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COVID-19 AUSTRALIA: TEMPORARY CHANGES TO INSOLVENCY LAWS - AUSTRALIAN FEDERAL GOVERNMENT ADDRESSES COVID-19 FINANCIAL DISTRESS

24 March 2020 | Australia
Legal Briefings – By **Paul Apáthy, Lisa Filippin and Lauren Wright**

The Australian Federal Government has now passed temporary amendments to insolvency and corporations laws in light of the challenges COVID-19 poses to many otherwise profitable and viable businesses.

As foreshadowed in its announcement on Sunday 22 March 2020, the Australian Federal Government has now passed temporary amendments to insolvency and corporations laws in light of the challenges COVID-19 poses to many otherwise profitable and viable businesses. The changes proposed in Schedule 12 to the *Coronavirus Economic Response Package Omnibus Bill 2020* (Cth) (the **Bill**) are intended to avoid unnecessary insolvencies and bankruptcies by providing a safety net for:

- directors and businesses to help them operate during a temporary period of illiquidity rather than enter voluntary administration or liquidation; and
- individuals to assist them with managing debt and avoiding bankruptcy.

The Bill passed both Houses of Parliament on 23 March 2020, and is expected to shortly receive Royal Assent.

As part of the changes, directors will be temporarily relieved from the risk of personal liability for insolvent trading, where the debts are incurred in the ordinary course of business. The temporary relief will operate during a six-month period starting on the day after the Bill receives Royal Assent, alongside the existing safe harbour regime.

In addition, the minimum threshold at which creditors can issue a statutory demand has increased from $2,000 to $20,000 for a period of 6 months, and companies will have 6 months to respond to a statutory demand rather than the current 21 days. Other measures are detailed below.

The changes will take effect the day after the Bill is given Royal Assent, and will have no retrospective application. There remains uncertainty on some aspects of the Bill, as discussed below.

These measures will be welcome relief to corporate boards facing the uncertain impact of COVID-19 on their business and cashflow position. We expect these measures will assist many companies to continue trading through the current period of disruption, rather than requiring them to appoint external administrators.

However, these measures may also make it more difficult for suppliers and other creditors to recover overdue payments, which could have the ultimate effect of increasing credit risk and shifting liquidity pressure from debtors to suppliers and creditors. Suppliers will need to be more vigilant with their trading counterparties and consider adjusting their trading terms to address this risk.

TEMPORARY RELIEF FOR FINANCIALLY DISTRESSED BUSINESSES AND INDIVIDUALS

The temporary measures, effective on the day after the Bill receives Royal Assent (the **Effective Date**), are as follows:

INSOLVENT TRADING (COMPANIES)

The existing safe harbour provisions in the *Corporations Act 2001* (Cth) (**Corporations Act**) will be supplemented by additional temporary relief for directors from personal liability for debts incurred when trading while insolvent where the debt is incurred:

- in the ordinary course of the company's business;
- during the six month period starting on the Effective Date (or any longer period

prescribed by regulations); and

- before any appointment during this period of an administrator or liquidator.

A holding company may rely on the temporary safe harbour for insolvent trading by its subsidiary if:

- it takes reasonable steps to ensure the temporary safe harbour applies to each director of the subsidiary and to the debt(s) incurred; and
- the temporary safe harbour does actually apply in relation to each of the directors and to the debt.

The person or holding company seeking to rely on the temporary safe harbour relief bears the evidentiary burden in establishing they are entitled to the relief. 'Evidential burden' in the new safe harbour regime means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Although providing relief to directors for the consequences of insolvent trading, the company will continue to remain liable for debts incurred.

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The Explanatory Memorandum to the Bill (the **Explanatory Memorandum**) states that a debt is incurred in the ordinary course of business *if it necessary to facilitate the continuation of the business* during the 6 month period commencing on the Effective Date. This provides a narrower protection than that included in the existing safe harbour regime (which provides protection for debts incurred directly or indirectly with a course of action likely to lead to a better outcome for the company). The examples given as to what 'debts incurred in the ordinary course of business' are:

- taking out a loan to move some business operations online; and
- debts incurred through continuing to pay employees during the COVID-19 pandemic.

Care will need to be taken by directors to ensure a debt incurred is in the ordinary course of business. It would appear from the example given in the Explanatory Memorandum (of a loan to move business online), that the expression ordinary course of business is intended to be widely interpreted, to facilitate transactions with a view to saving the business, but this is an area of potential uncertainty. For example, would a debt incurred as part of a rescue financing be considered to be incurred in the ordinary course of business?

