CRS Insolvency Services

Insolvent Trading

Introduction

The Corporations Act requires directors to prevent their company from incurring debts that it is not able to pay. But the 'insolvent trading' provisions go much further than that - if directors allow insolvent trading, they may be held personally liable for those debts.

There are defences, but they are not easily accessed. The legislation has been framed on the basis that directors will acknowledge their responsibilities and take positive action if there is doubt as to the solvency position of the company.

The purpose of this alert is to provide an overview of the insolvent trading regime, to assist your director clients in recognising the warning signs of insolvency, and to assist understanding as to what a director should do if one suspects a company may be insolvent or becoming insolvent.

This is of great significance as ASIC is increasing its focus on reducing insolvent trading and phoenix company activity through a funding program known as **The Assetless Administration Fund.** ASIC may now fund a liquidator to investigate situations which may lead to enforcement action.

A guide to Insolvency for directors?

If a company falls behind in its payment of tax liabilities, the ATO can issue a Director Penalty Notice to any or An insolvent company is one that is unable to pay all its debts when they fall due for payment. There are serious penalties for allowing a company to trade whilst it is insolvent. If your company is in financial difficulty, you should seek independent advice on your duties and the options available.

Who is a director?

A director is not just a person appointed to that role. Under the Corporations Act 2001 (Corporations Act), a person may also be a director if they are not formally appointed but act in that role, or if the directors of the company act in accordance with their instructions or wishes.

In case study two overleaf, there is an example of an insolvent trading claim made against a person who arranged for his daughter to be registered as a director. In case study five there is an example of a $4.6m insolvent trading claim made against a company and it's senior managers.

Duty to not trade while insolvent

As well as general directors' duties, one has a positive duty to prevent a company from trading whilst it is insolvent. This means that before a new debt is incurred, a director must consider whether there are reasonable grounds to suspect that the company is insolvent or is likely to become insolvent as a result of incurring the debt.

An understanding of the financial position of the company only when one signs off on the yearly financial statements is not sufficient. One needs to be constantly aware of the company's financial position.

Duty to keep books and records

A company must keep adequate financial records to correctly record and explain transactions and the company's financial position. If a director fails to maintain adequate books and records and the company is later placed into liquidation, the liquidator will be able to presume that the company was insolvent for the period that adequate records were not maintained.

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Consequences of insolvent trading

There are various penalties and consequences of insolvent trading, including civil penalties, compensation proceedings and criminal charges. The Corporations Act provides some statutory defences for directors.

Genuinely believing the company to be solvent

A director who genuinely believed the company to be solvent can claim a defence. It is not good enough for a director to say that they believed the company was solvent – the Court must form the view that a 'reasonable person' would have formed the opinion that the company was solvent.

Competent and reliable person

A director can also claim a defence if they can establish that they genuinely and reasonably relied upon a 'competent and reliable person' to provide them with information about the company's solvency.

Illness or some other good reason

A director who did not take part in the management of the company can claim a defence – but only if there was a good reason such as illness – that prevented them from taking part in the management of the company.

Taking steps to stop the company incurring the debt

A director who takes 'all reasonable steps' to stop the company from incurring a debt can also claim a defence. Notably, the legislation specifically requires the Court to consider the specific steps taken by the director to appoint an administrator.

However, directors may find it difficult to rely upon these if they have not taken steps to keep themselves informed about the company's financial position.

Civil penalties

Contravening the insolvent trading provisions of the Corporations Act can result in civil penalties against directors, including pecuniary penalties of up to $200,000.

Compensation proceedings

Compensation proceedings for amounts lost by creditors can be initiated by a liquidator or a creditor against a director personally. Compensation payments are potentially unlimited and could lead to the personal bankruptcy of directors. The personal bankruptcy of a director disqualifies that director from continuing to act as a director or managing a company.

ASIC can also take action to recover damages, and in case study one ASIC took action against a director after creditors had negotiated a deed of company arrangement which was intended to protect the director from insolvent trading claims.

Criminal charges

If dishonesty is found to be a factor in insolvent trading, a director may also be subject to criminal charges (which can lead to a fine of up to $220,000 or imprisonment for up to 5 years, or both).

What to do if you suspect financial difficulty

If you suspect a company is in financial difficulty, get proper accounting and legal advice as early as possible. One of the most common reasons for the insolvency of a company was professional advice was sought too late. Directors cannot have a 'head in the sand' attitude, hoping that things will improve—they rarely do.

