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Director Liability and Insolvency Laws

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COVID-19: Important changes to director and officer liability and insolvency laws

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These changes start now

Effective from 25 March 2020, the federal government has implemented a six-month period of temporary relief for directors from personal liability for trading while insolvent as part of its COVID-19 response package. These changes are welcome breathing space for business owners, directors and boards who are navigating the challenges of financial distress due to COVID-19.

Lifting of director liability for insolvent trading

Under insolvent trading laws in section 588G of the Corporations Act, directors can be held personally liable for debts incurred by the company if, at the time the debts were incurred, there were 'reasonable grounds' to suspect that the company was insolvent or would become insolvent by incurring the debt. An insolvent company is one that is unable to pay its debts when they fall due.

Under the *Coronavirus Economic Response Package Omnibus Act 2020* (Cth) (No 22), (the ACT) for a period of 6 months from 25 March 2020, directors are relieved of personal liability for insolvent trading if a debt is incurred:

In the ordinary course of the company's business	**During the 6 month period commencing 25 March 2020**	**Before appointment of an administrator or liquidator**

What is *'in the ordinary course of business'*?

Every business is different, so the law is not prescriptive regarding what debts will be in the ordinary course of business. However, in the current context this may be broader than usual legal interpretations, so a debt may be considered to be incurred in the ordinary course of business if it is necessary to facilitate business continuity during the 6 month period. For example, the Explanatory Memorandum to the Act suggests this could include debts incurred through continuing to pay employees during the COVID-19 pandemic, or taking out a loan to move some business operations online.

How is this different to the existing Safe Harbour regime?

The Safe Harbour regime is explained in further detail below. The key difference is that this temporary expansion of the safe harbour defence is less technical, broader in nature and easier to satisfy. Most importantly, it provides protection for a broader category of debts and is not confined to actions arising to specifically preserve or restructure the company as it moves closer to insolvency.

Evidentiary burden: How do directors invoke these measures?

This relief provides a broadening of the existing defence to a claim of insolvent trading. The director or person seeking to rely on these temporary measures will bear the burden of proof. Accordingly, the director or board will need to be able to produce evidence (e.g. factual circumstances, timing, board minutes and considerations, advice from financial advisors and lawyers) that supports a reasonable possibility that the debt was incurred in the ordinary course of business. However, this reform is certainly not a 'free pass'. Directors must continue to carefully oversee the solvency of their organisation and mitigate the potential long term impact of excessive debts incurred during this period.

Don't forget the existing Safe Harbour Regime

In 2017, Australia introduced new 'Safe Harbour' laws which offered protection from personal director liability for debts incurred as part of pursuing a turnaround plan that was reasonably likely to result in a 'better outcome' than insolvency. Aimed at encouraging directors and officers to pursue rescue and restructuring plans rather than placing an insolvent company immediately into external administration, this regime and the 6 month temporary relief from personal liability for insolvent trading are important mechanisms for business owners and directors trying to do all that they can to survive this crisis.

To rely on the existing Safe Harbour regime, a director or officer must satisfy certain requirements and receive appropriate advice, including:

Mandatory thresholds	Course of action	Nature of debts
• Whether the company substantially met its obligations to: > Pay employee entitlements (including superannuation) > Maintain books and records > Tax reporting > Provide information to administrators if appointed	• Developing one or more courses of action that are **reasonably likely to lead to a better outcome** than an immediate liquidation or voluntary administration • Usually developed in conjunction with financial and legal advisors	• Debts incurred directly or indirectly in connection with the course of action • Alternatively, no significant debts were incurred / ordinary trading debts paid as and when they fell due

Other director duties continue to apply

All other Corporations Act duties will continue to apply, including:

> duty to act with care and diligence

> duty to act in good faith in the best interests of the company and for a proper purpose

> duty to not improperly use their position or information received for personal gain.

In circumstances of dishonesty, fraud, illegal phoenix activity or other corporate misconduct, directors and companies will still be subject to the usual criminal penalties under the Corporations Act. Further, if your organisation becomes insolvent, the temporary relief will not be available if a director or officer fails to comply with obligations to assist an administrator, liquidator or controller.

So what should directors do about debts?

In the current COVID-19 context, directors will need to make urgent but carefully considered decisions about incurring debt. The application of these temporary relief measures and safe harbour regime will need to be determined on a case by case basis by directors, while exercising due care, diligence and caution when assessing whether each debt is necessary (and in the ordinary course of business) for the business to survive in the current climate. Despite the temporary relief measures, if the company is approaching insolvency, case law states that directors must start to take the interests of creditors into account. This means directors should, on an ongoing basis, exercise careful judgement when deciding to incur additional liabilities at a time when solvency of the organisation is questionable.

To maximise your access to these defences, good corporate governance and record keeping (including board minutes) is essential. Contemporaneous written evidence is a material assistance in establishing your defence.

You should consult closely with your financial and legal advisors, and usual prudent decision making and sensible mitigation of liabilities, costs and expenses will apply. The temporary safe harbour is designed to give directors the confidence to continue to pay their bills, trade where possible, and retain staff through this crisis without pressure to enter into administration if there is a chance the business is close to insolvency.

Other important changes: Higher thresholds and more time to respond to creditors

Other temporary changes have been implemented under the Act that seek to soften the financial blow and give directors comfort and time to respond in the event of debt and creditor issues arising during this period:

TOPIC	CURRENT	NEW
Minimum amount required for the issue of a creditor's statutory demand on a corporation	$2,000	$20,000
Time within which a corporation must respond to a statutory demand	21 days	6 months
Minimum debt for which a creditor may institute involuntary bankruptcy proceedings	$5,000	$20,000
Time for a debtor to respond to a bankruptcy notice	21 days	6 months
Period within which a debtor is protected from enforcement action by a creditor, following declaration of intention to present a debtor's petition	21 days	6 months

In short, it is important to stay on top of these changing director liability and governance obligations to maximise these new protections in place to help businesses. If you haven't already, make sure you:

1. Get across your financials and stay up to date with whether your business is solvent or nearing insolvency
2. Adhere to good corporate governance and record keeping (including board minutes)
3. Check your insurance policies, including business continuity, director and officer insurance
4. Ensure you have **Director Deeds of Indemnity** in place
5. Review your business continuity and **business succession** plans
6. Sign up to our mailing list to stay up to date on the latest COVID-19 **employer FAQs**, **Tenancy Guides**, **Contract Issues** and other business matters.

This guide is intended to help you navigate this difficult time and decide what is right for you and your business.

If you are concerned about your potential liability as a director or you have a specific question, please get in touch with one of the team.

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