IN FOCUS

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INFORMAL WORKOUTS
SAFE HARBOUR

HALL CHADWICK

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In our In Focus Publication "Financial Solutions" we noted we would provide further detail with respect to various corporate restructuring options available – both informal and formal.

In this edition of In Focus we focus on informal workouts

Informal Workout

If action is taken early, an informal workout may be able to be effected, without the stigma of a formal appointment, which could reduce the value of the assets of a company or lead to the loss of confidence of investors and/or customers.

Furthermore, generally a formal appointment will involve additional costs, adverse publicity and result in an independent practitioner controlling the company's business, property and affairs.

The advantages of a workout are as follows: -

- Reduction in costs;
- Directors retain control of the business;
- The company's reputation can be preserved;
- Directors can avoid insolvent trading and other voidable transaction recoveries;
- It is not a creditor driven process

The disadvantages of a workout are as follows: -

- Directors may be found during the process to have breached their directors duties;
- Any standstill and workout agreement requires the agreement of all creditors, i.e. without such agreement the non-consenting creditors are free to pursue their normal legal remedies and this can jeopardise the objectives of the workout. This is contrasted with a VA, wherein the decision of the creditors present, and voting at the Section 439A meeting, binds the entire body of creditors. Hence, formal administration can provide for more certainty than an informal workout;
- Financiers can potentially fall foul of the Corporations Act provisions with respect to insolvent trading by 'shadow' directors;
- Directors may be held liable for insolvent trading;

The safe harbour protection introduced in 2017 into the Corporations Act with respect to insolvent trading could be utilised in conjunction with an informal workout strategy when the threshold of insolvency approaches

Safe Harbour

Pursuant to Section 588G(1) of the Corporations Act – Director's duty to prevent insolvent trading by company, a director of a company can be held personally liable if : -

a. a person is a director of a company at the time when the company incurs a debt; and

b. the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and

c. at that time, there are reasonable grounds for suspecting that the company is insolvent, or would become so, as the case may be; and

The risk of being held personally liable (and also criminal liability) can be seen as a trigger for director's to place the company into Voluntary Administration prematurely rather than working towards a restructure outside of a formal appointment in a distressed situation.

The Government considered that the introduction of a safe harbour to the insolvent trading provisions would *facilitate the restructure of businesses, striking a better balance between encouraging entrepreneurship and protecting creditors.*

Directors are provided with a 'carve out', against liability for insolvent trading as opposed to a defence to insolvent trading where they "start taking a course of action that is reasonably likely to lead to a better outcome for the company and the company's creditors" than an external administration. This shifts the evidential burden away from the director, to the party alleging the safe harbour does not apply.

It should be noted that such protection only extends to debts "incurred in connection with that course of action."

This model looks to protect directors against insolvent trading claims where a director has been acting in the best interests of the company and its creditors as a whole with a safe harbour within which they may attempt to return the company to solvency.

Carve out

- If the debt was incurred as part of reasonable steps to maintain or return the company to solvency within a reasonable period of time; and
- The person held the honest and reasonable belief that incurring the debt was in the best interests of the company and its creditors as a whole; and
- Incurring the debt does not materially increase the risk of serious loss to creditors.

The better "outcome" test is an objective test, dependant on the circumstances of each case.

Factors to be considered

- The steps taken to prevent misconduct by officers and employees of the company;
- The steps taken to ensure the company maintains appropriate financial records;
- Obtaining appropriate advice from an appropriately qualified entity;
- The director keeping themselves informed about the company's financial position;
- Developing and implementing a restructuring plan to improve the company's financial position.

Exclusions

- A person who is disqualified from managing a corporation at the time the debt was accrued;
- Australian Securities & Investments Commission ("ASIC") has determined the person was ineligible as a result of prior conduct;
- There has been a substantial failure to meet its taxation law reporting requirements or is one of two or more such failures by the company during the 12 month period prior to the debt being incurred; and
- There has been a substantial failure to pay employee entitlements, including superannuation contributions.

End of Protection

a. the action ends;

b. the course of action stops being reasonably likely to result in a better outcome for the company and its creditors; or

c. the company enters external administration.

Public Companies – ASX Listing Rules

ASX Guidance note 8 makes it clear that entities in financial difficulties are subject to the same disclosure obligations as other entities.

Listing Rule 5.10 was amended in March 2018 to reflect the availability of the safe harbour.

The fact that an entity's directors are relying on the insolvent trading safe harbour provisions to develop a course of action that may lead to a better outcome for the entity, is not something that ASX would generally require an entity to disclose under Listing Rule 3.1.

