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30 November 2022

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Committee Secretary

Corporate Insolvency in Australia

Thank you for the opportunity to provide comment to the Parliamentary Joint Committee on Corporations and Financial Services (the **Committee**) inquiry into corporate insolvency in Australia (**the Inquiry**).

The Australian Institute of Company Directors' (**AICD**) mission is to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society. The AICD's membership of 50,000 reflects the diversity of Australia's director community, comprised of directors and leaders of not-for-profits (**NFPs**), large and small-medium enterprises (**SMEs**) and the government sector.

The AICD has contributed extensively to insolvency policy development processes over a number of years reflecting the importance of these settings to how directors make decisions on the viability of businesses, including assessing turnaround prospects and preserving employment. The AICD was a key industry proponent of the introduction of the Insolvency Safe Harbour under sections 588GA and 588GB of the *Corporations Act 2001* (the **Corporations Act**) (**the Safe Harbour**) in 2017 and separately strongly supported the temporary COVID-19 insolvent trading moratorium (**COVID-19 moratorium**) in 2020.

1. Executive Summary

The AICD welcomes the Inquiry as an important opportunity to comprehensively assess the current performance of Australia's insolvency regime and consider further opportunities for reform. The success of the Safe Harbour and COVID-19 moratorium reflects the potential for measured reforms to Australia's insolvency regime as an important element of the new Government's microeconomic reform agenda.

The AICD has limited its comments in this submission to the broader policy settings of the insolvency regime as they relate to how directors interact with the regime, with a particular focus on director liability, NFPs and SMEs. Key industry bodies representing insolvency and administration practitioners, accountants and legal experts are better placed to provide specific feedback on other elements of the insolvency regime.

Our key points are as follows:

- The AICD strongly supports a 'root and branch' review of Australia's insolvency regime by the Australian Law Reform Commission (**ALRC**) or Productivity Commission as a vital mechanism to comprehensively assess current performance, interaction with other elements of corporate law,

personal liability settings, application to NFPs and charities and how to ensure the regime remains fit-for-purpose in the future;

- The Inquiry should examine the appropriateness of director liability insolvent trading threshold being lifted to 'wrongful trading' in line with other jurisdictions and separately the possibly harmonisation of the Safe Harbour and the Business Judgement Rule under the Corporations Act;
- The AICD recommends the Inquiry encourage swift implementation of the recommendations of the Safe Harbour Review;
- The Inquiry should assess possible amendments to the small business restructuring regime to improve its effectiveness and accessibility for directors of SMEs; and
- The Inquiry examine the Australian Taxation Office's (**ATO**) use of Director Penalty Notices (**DPN**) and whether there is sufficient guidance on under what circumstances the ATO will use a DPN.

2. Root and branch review

The AICD welcomes the broad scope of the Terms of Reference of this Inquiry as a reflection of the importance of the insolvency regime to Australia's economic growth and ongoing prosperity. The AICD has advocated over many years, most recently during the establishment of the Safe Harbour, for reform of insolvency law as a key, and often underappreciated, area of microeconomic reform. In our view, the insolvency regime should encourage entrepreneurialism, maintain employment and enable directors to save businesses that are fundamentally viable in the long-term.

The AICD recommends that the Committee consider whether a comprehensive 'root and branch' review of the insolvency regime is required. While the Committee's Inquiry is an important first step in assessing the current effectiveness of key elements of the insolvency regime, our view is that there is a strong rationale for a root and branch review conducted by an external body with extensive economic and legal expertise, such as the Productivity Commission or the ALRC. The ALRC's ongoing Review of the Legislative Framework for Corporations and Financial Services Regulation is a useful model for what a root and branch review of the insolvency regime may resemble.

It has been 34 years since the last comprehensive review of Australia's insolvency regime by the ALRC (the **Harmer Review**).[1] It took almost five years from the Harmer Review recommendations in 1988 until the majority were implemented in the *Corporate Law Reform Act 1993* (Cth). Since those reforms commenced there has been a piecemeal approach to insolvency regime changes, including in recent years the introduction of the Safe Harbour, small business restructuring (**SBR**) regime, the Fair Entitlements Guarantee scheme, COVID-19 moratorium, and steps to combat phoenixing.

