How safe is Safe Harbour?

Understanding how to navigate financial stress

The better the question. The better the answer. The better the world works.
Introduction

Australia’s insolvency laws have recently undertaken major reform with the inclusion of a new Safe Harbour provision aimed at protecting directors from personal liability when navigating financial stress and threats to solvency.

These reforms are born from the Government’s innovation agenda which is an attempt to create a culture of entrepreneurship and innovation.

Given the existing legal constructs around financial distress put too much focus on stigmatising and penalising failure, the reforms are seen as a positive step forward which will lead to better decision making and better outcomes.¹

In particular, the threat of Australia’s insolvent trading laws, combined with uncertainty over the precise moment a company becomes insolvent, have long been criticised as driving directors to terminal solutions, even in circumstances where the company may be viable in the longer term². These remedies often cause substantial value to be destroyed overnight.

Under section 588G of the Corporations Act, a director of a company may be personally liable for debts incurred by the company if at the time the debt is incurred there are reasonable grounds to suspect that the company is insolvent. Breaching the insolvent trading provisions may result in civil and criminal penalties against an insolvent company’s directors.³

In turn, this creates a tension between a directors own personal interests and those of the company which may be capable of surviving the liquidity event.

Provided directors of a company with solvency concerns meet the stringent requirements in developing or pursuing a course of action reasonably more likely to lead to a better outcome for the company, they will now have the benefit of Safe Harbour which will protect them from liability.

As this is new law, its application will at some point be tested in the Courts. EY therefore considers that to reduce later challenge the most appropriate approach to these situations will be:

- **Act early**
  - It is best to avoid leaning on Safe Harbour protection in the first place.

- **Understand the issues**
  - Understand the key operational, legal, financial and commercial issues to be addressed.

- **Get proper advice**
  - This will constitute a combination of both situational experience and sector experience/knowledge.

¹ ² ³ The Parliament of the Commonwealth of Australia Treasury Laws Amendment (2017 Enterprise Incentives No.2.) Bill 2017 Explanatory Memorandum
Safe Harbour – What you need to know

The aim of the Safe Harbour reform is to facilitate more successful company restructures outside of a formal insolvency process where doing so would achieve a better outcome for the company than immediately appointing an administrator or liquidator.

This encourages directors to closely monitor the financial position of the business, engage early with financial stress and then actively take steps to either restructure the business or, if that is not possible, to move quickly to formal insolvency.

Safe Harbour focuses on the behaviour of directors in trying to turn their company around, rather than just the solvency of the company and the timing of debts being incurred as has previously been the case.

For the conscientious directors, the Safe Harbour law reforms should not necessarily change the process directors undertake to make informed decisions about a company navigating financial stress and threats to solvency.

However it will facilitate more options because the turnaround can be planned and actioned in an environment where directors’ own personal position no longer conflicts with the best interests of the company and its stakeholders.

There are a range of factors that contribute to the successful restructure of a company, from the depth of operational restructuring undertaken to the level of engagement with stakeholders. However, by shifting the paradigm and encouraging consultation with experienced professionals, these legislative reforms should now enable directors to navigate turnaround with far greater control.

In order to be able to rely on Safe Harbour provision the following key elements should be met:

<table>
<thead>
<tr>
<th>Safe Harbour – key elements</th>
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<tbody>
<tr>
<td>1 The company must continue to meet obligations for the payment of employee entitlements and taxes</td>
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<td>2 The turnaround must be likely to lead to a better outcome than an immediate insolvency appointment</td>
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<td>3 Directors must continue to discharge their directors duties and maintain appropriate financial records</td>
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<td>4 Directors must continue to comply with their other legal duties including continuous disclosure obligations</td>
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<tr>
<td>5 The company should seek professional advice from an “appropriately qualified entity” to develop and implement a restructuring plan</td>
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Safe Harbour – What you need to know
Safe Harbour protection allows directors to maintain control of the restructuring process whilst minimising personal exposure.

Benefits for Directors:
- Protects directors from liability for debts incurred by an insolvent company if they develop and take a course of action that is reasonably likely to lead to a better outcome for the company.
- Gives directors space to allow them to turn the company around without the need to manage the conflict which arises between personal interest and directors duties.
- In a stressed scenario, the directors retain control but equally have the framework to call in the right advisors.

How long does Safe Harbour last?
The Safe Harbour provisions will provide protection to a director who suspects their company may become or is insolvent, and who then starts developing one or more courses of action, and one of those courses of action is reasonably likely to lead to a better outcome for the company than the immediate appointment of an administrator or liquidator.

Safe Harbour will continue until the turnaround has been successful or the company pursues an alternative course of action (which may not necessarily be mutually exclusive) e.g., voluntary administration or scheme of arrangement.

Other considerations:
- During Safe Harbour, directors must continue to comply with all their obligations under the law, including their director’s duties and any continuous disclosure obligations.
- The Safe Harbour for company directors and holding companies imposes an evidential burden on company directors to provide reasonable evidence that they have been acting under the Safe Harbour.
- The development and deployment of a turnaround plan will need constant monitoring and adjustment to ensure that it remains appropriate and will achieve its purpose of leading to a better outcome for the company.
Key drivers of distress in Australia in the last 12 months

Although we have been in a relatively benign economic environment, there is instability, which has resulted in a number of high profile insolvencies in Australia in the last 12 months. Lack of access to capital has been a common issue for these companies, driven by changing consumer behaviours, declining markets and/or higher costs of operating.

