MARSH & McLENNAN COMPANIES

DE-RISKING THE DISTRESSED

D&O Deep Dive: Financial Distress and What It Means for Directors

COVID-19 and the economic "shutdown" as a result of government action to limit the spread of the pandemic has brought into sharp focus directors' duties in relation to financial reporting and potential insolvency.

In Australia, the Federal Government has acted to ameliorate the risk of actions against organisations and their directors relating to potential insolvency or poor financial performance as a result of the economic downturn. The uncertainty associated with the impacts of COVID-19 has had a flow on effect in the insurance market with insurers seeking to impose Insolvency/Financial Mismanagement Exclusions on Directors and Officers (D&O) Liability insurance policies for companies, in particular, those without strong balance sheets or comfortable debt positions.

We examine the current state of play and the latest developments in the insolvency space. With the potential to undermine the value of D&O insurance, this is of particular concern to directors and officers since D&O insurance was designed to be the last line of defence in situations where the companies were unable to indemnify them due to insolvency.

Coronavirus Economic Response Package Omnibus Bill 2020 and associated Bills

In late 2017, *the Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 2017 (Cth)* was enacted. Amongst other things, this included safe harbour provisions, which provided directors with an exception from insolvent trading liability where they were developing courses of action, which were reasonably likely to lead to a better outcome for the company than administration or liquidation.

In view of the economic impact resulting from government restrictions as an effort to limit the spread of COVID-19, the Federal Government announced amendments to a number of acts and regulations to provide further relief for financially stressed businesses[1]. These amendments include:

- an additional "safe harbour" from insolvent trading liability in respect of debts incurred during the next six months (commencing from 23 March 2020) "in the ordinary course of the company's business";
- a temporary increase in the minimum amount of debt required to be owed, from $5,000 to $20,000, before a creditor can initiate involuntary bankruptcy proceedings against a debtor;
- temporarily providing debtors more time to respond to a bankruptcy notice, with the period being extended from 21 days to six months;
- temporarily extending the timeframe in which a debtor is protected from enforcement action by a creditor following presentation of a declaration of intention to present a debtor's petition, with the period being extended from 21 days to six months;
- increasing the statutory minimum for a creditor to issue a statutory demand to a debtor from $2,000 to $20,000; and
- temporarily providing debtors more time to respond to a statutory demand with the period being extended from 21 days to six months[2].

1 Coronavirus Economic Response Package Omnibus Bill 2020 and other associated Bills

2 Coronavirus Economic Response Package Omnibus Bill 2020 and associated Bills, Explanatory Memorandum, p 135f.

Safe Harbour Amendment

Pursuant to the insolvent trading laws set out in s588G of the Corporations Act 2001 (Cth) (the Act), a director of a company can be personally liable for debts incurred by the company if, at the time the debts were incurred, there were "reasonable grounds" to suspect that the company was either insolvent or would become insolvent by incurring the debt.

With effect from 23 March 2020, the *Coronavirus Economic Response Package Omnibus Bill 2020 and other associated Bills* inserted a new section 588GAAA "Safe harbour—temporary relief in response to the coronavirus" into the Act. This amendment aims to provide relief for directors in relation to subsection 588G(2), which deals with awareness of grounds for suspecting insolvency whilst incurring debt. The new section 588GAAA provides that:

1. Subsection 588G(2) does not apply in relation to a person and a debt incurred by a company if the debt is incurred:

   A. in the ordinary course of the company's business; and

   B. during:

      i. the 6 month period starting on the day this section commences; or

      ii. any longer period that starts on the day this section commences and that is prescribed by the regulations for the purposes of this subparagraph; and

   C. before any appointment during that period of an administrator, or liquidator, of the company.

2. A person who wishes to rely on subsection (1) in a proceeding for, or relating to, a contravention of subsection 588G(2) bears an evidential burden in relation to that matter.

When the safe harbour does not apply

3. Subsection (1) is taken never to have applied in relation to a person and a debt in the circumstances prescribed by the regulations for the purposes of this subsection.

Definitions

4. In this section:

   evidential burden, in relation to a matter, means the burden of adducing or pointing to evidence that suggests a reasonable possibility that the matter exists or does not exist.