These separate insolvency policy reforms over the past two decades have had distinct policy objectives with a number resulting in improvements in the regime and economic benefits, for instance the Safe Harbour. However, in totality the ad hoc and disjointed manner of reform has contributed to an insolvency regime that is increasingly complex and challenging for users, observers and regulators to navigate and oversee. As discussed further below, the AICD considers that for directors of SMEs, for example, the current regime has considerable limitations, not least of which is the interaction with personal liability and bankruptcy for SME directors.

[1] ALRC, General Insolvency Inquiry (ALRC Report 45), 1988.

Application of the insolvency regime to NFPs and charities

The AICD has had long standing concerns with the application of the insolvency regime to directors of charities and NFPs. There is a patchwork of state and Commonwealth legislation that is relevant to governance of the NFP sector with application varying on whether an NFP is an incorporated association under a state or territory law, or whether it is a company limited by guarantee and subject to the Corporations Act. In addition, there is the Australian Charities and Not-for-profits Commission (**ACNC**) requirements via Governance Standard 5: Duties of Responsible Persons that place an obligation on a responsible person (i.e. directors and senior managers) to not allow a charity to trade while insolvent.

AICD members have provided feedback that this legislative complexity and ambiguity has raised uncertainty about how to approach decision making around solvency and administration. This is a particularly pronounced issue for the NFP sector where there is often limited financial resources and external funding arrangements are key to whether an organisation is viable.

While the Safe Harbour Review provided clarity that directors of NFPs that are companies limited by guarantee can access the Safe Harbour, it recognised that broader challenges with the insolvency regime's application to NFPs exist. In particular, the concept of 'solvency', where a NFP often has limited capital and relies on grants or donations.

A comprehensive review, including considering the application of the regime to NFPs, was a central recommendation of the Safe Harbour Review with it finding a strong basis for a review that also reflected on how Australia's regime related to a more globalised economy:

> *A comprehensive review that not only considers the past 30 years of jurisprudence on our current insolvency regime, but also assesses the impact of our insolvency laws on our trading partners, on domestic and international capital markets and other economic and social factors, would be a significant and invaluable development.*[2]

A root and branch review would enable a holistic picture of how the regime is performing, including in comparison to similar international jurisdictions, and closely consider the interaction between other elements of the Corporations Act, for instance the business judgement rule, taxation, bankruptcy laws and the application to charities and NFPs.

3. Director liability environment

Australia's insolvent trading rules remain among the strictest in the world, according to comparative analysis by law firm Allens Linklaters for the AICD. The analysis found that Australia's insolvent trading laws take a punitive approach through both the potential for criminal and civil liability, which is out of step with settings in the United Kingdom (**UK**), New Zealand, Hong Kong, Canada and the United States.[3]

The Safe Harbour was an important step forward in modernising Australia's insolvency regime and, as discussed below, has been effective in certain circumstances in enabling directors to work flexibly to turnaround businesses. However, we believe that insolvency law continues to remain unduly punitive and excessively focused on the interests of creditors to the detriment of other key stakeholders, including owners, employees and directors.

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[2] The Treasury, Review of the insolvent trading safe harbour - Final report, March 2022, page 5.

[3] AICD research: *Criminal and Civil Frameworks for Imposing Liability on Directors*, February 2020, available here.

Wrongful trading threshold

We encourage the Committee to consider whether increasing the threshold of the insolvent trading director duty to 'wrongful trading' in line with the UK warrants further analysis. Under the relevant provisions of the UK's *Insolvency Act 1986*, the threshold for director liability requires *actual knowledge or negligence* that there was no reasonable prospect of the company avoiding liquidation and they did not take steps to minimise losses to creditors. By contrast, section 588G of the Corporations Act is based on a lower threshold of needing to prove only that there was *reasonable suspicion* in the mind of the director that the company was insolvent.