Due to this uncertainty, the existing safe harbour regime may continue to have some ongoing relevance as companies respond to the financial challenges posed by COVID-19. That is, although the debt incurred as part of the rescue financing might not be in the ordinary course of business, it may comfortably fall within the existing safe harbour protection (assuming that the other criteria are satisfied). Directors may therefore seek to rely on both safe harbour regimes during the next six months to obtain protection under both regimes for debts incurred where there might be ambiguity.

In any event, it can be expected that distressed companies should and would seek to pursue the core requirement of safe harbour: to develop and take a course a course of action reasonably likely to lead to a better outcome than administration or liquidation where that is practically achievable. In addition the factors that may be taken into account under the existing safe harbour regime (for example, ensuring directors are receiving proper information and keeping appropriate financial records, are properly advised and are developing a plan for restructuring the company to improve its financial position) are good practice and helpful for discharging the directors' general duties to the company.

Creditors and counterparties to transactions with stressed companies should be aware of the heightened voidable transaction risk (in particular the risk of payments received by creditors subsequently being set aside as preferences) if those companies are insolvent (i.e. unable to pay their debts) but are continuing to trade in reliance on these reforms. This could cause counterparties to more frequently require upfront payment, rather than extending customary credit terms.

Further, it appears the Bill contemplates the use of regulations to restrict certain circumstances in which a director may not be able to rely on the temporary safe harbour relief. It is unclear what those circumstances are, and there are no draft regulations yet available. This provides some uncertainty for directors, though if the amendments are to have the desired effect then presumably any exceptions will be reasonably narrow and targeted.

As with the current safe harbour regime, the protections do not extend to protection from the criminal penalties associated with insolvent trading that is dishonest.

STATUTORY DEMANDS (COMPANIES)

For statutory demands served on or after the Effective Date:

- the threshold at which creditors can issue a statutory demand on a company has increased from $2,000 to $20,000; and
- companies will have 6 months (rather than the current 21 days) to respond to statutory demands served on them.

These changes apply for 6 months from the Effective Date. The likely impact will be a significant reduction in the use of statutory demands by creditors to force companies to make payment.

The provisions do not affect:

- other methods of winding up, including the winding up by the court where it is otherwise demonstrated that the company is unable to pay its debts, on just and equitable grounds or where winding up is sought by ASIC; or
- the ability of a creditor to sue a company to recover a debt, and once judgment is obtained, to then rely upon the enforcement regime available (i.e. attachment of debts or sale of assets by the sheriff).

The provisions will, however, impact on creditors who may rely on the statutory demand process as a reasonably cheap and simple way to pressure debtors to pay outstanding debts.

BANKRUPTCY PROCEEDINGS (INDIVIDUALS)

For bankruptcy notices issued, and declarations presented, on or after the Effective Date:

- the threshold for a creditor to initiate bankruptcy proceedings against an individual has increased from $5,000 to $20,000;
- debtors will have 6 months (rather than the current 21 days) to respond to a bankruptcy notice;
- the period of protection a debtor receives after making a declaration of intention to present a debtor’s petition is extended from 21 days to 6 months.

These changes apply for 6 months from the Effective Date.

TEMPORARY POWERS GIVEN TO THE TREASURER

Schedule 8 to the Bill enables the Treasurer to provide short-term regulatory relief to classes of persons that are unable to meet their obligations under the Corporations Act or the *Corporations Regulations 2001* (Cth) (the **Corporations Regulations**) by:

- determining that specified classes of persons are exempt from specified obligations; or
- modifying specified obligations to enable specified classes or persons to comply with their obligations during the COVID-19 crisis.

This mechanism commences on the Effective Date for 6 months. It is only available where a class of companies is unable to comply with their obligations – either because it would not be reasonable to expect them to comply with the provisions, or because the exemption or modification is otherwise necessary or appropriate to facilitate the continuation of business or mitigate economic impacts of COVID-19. We expect this power to be used to provide relief to directors from complying with statutory obligations which are impracticable in the current situation, such as requirements to hold meetings in person.

OTHER MEASURES

TAX PAYMENTS AND ENFORCEMENT

On 22 March 2020, the Australian Federal Government also announced that the ATO will tailor solutions for businesses struggling due to COVID-19, including temporary reduction of payments or deferrals, and withholding enforcement actions including Director Penalty Notices and wind-ups. This is not included in the Bill, but the ATO has issued a media release with further details.

Herbert Smith Freehills' dedicated restructuring, turnaround and insolvency team will continue to review the Australian Federal Government's response to COVID-19 and will provide further updates as additional information becomes available.

Please contact any of the Herbert Smith Freehills' Restructuring Turnaround and Insolvency team below for further details on these changes, or to discuss your specific circumstances.

For further details, refer to the Treasurer's media release, the Bill and the Explanatory Memorandum.

More on navigating the COVID-19 outbreak

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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