Section 588GAAA does not define or indicate which debts are regarded as being incurred "in the ordinary course of business". However, the Explanatory Memorandum to the Coronavirus Economic Response Package Omnibus Bill 2020 and other associated Bills provides:

> "A director is taken to incur a debt in the ordinary course of business if it is necessary to facilitate the continuation of the business during the six month period that begins on commencement of the subparagraph. This could include, for example, a director taking out a loan to move some business operations online. It could also include debts incurred through continuing to pay employees during the Coronavirus pandemic[3]."

It is also important to note that the other directors' duties still apply, including where a company is approaching insolvency, directors are required to take the interests of creditors into account.

ASIC is also closely monitoring financial reporting obligations, and in particular, the impact of COVID-19 on Australian capital markets. Undermining the Value of D&O Insurance

3 *Id.* at p 139.

Undermining the Value of D&O Insurance

Insolvency & Side C Cover

Historically, the better D&O insurance policies in the market did not contain an insolvency exclusion and further contained an express condition to the effect that the bankruptcy or insolvency of an insured would not relieve the insurer of any obligations under the policy.

For directors, the real value of a D&O policy was its ability to provide cover when the company was unable to indemnify the directors due to either:

A. a legal prohibition[4]; or

B. the corporation being financially unable to indemnify directors due to cash flow restraints, potential insolvency, or actual insolvency.

Insolvency adds another layer of complexity where a D&O policy contains what is commonly referred to as "Side C" cover, or Securities Entity Cover. Side C provides cover for the corporate entity itself in respect of claims made against it associated with its securities.

If any insured company becomes insolvent, the existence of this Side C coverage may result in the D&O policy and any proceeds derived from it being treated as assets of the company. This could result in applications by liquidators to attach the proceeds of the policy and apply them to the company's liabilities, effectively making the proceeds available to creditors[5]. This could result in insured directors and officers being either delayed in accessing their policy proceeds, or losing their insurance protection altogether and thereby having to self-fund any defence, settlement or judgment.

To help alleviate some of the drawbacks of Side C cover, a Priority of Payments Clause (or Order of Payments Clause) in combination with tailored program structures have been used to combat the Side C dilemma[6].

Financial Mismanagement/Insolvency Exclusions

Interestingly, in light of the current COVID-19 pandemic, the Side C dilemma may soon be a thing of the past with the resurgence of Financial Mismanagement/Insolvency Exclusions, which first came into light in the late 2000s during the global financial crisis. The known and unknown impacts of COVID-19 have prompted insurers to propose these exclusions once again, in particular, targeting companies which may not have strong balance sheets or desirable debt positions.

Under a Financial Mismanagement/Insolvency Exclusion, irrespective of what covers are in place, the policy will not respond in the event of any Claim or Investigation in any way involving any allegations that an Insured Entity is unable to pay its debts as and when they fall due, or has had an administrator, controller, receiver, manager, liquidator or any other external insolvency officeholder appointed to it.

Wordings of such exclusions may vary amongst insurers, but many also exclude claims brought by or on behalf of any creditor, debt holder, liquidator, administrator or receiver of any Insured Entity, as defined under the policy.

Marsh will continue to resist the imposition of these exclusions on behalf of our clients and amend to narrow their scope where possible. We will also explore alternative insurance markets or program structures to ensure a D&O program continues to offer the protection it was designed for: as the last line of defence for the protection of the personal assets of directors and officers.

It is important to remember that there are various ways for a company to structure its D&O insurance program to ensure it meets the needs of both the corporate entity as well as its directors and officers. Alternative products, structures and policy or statutory provisions (including those regarding the notifications of claims and/or circumstances) are available to assist and fill any perceived or actual gaps in cover.

Has your business been financially impacted by COVID-19? *To learn more about where D&O implications fit in and how to manage the unique risk and people issues through the various phases of the Restructuring and Turnaround Lifecycle, download a copy of De-Risking the Distressed: Risk and People Solutions for Distressed Companies.*

4 For example, section 199A of the Corporations Act 2001 (Cth).

5 Pursuant to section 562 of the Corporations Act 2001 (Cth). Refer to Paper by Fred Hawke, Partner of Clayton Utz: *Side C Securities Cover – The Albatross around the Neck of Directors and Officers Liability Insurance October 2008*.

6 A Priority of Payments Clause (or Order of Payments Clause) specifies the order in which payments are to be made under a D&O policy, with insured persons' non-indemnifiable loss prioritised over the corporate entity. Such clauses were designed to protect insured persons' interests in D&O policy proceeds, especially where there may be competing interests for the proceeds of the policy (eg. where there is a Side C claim and a Side A&B claim or in an insolvency scenario).

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