ASX is of the view that investors would expect directors of an entity in financial difficulty to be considering whether there is a better alternative for the entity and its shareholders than an insolvent administration. The fact they are doing so is not likely to require disclosure unless it ceases to be confidential or a definite course of action has been determined.

ASX takes the view the appropriate course when an entity is attempting a financial restructure or reorganisation, is to approach ASX with respect to a voluntary listing suspension to manage its disclosure obligations.

Safe Harbour in Practice

When reviewing the effectiveness of the provisions it should be borne in mind that there is no statutory record of companies adopting the safe harbour, and much of the negotiation is likely to be conducted in confidential circumstances.

Therefore we are largely left with anecdotal evidence of the utilisation of the safe harbour, which suggests that it has not been embraced as widely as anticipated to date.

The research that is available suggests that safe harbour advice is more likely to be utilised by public companies and large proprietary companies rather than small business.

This stands to reason for a number of reasons:

- Such companies are more likely to satisfy the safe harbour qualification criteria;
- Such companies have the resources to pay for safe harbour advice and implementation of restructure plans;
- Directors of smaller companies are likely to already be personally exposed by way of personal guarantees.

Having said that safe harbour may be appropriate in the following circumstances:

Where a company is asset rich – cash flow poor – the safe harbour could be utilised to execute a strategy of selling illiquid assets with a supportive creditor base;

Pre-positioned sales – the safe harbour may be useful to provide directors sufficient comfort to pursue a pre appointment sale if it is the best interests of creditors;

White Knight Transactions - If a company is relying on a last ditch sale process to generate liquidity to save the business, it is sensible for the directors to form the view that this represents a better outcome for the company in accordance with safe harbour provisions.

Refinance Negotiations - The safe harbour could provide directors protection, in respect of refinance negotiations conducted in distressed conditions should those negotiations ultimately prove to be unsuccessful.

General Comments

- The Governments stated agenda of "hibernating" effected businesses for the duration of the health measures associated with containing the corona virus is effectively encouraging informal workouts of varying sizes and complexity on an unprecedented level;
- Pursuant to the Coronavirus Economic Reform Package Omnibus Act 2020 (Cth) all company directors will be temporarily released of their duty to prevent insolvent trading with respect to any debts incurred in the ordinary course of the company's business. Accordingly, the potential of personal liability for insolvent trading is lifted for the 6 month duration of the legislation. To secure the relief, debts must be incurred in the ordinary course of the company's business i.e that is necessary to facilitate the continuation of the business. This has been characterised as a second temporary safe harbour.

  Notwithstanding this relief directors should be aware that this does not absolve them of their fiduciary duties as a director, which include, acting with due care and diligence, acting in good faith and for a proper purpose;
- It may be that the existing safe harbour framework should also be considered if available as if applied correctly it provides a evidential framework for decisions made during the safe harbour period by way of a turnaround plan. Further the cash flow implications for many businesses may extend beyond the six month period of the temporary relief provided by the Omnibus Act;
- An element of the safe harbour requires that directors form the reasonable opinion that the steps they are taking are in the best interests of creditors. In the prevailing business conditions this is a significant burden due to uncertainties associated with the length of the restrictions on restoration of normal trading conditions and resultant difficulties of budgeting cashflow with any degree of accuracy.
- Accordingly any safe harbour restructuring plan entered into in this period would require careful monitoring to ensure it continues to provide the intended protections for both directors and creditors

HALL CHADWICK

For more information, please contact your local Hall Chadwick office:

NEW SOUTH WALES
Level 40, 2 Park Street
Sydney NSW 2000
Tel: +61 2 9263 2600
sydney@hallchadwick.com.au

SOUTH AUSTRALIA
Level 21, 25 Grenfell Street
Adelaide SA 5000
Tel: +61 8 8545 8422
adelaide@hallchadwick.com.au

VICTORIA
Level 14, 440 Collins Street
Melbourne VIC 3000
Tel: +61 3 9820 6400
hcm@hallchadwickmelb.com.au

QUEENSLAND
Level 4, 240 Queen Street
Brisbane QLD 4000
Tel: +61 7 3211 1250
brisbane@hallchadwick.com.au

WESTERN AUSTRALIA
Level 11 Allendale Square,
77 St Georges Terrace Perth WA 6000
Tel: +61 8 6557 6200
perth@hallchadwick.com.au

NORTHERN TERRITORY
Paspalis Business Centre
Level 1, 48-50 Smith St Darwin NT 0800
Tel: +61 8 8943 0645
darwin@hallchadwick.com.au

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