight, especially if they are the sole director and sole shareholder.

(b) The majority of ASIC investigations are initiated after:

(i) the company becomes insolvent; and

(ii) a liquidator discovers and reports the activity of the director.

5.4 Strategies

(a) A prosecution is always regarding an act or omission to act that makes the person who acted or omitted to act liable to prosecution. It is therefore always necessary to isolate the act/s or omission/s to act and consider them objectively but in context.

(b) Before any statement or admission is made, the first step of an investigated director should be to:

(i) collect all the facts and evidence of the relevant acts or omissions to act;

(ii) brief a competent lawyer to review the facts and advise on the legal position. It is important to note that the lawyer should be engaged by the director to advise the director in a personal capacity, and not the company;

(iii) form a case theory. What the director did, why, and the context of those actions.

(c) After obtaining advice, sensibly engage with the liquidator to explain the director's actions, using the case theory and providing relevant evidence.

(d) In the event ASIC are involved, engaging with ASIC in a similar fashion to the liquidator, building on the case theory with a view to satisfying ASIC that:

(i) the director's actions were lawful and justified; and/or

(ii) ASIC should exercise its discretion not to prosecute.

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