BANKRUPTCYSOLUTIONS

INSOLVENT TRADING

THE LAW

Directors have a duty to prevent their company from trading when it is insolvent. If a director breaches his duty to prevent insolvent trading he can be made personally liable for the debts incurred by his company.

The concept of not purchasing new goods or services on credit after the date a company becomes insolvent is simple. The contentious issues are always the exact date of a company's insolvency and the defences available to directors.

Section 588G of the Corporations Act establishes a director's duty to prevent insolvent trading by a company. The section applies if:

- A person is a director of a company and
- At the time a debt was incurred:
- The company was insolvent and
- There are reasonable grounds for suspecting the company was insolvent

DIRECTOR DEFENCES

Directors can avoid personal liability for their company's debts if they can establish one of the following three defences:

The director had reasonable grounds to expect the company was solvent
The director did not participate in the management of the company due to illness or another good reason or
The director took all reasonable steps to prevent the company from incurring debt.
The second and third defences sound enticing, but are difficult to establish in practice.

It's important to note that there are two different thresholds of evidence. To utilise the available defence, a director must establish reasonable grounds to "expect" solvency while the director will be made liable for insolvent trading when they "suspect" insolvency.

WHAT IS THE DEFINITION OF A DIRECTOR?

The Corporations Act defines a director in fairly broad terms, including:

- Validly appointed directors
- People who act as directors or hold themselves out to be directors of companies regardless of their title within the company
- Shadow directors, that is people who regularly act for the directors of the company in accordance with their instructions or wishes.

Professional advisers such as accountants, lawyers and liquidators are excluded from this definition when they are simply giving their advice in the normal course of their work. If they start to take an active role in the management of the company, however, they can cross the line and be regarded as a director.

Examples of people whom the Courts have found to be shadow directors include:

- A management consultant who starts implementing a corporate recovery plan
- A shareholder in a joint venture who has dictated the actions of the company but was not appointed as a director and
- A lender being overly involved in the management of his customer's affairs.

Although a company cannot itself be appointed a director of another company, it is possible for a company to be a shadow director of another company.

Professional advisors and third parties assisting a company who are concerned about being deemed a director should also be aware of section 79 of the Corporations Act. This section can make a person who is an accessory to a breach of the Act (such as insolvent trading) liable for that breach. This section refers to persons who have aided, abetted, counselled, procured, induced or been knowingly involved in, or party to, a breach of the Act.

Only directors have a duty to prevent insolvent trading. Unlike the other statutory duties, it does not apply to officers.

Holding companies will generally be liable for the insolvent trading of their subsidiaries.

WHAT IS THE DEFINITION OF A DEBT?

A critical element of the insolvent trading law is the concept of when a company incurs a debt.

There is no definition of "debt" or "incurs" in the Corporations Act and so the definition of this concept is found through examining past judicial decisions, which are often contradictory. As the Chief Justice of the High Court, Murray Gleeson once said,

> *The words 'incurs' and 'debt' are not words of precise and inflexible denotation.*

It may be difficult to believe, but what most people might think are simple concepts have been rendered complex and vague by the Courts.

Suffice to say, as a general principle directors may be liable for debts that are incurred and payable and not merely accrued or payable at some later date.

WHEN IS A COMPANY INSOLVENT?

The date of insolvency is always a subjective and complex issue. Lawyers love this issue because there's always something to argue about.

Whole textbooks have been written on this single concept (liquidators have been known to keep them besides our beds and read them on holidays).

The problem with determining a date of insolvency is that companies have good and bad months. A temporary lack of liquidity is not the same as insolvency. Some companies are asset-rich and cash flow-poor. Some have access to credit. These are just a few of the issues that must be considered when considering a company's solvency.

The concept of insolvency is simple. If you can't pay your creditors, you are insolvent. But the application of this concept to the specific circumstances of a corporate failure is difficult and contentious. Establishing insolvency is often described as an art rather than a science.

As section 95A of the Corporations Act states:

> *A company is solvent if, and only if, it is able to pay all its debts as and when they become due and payable.*

There is no specific requirement that debts must be paid from the company's own money (this was removed in 2001). The statutory focus is on solvency, not liquidity. Thus it is appropriate to consider the terms of credit and financial support available to the company to pay its creditors.

