ROB BRAUER
Partner,
McGrathNicol

comment & opinion

SAFE HARBOUR IN PRACTICE

Four things we've learned.

The two year anniversary of the safe harbour reforms arrives in September this year. Heralded as a major milestone in Australia's restructuring and turnaround landscape, it's clear the reforms are yet to reach their full potential.

Safe harbour was designed to protect directors against an insolvent trading claim in certain circumstances should they choose to allow a suspected insolvent company to continue to operate while a turnaround plan is attempted.

Prior to the reforms being introduced, our research indicated that companies in external administration (irrespective of size) traded insolvent for an average of six months. This exposes the personal assets of the directors to a liquidator's claim. Even well-advised directors of ASX-listed businesses have been challenged retrospectively by liquidators for a period of insolvent trading.

The safe harbour rules were designed to help mitigate these risks to allow directors to attempt to deliver a 'better outcome' than insolvency. While it will take some time to assess the reform's results, practical experience to date has seen four key themes emerge:

1. ABOUT HALF OF COMPANIES SEEKING SAFE HARBOUR ADVICE END UP IN AN INSOLVENCY PROCESS ANYWAY

As the legislation requires a 'suspicion' of insolvency before the safe harbour protection becomes relevant, this should not be surprising. The important point is that safe harbour provisions *are* triggering earlier discussions between directors and turnaround experts, resulting in discernible benefits including:

- a reduction (or complete removal) of the period of time a director is exposed to an insolvent trading claim
- a higher return to creditors, as assets are not being further eroded by trading losses had an insolvency appointment occurred later, and
- a smaller deficiency to creditors, and hence lower residual exposure under a director's personal guarantee if any have been provided.

2. PLENTY OF QUESTIONS REMAIN

Apart from ASX guidance regarding continuous disclosure obligations (Guidance Note 8, particularly at 5.10 which was amended in March 2018), there is currently a lack of information or legal precedent to clarify some of the practicalities of the safe harbour provisions. Many issues are open to interpretation, including:

- Who is an appropriately qualified entity (i.e. advisor) in which circumstances? When should lawyers engage with accountants and accountants engage with lawyers? When are neither required?
- What is the best engagement structure? Via accountants or lawyers? With the company? With the directors? Does it matter?
- What constitutes a 'better outcome for the company'? What if equity interests and creditor interests are in conflict? Can preparation for a 'better insolvency' (i.e. a better dividend) be considered a better outcome as directors delay an inevitable insolvency appointment? What happens if different creditors are impacted differently during that period of potential insolvent trading?

As yet, there is little industry consensus on these issues with each scenario and new engagement being tailored to the facts and the preferences of the advisors involved.

3. SAFE HARBOUR HAS BEEN USED IN A WIDE RANGE OF SCENARIOS

The reforms can achieve a better outcome for companies of all sizes and in a variety of situations. Common scenarios observed in practice to date include:

Safe harbour

Asset-rich, cash-poor businesses

In one example, creditors were estimated to receive full repayment in a liquidation scenario, but trade creditors had not been paid within terms for nearly two years. Safe harbour provided directors with sufficient comfort to execute a strategy of selling illiquid assets, raising capital, and continue payment negotiations with a supportive trade creditor base.

Pre-positioned sales

Pre-positioned sales are sale processes or negotiations underway before an insolvency event which may be considered by an insolvency practitioner once they are appointed. Continuing to trade during a sales process in the knowledge of an impending insolvency event increases a director's personal liability exposure should a pre-positioned transaction fail.

Safe harbour advice during this period may mitigate this risk and may permit a pre-positioned transaction to complete post appointment if it is deemed in 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 a view that this presents a better outcome for the company in accordance with safe harbour provisions.

Even if directors believe the sale process is being undertaken whilst the business is solvent, this may differ from the view taken by a liquidator in retrospect if the transaction does not complete and the financial position of the business is later interrogated.

Finance negotiations

In distressed scenarios, refinance negotiations can play out 'against the clock' before the company's funds are exhausted or existing facilities expire. Safe harbour protection is a valuable overlay for directors in the event that negotiations fail.

> 'Safe harbour advice is evident in less than 15% of total external administrations.'

4. UPTAKE APPEARS LOWER THAN EXPECTED

While the addition of the safe harbour provisions to a turnaround professional's toolkit has opened more boardroom doors, the number of directors seeking formal advice appears lower than expected. A significant hurdle for directors (who are often also owners) appears to be having to admit to a suspicion of insolvency.

Practical experience of our firm assessed over the last 18 months, suggests that two-thirds of companies reviewed appear to have traded whilst insolvent. Of those, only about 10% of directors had sought advice regarding safe harbour protection which suggests there remain instances where directors may be unnecessarily risking personal liability, even when allowance is made for companies that would not have met the eligibility criteria for safe harbour.

Overall, safe harbour advice is evident in less than 15% of total external administrations (voluntary administrations or creditors' voluntary liquidations) which on face value appears low. However, this figure increases to approximately 50% for ASX-listed and large proprietary companies. These are typically companies with professional directors who are presumably more willing to engage with (and pay for) advice in challenging times.

Conversely, less than 5% of directors of small proprietary companies had sought safe harbour advice. The lower uptake for directors of small businesses is thought to arise from a sense that they are already personally exposed as a result of a number of guarantees provided to creditors which safe harbour cannot assist with.

SOME WAY TO GO

There appears some way to go before the anticipated impacts of safe harbour reforms are fully realised across the corporate spectrum. Better education and awareness of directors around these issues will be key. However, anecdotally, many are seeing the benefits. Chairpersons involved in two of the more recent, high-profile turnaround cases have publicly espoused the virtues of safe harbour.

At its simplest level, it appears to provide a 'psychological' comfort to board members to both stay the course in a distressed or crisis scenario (as opposed to resigning and leaving others to carry the burden) and to design a turnaround plan which attempts a solvent restructure.

In passing the safe harbour legislation, the Federal Government incorporated a review process after two years (September 2019). In the author's view, the legislation should achieve a 'pass mark' to date.

Even though the uptake may be less than expected (particularly for small proprietary companies), nothing has been taken away by the introduction of safe harbour. Practical observations suggest the evidence of its misuse is rare and the pathway to earlier engagement with advisers, improved creditor returns and limiting personal liability is evident.