Signs that may indicate a company is at risk of insolvency

Most businesses experience one or more of these problems at some point in time – but if you experience them on a sustained basis it may be time to seek professional assistance.

- ongoing losses
- poor cash flow
- incomplete financial records or disorganised internal accounting procedures
- increasing debt (liabilities greater than assets)
- problems selling stock or collecting debts
- unrecoverable loans to associated parties
- creditors unpaid outside usual terms
- solicitors' letters, demands, summonses, judgements or warrants issued against a company
- suppliers placing a company on cash-on-delivery (COD) terms
- issuing post-dated cheques or dishonouring cheques
- special arrangements with selected creditors
- payments to creditors of rounded sums that are not reconcilable to specific invoices
- overdraft limit reached or defaults on loan or interest payments
- problems obtaining finance
- change of bank, lender or increased monitoring/ involvement by financier
- inability to raise funds from shareholders
- overdue taxes and superannuation liabilities
- board disputes and director resignations, or loss of management personnel
- increased level of complaints or queries raised with suppliers
- an expectation that the 'next' big job/sale contract will save the company

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What to do if your company is insolvent

If a company is insolvent, the directors cannot allow it to incur further debt. Unless it is possible to restructure, refinance or obtain equity funding to recapitalise the company. If you can't achieve that you should seek independent professional assistance to consider if you should place your company into Voluntary Administration.

Voluntary administration

Voluntary administration is designed to resolve the company's future direction quickly. A Voluntary Administrator takes full control of the company to try to work out a way to save the company or the company's business. After a company is placed into Voluntary Administration, it is sometimes possible to restructure it through a Deed of Company Arrangement. If it isn't possible to save the company or its business, the aim is to wind down the affairs of the company in an orderly manner.

Placing a company into Voluntary Administration is a relatively straightforward process, as it can be initiated by the board of directors resolving that the company is insolvent, or likely to become insolvent, and appointing an administrator.

What should you do if you think your business might be insolvent?

If you think your company may be insolvent you should seek expert advice. Call CRS Insolvency Services on 1800 210 073 for urgent assistance.

Important note: This information sheet contains a summary of basic information on insolvency. It is not a substitute for legal advice. Some provisions of the law referred to may have important exceptions or qualifications. This document may not contain all of the information about the law or the exceptions and qualifications that are relevant to your circumstances. You will need a qualified professional advisor to take into account your particular circumstances and to tell you how the law applies to you.

Directors under fire

Case Study 1 - Elliott v Water Wheel Holdings Ltd
(Subject to a Deed of Company Arrangement)

High profile businessman John Elliott was ordered to pay $1.3m in insolvent trading claims arising out of the failure of the listed company Water Wheel Holdings group of companies. Although the companies had entered into deeds of company arrangement that released the directors from claims made by the companies, an Insolvent Trading claim was made by ASIC. After a ruling by the Federal Court that the deed did not prevent a claim by ASIC, Mr. Elliott later took steps to have himself made bankrupt.

Case Study 2 - Crossroads Fashions Pty Ltd (in liquidation) & Anor v Gavin & Anor

A 'shadow director' - the daughter of the person actually registered as the director - was ordered to pay $135,094.49 plus costs and interest of $18,237.76 after the failure of a small chain of women's fashion stores.

The Court found that the director's explanation that missing financial records were lost through actions of landlords and their agents was 'unconvincing' - with the result that their absence made it significantly easier for the liquidator to establish that the company was insolvent.

Case Study 3 - Woodgate v Davis

The sole director of two companies that carried on business in partnership attempted to argue that the insolvent trading provisions did not apply to companies that operated via a partnership. When that argument failed he was left facing a $3.37m claim.

Case Study 4 - Scott v Williams & Ors

A director was pursued for a total of $2.53m, including $1.12m incurred after the directors had been advised - by the accountant who was now the liquidator, and their own solicitor - not to incur credit at all. The Court found the director liable for insolvent trading, however exercised discretion to limit the liability to 'only' $500,000 which was the amount another director had agreed to pay in an out-of-Court settlement.

Case Study 5 - Ho v Akai Pty Limited (In Liquidation)

A liquidator pursued a company and some of its officers for claims totaling $4.566m, arguing that they had acted as shadow directors of a company now in liquidation.

The company had been authorised by a management agreement' to make decisions and implement them in anticipation of a corporate rescue that did not eventuate. Allowing disallowing a part of the claim, the Federal Court of Appeal held that it was 'at least arguable that the company and some of its senior managers had acted as shadow directors.

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