A lifting of the threshold would support all organisations and encourage innovation and appropriate risk-taking to ensure long-term economic prosperity. As noted below, there are challenges for directors of SMEs utilising the Safe Harbour and questions on the effectiveness of the SBR regime. A higher threshold would be a significant step in reducing personal director liability and promote a focus on turnaround and restructuring. The AICD also considers that it would not blunt any incentive on directors to restructure businesses but rather provide greater comfort that they could take measured risks and seek innovative solutions to viability challenges without the threat of personal liability. Additionally, increasing the threshold will reduce the costs that are associated with obtaining advice on restructuring and insolvency, including utilising the Safe Harbour.

The Safe Harbour Review cited a number of submissions from key industry stakeholders, including the Law Council, who were supportive of lifting the threshold as a potential mechanism to resolve the existing complexity and ambiguity with how the insolvent trading director duty interacts with other elements of corporate law, including director duties contained in Part 2D.1 of the Corporations Act.[4] While the Safe Harbour Review found there was appeal in lifting the threshold its appropriateness to Australia should be closely considered and was beyond the scope of its review.[5] The AICD recommends the Committee consider what steps should be taken to assess changes to the threshold, including as a component of a 'root and branch' review.

Business Judgement Rule

The Business Judgement Rule (**BJR**) under section 180(2) of the Corporations Act is a key element of Australia's director duty framework, particularly the duty of care and diligence. In its intent the BJR resembles the Safe Harbour in that it reflects that directors often make decisions with imperfect information and should be protected from sensible commercial risk taking. The AICD considers there is an opportunity for this Inquiry to assess whether there are opportunities for alignment or harmonisation between the BJR and the Safe Harbour.

In 2021 the AICD commissioned Allens to research the scope, operation and effectiveness of Australia's BJR as compared with other jurisdictions.[6] The research found significant shortcomings with the operation of the BJR, including that it provides little real assistance to directors in litigation, and is not performing its intended function of encouraging risk-taking in business.

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[4] The Treasury, Review of the insolvent trading safe harbour - Final report, March 2022, page 84.

[5] Ibid.

[6] AICD research: *Time to reconsider Australia's business judgment rule*, August 2021, available here.

The Safe Harbour Review recognised the similarities between the BJR and the Safe Harbour as reflected in the respective Explanatory Memorandums and noted that a number of submissions had argued for an examination of the harmonisation or replacement of the BJR with an expanded Safe Harbour.[7]

The AICD appreciates that examining the performance of the BJR in isolation is beyond the Terms of Reference of this Inquiry. However, consistent with the findings of the Safe Harbour Review, we do consider the interaction between the BJR and the insolvency regime is an important component of the legislative architecture that promotes directors turning around businesses rather than unnecessarily placing them in administration or liquidation. Our strong view is that the BJR and Safe Harbour relationship should be examined as a component of a 'root and branch' review.

4. Insolvency Safe Harbour Review Recommendations

The AICD was a strong supporter of the introduction of the Safe Harbour and welcomed the review conducted by the expert panel in 2021. The AICD provided a joint submission with the Business Council of Australia (**BCA**) to the Review in October 2021 that reflected our view that the Safe Harbour has been a successful insolvency policy reform that has driven changes in director behaviour to focus on restructuring businesses.[8]

The AICD welcomed the Safe Harbour Review findings that the Safe Harbour provisions have been a positive corporate law reform that has improved governance and economic outcomes and delivered real turnaround options to directors of listed, large, and some medium companies. The Review drew upon a significant number of case studies, including those shared by the AICD/BCA, in demonstrating the effectiveness of the Safe Harbour.

The Safe Harbour Review made a number of recommendations that fall into three categories:

1. legislative amendments to improve the operation of the Safe Harbour;

2. guidance from Treasury and the Australian Securities and Investment Commission (**ASIC**) to improve access, understanding and awareness of the Safe Harbour; and

3. the need for a holistic review of Australia's insolvency regime commissioned by Treasury.

The previous Government noted or accepted the recommendations in full in its response in March 2021.[9] To date none of the recommendations appear to have progressed. We recommend the Committee utilise this Inquiry to urge the Government and regulators to progress and implement these recommendations. The legislative amendments will improve the operation of the Safe Harbour and resolve certain areas of ambiguity.

