CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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Insolvent Trading Safe Harbour Options Paper
Corporations and Financial Services Division
The Treasury
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Dear Treasury

Insolvent trading: A safe harbour for reorganisation attempts outside of external administration

Chartered Secretaries Australia (CSA) is the independent leader in governance and risk management. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, it is focused on improving organisational performance and transparency. Our members are all involved in governance, corporate administration and compliance with the Corporations Act (the Act). Our members work in both public listed and public unlisted companies, as well as in private companies. We have drawn on their experience in the formulation of each submission on the matters contained in the consultation paper: *Insolvent trading: A safe harbour for reorganisation attempts outside of external administration* (the consultation paper).

We welcome the opportunity to comment on the consultation paper.

General comments

CSA strongly supports the philosophy behind the current insolvent trading provisions of the Corporations Act that creditors (including small businesses and employees) should be able to deal with companies confident in the knowledge that the directors of the company have not formed the view that the company is insolvent. However, CSA accepts that there could be instances where the risk of personal liability for trading while insolvent leads directors to appoint external administrators prematurely in circumstances where a work-out managed by the directors and the company might ultimately lead to a better outcome for shareholders, creditors and employees.

CSA considers that any reforms to directors' personal liability for insolvent trading should not be made at the expense of innocent creditors and employees who deal with a company in good faith on the assumption that the company is solvent.

The consultation paper asks whether the current law should be preserved (Option 1), or whether a business judgment rule for insolvent trading (Option 2) or a moratorium (Option 3) should be introduced.

CSA is of the view that there is insufficient evidence of difficulties attached to the status quo to convincingly support the adoption of either Options 2 or 3, particularly as currently expressed in the consultation paper, unless it can be demonstrated that it will produce better outcomes not only for directors and shareholders, but also for creditors.

The defences in s 588H currently operate well to ensure that there is a balance between taking sensible commercial risks and the protection of creditors, and any reform of the law that is applied to directors' duties in regard to insolvent trading should not be at the expense of creditor protection.

CSA is aware that the business judgment rule, as currently defined in s 180 of the Act, arguably has a narrow focus and believes it could be broadened in scope. CSA supports the introduction of a consistent defence covering a range of provisions. CSA notes that the concept of a 'safe harbour' exists in corporate law in the United States. This provision applies to all decisions and stops the courts from 'second-guessing' commercial decisions by boards of directors and companies. CSA fully supports a general defence that operates in this manner. CSA also supports a general defence that clarifies that, if a director or other officer has 'done the right thing', they will be protected. CSA believes that it is appropriate that a general defence also apply in cases of insolvent trading, so long as in these cases the general defence recognises the additional duties owed to creditors. CSA considers that entrepreneurship which puts creditor protection at risk would be difficult to defend.

CSA expressed its support for a general defence in our submission on the earlier 2007 paper, *Sanctions in Corporate Law.* In that submission we reported on a survey of members which showed that the majority thought that a reduction in personal legal liabilities would result in a heightened appetite for risk, leading to a more effective and prosperous corporate Australia. However, CSA members simultaneously expressed caution, noting that there is considered risk and foolhardy risk, and that any reduction in personal legal liabilities should not suggest that directors could feel the need to be less diligent than they should be. CSA members also noted that reduced liabilities might lead to increased risk, but that there was no guarantee that this would lead to a more prosperous economy, as confidence in corporate Australia could also be reduced.

Option1: Preserve the status quo

CSA contends that there are very few concrete examples, if any, of financially sound companies being placed in premature administration because of directors' concerns as to personal liability for insolvent trading. It is also difficult to measure the savings to individual businesses and employees who have been saved from losses (or at least further losses) because of the strong incentives to directors not to trade while insolvent, but CSA submits that these savings would be substantial. The current law has not been shown to be so faulty that a reform of the insolvent trading provisions is needed, as proposed in Options 2 and 3.

Due to the absence of compelling evidence that the current laws are inhibiting efforts to reorganise and rescue businesses, **CSA recommends** that the status quo be preserved.

Option 2: A business judgment rule for insolvent trading

CSA strongly supports the concept of an informed market and is of the view that providing information to existing and potential creditors should be a foundation stone of any approach to the insolvent trading laws.