Changing consumer behaviours
- Stagnating wage growth lowering discretionary spending
- Disruption lessening demand for brick and mortar outlets

Declining markets
- Declining commodity prices
- Slow retail environment

High cost base
- Significant rental expenses and increasing pressure from landlords
- Suppliers increasing costs to maintain margins

Access to capital

Changing consumer behaviours

Declining markets

High cost base
Factors driving future turnaround activity
The following factors are expected to drive greater turnaround activity in the next five years.

1 | Geopolitical
The political risks in North Korea will impact Australia’s major trading partners and suppliers of capital China and Japan and continue to disrupt markets, trade routes, labour and confidence.

2 | Cost and availability of capital
The Federal Reserve, the ECB and RBA are all looking to tighten interest rates. In addition, in Australia the influence the RBA has on interest rates has reduced as bank sources funding elsewhere and pass on higher costs to borrowers.

3 | Consumers
Low wage growth is squeezing consumer incomes and deteriorating savings. This is not a solid base to manage high level of debts and exposes supply chains in a tightening monetary policy environment. The retail industry is already seeing the impact of these pressures, as are their landlords.

4 | Disruption
Technological, social, political ... from channel to product, if they don’t have the capital to invest – or they invest badly.

5 | Alternative debt markets
At the end of 2016, the alternative debt funding market had already grown to more than $45b (compared to $35b in 2015). There is potential for this unregulated market to double in the coming years, with new domestic and offshore funds continuing to enter the market.

How can we help you?

Whilst the position has improved, our advice is to avoid entering into Safe Harbour if at all possible by intervening early and seeking advice from experienced professionals.

EY is a C-Suite brand that is focussed on helping create value through rescue and turnaround and only using insolvency solutions where needed to preserve value, and only then in smart ways. We regularly assist directors of companies facing difficult, high stakes and/or complex situations. We work with you so that you retain control of the company and its turnaround process.

Selecting your Independent Advisor

If Safe Harbour is necessary, it is important your Independent Advisor be appropriately qualified to gain the protections afforded by these new laws. This means that your advisor needs to be:

1. Capable of providing situational experience/knowledge – our professionals have stood in your shoes and advised many boards during similar situations
2. Proven deep sector experience/knowledge so as to understand the nuances at play – EY has deep sector expertise across nine market segments (and multiple more sub sectors),
3. Experienced at operational turnaround – our Operating Partners team has provided numerous operational turnarounds across multiple sectors and geographies.

Our ability to bring in other skills seamlessly

Accessing Safe Harbour and deployment of a turnaround plan will often require the use of other services. We work as highly coordinated teams and can bring in further situational knowledge as required, including:

- Business valuation and modelling
- Working capital and cash improvement
- Transaction tax
- M&A
- Corporate finance strategy
- Refinancing

Our approach

EY has a proven approach to advising clients wishing to benefit from Safe Harbour rules. Using our proprietary methodology EY.Insight.Activate, we will provide robust challenge, situational empathy and independent scrutiny to support the leadership team with executing an achievable turnaround plan.

Stakeholder Engagement

Our experience identifies stakeholder engagement as one of the most central elements to a successful turnaround. We have a proven track record of being able to manage multiple stakeholder groups with competing agendas. We aim to build consensus, and always take a no surprises approach to each engagement to build trust and rapport.

Key triggers and early warning signs

- Cash flow surprises
- Going concern and solvency issues
- Loss of key suppliers and/or customers
- Covenant breaches
- Changes to the executive team
- Changes in the board room
- Market disruption
- Changes in strategy
- Changes of ownership
- Changes in funding sources and critical funding requirements/discussions
- Increased stakeholder scrutiny
- Significant or unquantified legal claims

EY Restructuring – how we can help

EY Restructuring provides leadership in difficult and complex situations to solve, execute and ultimately transform the outcome. Services provided globally, connected locally and digitally enabled.

We commonly work with other EY transactions professionals so that the right advice is given to our clients

- Valuation
- Business Modelling
- M&A
- Tax
- Corporate Finance Strategy
- Refinancing
- Ratings and Hedging advice
- Forensics

Cash disciplines
Disciplines around cash and liquidity including reliability, accountability, visibility and predictability

Financial advisory
Special situations advisory services to key financial stakeholders including creditors, debtors and governments

Contingency planning
Options analysis and execution of a range of consensual and non-consensual restructuring solutions

Legal Entity Rationalisation
Integrated service designed to help organisations rationalise and simplify their legal entity structures to reduce cost and management time

Formal insolvency appointments
Formal insolvencies – to improve returns to creditors either through a rescue of the company or, where this is not possible, by realising assets and winding up the company

Chief Restructuring Officer
In-business support for corporates undergoing operational and financial restructuring can include Board appointments

Operating partners
On demand support from experienced senior executives to support management teams on complex and time critical matters – giving them confidence and support to provide the results required regarding financial and operational challenges
Partner contact details

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