The AICD is concerned that there has been little apparent movement by ASIC in developing standalone guidance on the Safe Harbour or updating *Regulatory Guide 217 Duty to Prevent Insolvent Trading* (**RG 217**) consistent with recommendation 4 and the specific guidance recommendation. Comprehensive guidance and separate amendments to RG 217 would assist advisors ensure their clients are accessing the Safe Harbour consistent with its intent and raise awareness in a manner that may improve utilisation by directors of SMEs.

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[7] The Treasury, Review of the insolvent trading safe harbour - Final report, March 2022, pages 81-82.

[8] AICD BCA submission, October 2021, available here.

[9] Government Response to the Review of the insolvent trading safe harbour, March 2022, available here.

As discussed in detail above, the AICD strongly supports a holistic review as a key mechanism in ensuring Australia's insolvency regime remains fit-for-purpose and reflects the significant economic change that has occurred in Australia since the Harmer Report in 1988.

4. Directors of SMEs

The AICD has received feedback from members who are directors of SMEs over a number of years about the challenges in applying the existing insolvency regime to the particular circumstances of these businesses.

The complexity, rigidity and high barriers for use of Australia's insolvency regime for SME directors and advisers was recognised in the SBR regime introduced by the Government in 2020. Despite the clear policy case to improve options for directors of SMEs in navigating the insolvency regime anecdotal evidence suggests that the SBR regime has not yet achieved its objectives. While there has been an increase in appointments under the SBR regime overt the past year AICD engagement with advisors and restructuring experts has indicated that there is significant complexity with the SBR regime that will continue to limit use.

Further, as found in the Safe Harbour Review there has been limited utilisation of the Safe Harbour by directors of SMEs due to the relative high cost of advice and significantly the nature of SME liability that is often intertwined with personal guarantees provided by directors over other assets, including family property.[10]

AICD engagement with industry bodies and insolvency experts has indicated that the SBR regime provides a template that, with amendment, may provide an effective framework for the directors of some SMEs. The AICD supports the Law Council's submission in respect of proposed amendments to the SBR regime.

The AICD recommends that the Committee explore options to amend the SBR regime to simplify and promote its use, including engagement with industry experts and key academic researchers who have explored this issue in detail.

Director Penalty Notices

The AICD has heard concerns from industry advisers about how the Australian Tax Office (**ATO**) has been approaching the issuing of Director Penalty Notices (**DPNs**) to directors of SMEs in the past year since COVID-19 temporary relief measures ended. In particular, advisors have indicated that, in their opinion, DPNs appear to have been issued in an arbitrary and inconsistent manner, including how the ATO distinguishes between utilising a 'lockdown' DPN as compared to a non-lockdown DPN.

As a DPN attaches personal liability to a director connected to taxation and superannuation liabilities of a business, it is clearly a significant tool available to the ATO that may have major ramifications for the viability of a business and the finances of an individual SME director. The AICD notes the Law Council's submission to the Inquiry on the increased and blunt use of DPNs by the ATO and how they can be unduly harsh on directors and an accompanying lack of clarity from practitioners on how the ATO determines when to issue a DPN. The AICD is concerned that the increased and inconsistent use of DPNs is not aligned with broader reforms to the insolvency regime in recent years, notably the Safe Harbour

[10] The Treasury, Review of the insolvent trading safe harbour - Final report, March 2022, page 23.

and SBR regime, that have sought to promote directors restructuring businesses, rather than placing them prematurely in administration or liquidation to avoid personal liability.

The AICD accepts there are circumstances where the use of a DPN may be appropriate, for instance repeated failure to make superannuation guarantee payments, however there should be clear guidance in what circumstances a DPN will be issued and how it aligns with broader policy settings under the insolvency regime. The current guidance on the ATO website is high-level and therefore not overly useful in a practical sense.[11]

The AICD encourages the Committee when assessing the role of the ATO to consider how it utilises DPNs, including whether there is sufficient guidance on under what circumstances the ATO will use a DPN.

5. Next Steps

We hope our submission will be of assistance. If you would like to discuss any aspects further, please contact Simon Mitchell, Senior Policy Adviser (smitchell@aicd.com.au).

Yours sincerely,

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[11] ATO guidance on DPNs available here.