While CSA can see the attraction of a modified business judgment rule (see our comments above in support of a general defence which could also apply in cases of insolvent trading), CSA does not support Option 2 to the extent that it would allow a company whose directors

suspected it to be insolvent to trade without informing creditors. CSA also notes that in the case of listed companies, the directors' continuous disclosure obligations would require them to inform the ASX if they suspected the company was insolvent.

The formulation proposed in the consultation paper states that a director's duty not to trade while insolvent would be considered to be satisfied if 'the financial accounts and records of the company presented a true and fair picture of the company's financial circumstances'. However, CSA notes that this information does not have to be disclosed to creditors.

The formulation in the consultation paper is based on keeping creditors uninformed of the financial position of the company. CSA is of the view that it is unacceptable to expose creditors to ongoing trading with the company without knowledge that it is insolvent and, indeed, morally unjustifiable to allow creditors to deal with a company without full disclosure of the company's financial position, given that the creditors may very well be unlikely to deal with the company if they had knowledge of the company's financial position. CSA is also of the view that it would be unacceptable for the business community as a whole, as confidence in corporate Australia could be diminished.

As the consultation paper notes on p 7 (at 3.4) directors owe very limited duties to creditors. Disclosure provides creditors with the opportunity to decide their course of action. For example, creditors could well be interested in a work-out and extending further credit. Conversely, creditors could take the view that the current directors are fatal to the ongoing viability of the company. CSA is of the view that the emphasis in insolvent trading laws should be balanced between directors' and creditors' needs and not weighted to directors' needs.

CSA also notes that if Option 2 were to be adopted as proposed, it would require a carve-out for listed companies from the continuous disclosure requirements. Such a carve out would undermine the principles of a fully informed market and may have consequences for the integrity of the market as a whole.

CSA recommends that Option 2 only be considered if creditors are required to be fully informed of the company's financial position. CSA also notes that any such modified business judgment rule would need to be subject to additional constraints as it should not be used to prolong trading while insolvent over indefinite periods.

Option 3: Moratorium

CSA is of the view that Option 3 provides directors with more certainty than Option 2 in terms of being able to effect a business rescue. CSA also agrees that creditors should have control of the process and be able to appoint receivers.

CSA notes that Option 3 provides for an informed market, while providing directors with a choice. It protects directors from attracting personal liability for trading while insolvent if they have the support of their creditors and remain in discussion as to the extension of credit. However, CSA also notes that it could trigger an event of default.

CSA notes that listed companies are already subject to a continuous disclosure regime, and therefore if a company is approaching insolvency, it will be required to disclose such price-sensitive information to the market. A moratorium would see both listed and unlisted companies subject to a full disclosure requirement. CSA notes that such disclosure could see creditors unwilling to extend credit.

Should Option 3 be viewed as the most appropriate approach, CSA believes that a mechanism will need to be considered for advising those who deal with the company that it is in a moratorium. Under the current law, a company is required to notify ASIC and place a notice on

its letterhead that it is in administration, which is the mechanism to ensure that all those dealing with the company know its financial position. CSA submits that there should be a similar obligation on a company whose directors wish to take advantage of a moratorium. The directors should also be required to convene a meeting of creditors at an early stage of the process to either approve the moratorium or alternatively vote to appoint an administrator or place the company into liquidation.

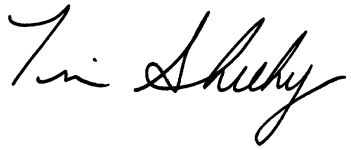
CSA also notes that the moratorium as proposed in the discussion paper would not prevent secured creditors taking action to enforce their security or unsecured creditors commencing proceedings to recover amounts owed to them or for the winding up of the company. This may limit the practical value of the moratorium in that, while the directors might not be personally liable for insolvent trading, individual creditors would continue to be able to enforce their rights.

Conclusion

In preparing this submission, CSA has drawn on the expertise of the members of our national policy committee, the Legislation Review Committee.

CSA would welcome further contact during the consultation process and the opportunity to be involved in further deliberations.

Yours sincerely



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