A company will be presumed to be insolvent in certain circumstances, which includes failure to keep adequate books and records for the 12 months preceding a liquidation. Where those presumptions do not apple, or they are rebutted, the liquidator will be required to demonstrate insolvency.

POTENTIAL SIGNS OF INSOLVENCY

Bad management

Typical signs of bad management may include:

- A dominant leader
- Inadequate and static administrative support
- Failure to use reliable financial information
- Wrong product mix
- Inability to respond to and implement change
- Lack of direction
- Decline in service standards
- Excessive remuneration of director
- Lack of professional advice
- Inadequate mix of management skills
- Employee conflicts with management
- Sale or closure of selected business lines or assets

Cash flow difficulties

Cash flow problems can include:

- Lack of working capital
- Bad credit risks and numerous or large bad debts
- Excessive inventory
- Excessive capital purchases
- Continued trading losses
- Reliance on trade credit
- Use of statutory expenditure as a source of finance
- Poor benchmarking with industry standards
- Increase in overdraft
- Financials show loss or reduction in profit

Excessive debt and under-capitalisation

- Insolvency will normally be a result of poor debt management and under capitalisation

Inadequate accounting

- Reliable financial information means:
- Budgets
- Cash flows
- Regular statements of financial position and performance
- Analysis of aged debtors and creditors reports
- Attendance to cash book and bank reconciliations

Singular reliance

- Reliance on a single project, source of work, person or team is not constructive

External factors

- Change in economic conditions
- Change in government policy
- Insurance claim not paid or delayed
- Currency fluctuations
- Increased competition

Disputes

- Most disputes are between directors or owners, but the most hostile disputes are between family members.

Where the potential signs of insolvency are evident, discussions with the client should be undertaken to evaluate the client's circumstances and options.

In practice, the date of insolvency is usually the date a company fails to pay its taxation obligations on time and starts accruing these debts without the consent of the ATO.

The deadline for the payment of ATO obligations is fixed and variations are difficult to organise so it's relatively easy to argue these debts were due and payable and not paid and thus the company is insolvent.

EVIDENCE OF INSOLVENCY

- Trading losses
- Net asset deficiency
- Failure to pay statutory debts including GST, PAYG, superannuation
- Delayed payment to non-essential creditors
- Part-payments and instalment plans with essential creditors
- Dishonoured cheques
- Artificial valuation of assets
- Sale and leaseback of assets
- Factoring of debtors
- COD terms with essential suppliers
- Receipt of winding-up notices
- Injection of director's own resources to provide short-term relief

Where there is evidence of insolvency, professional advisers should determine if their client should consider using the statutory frameworks that permit reconstruction of a business to avoid liquidation or bankruptcy.

CONSEQUENCES OF CONTRAVENTION

The consequences of insolvent trading include the following. The director may be:

- Personally liable and ordered to pay for debts incurred by the company when it was insolvent
- Disqualified from managing a company
- Ordered to pay a civil and/or criminal penalty of up to $220,000
- Sent to jail for up to five years.

IS INSOLVENT TRADING A CRIMINAL OFFENCE?

Directors are generally not deemed to be committing a crime when they breach their obligation to avoid trading when insolvent. They are breaking the law, but this will not usually constitute criminal behaviour.

On rare occasions, a director may be liable for the criminal offence of insolvent trading if they suspected the company to be insolvent and dishonestly failed to prevent the company incurring the debt.

"Dishonestly" is defined by criminal legal authorities as conduct that seeks, through intention or recklessness, to gain an advantage for the director, or when the director intends to deceive or defraud creditors from insolvent trading.

WHO CAN BRING PROCEEDINGS FOR INSOLVENT TRADING?

A liquidator of a company, a creditor of a company (with the consent of the company's liquidator or the Court) or ASIC may bring proceedings against a director to recover compensation for loss resulting from insolvent trading.

LITIGATION

The statutory framework that prohibits directors from continuing to trade an insolvent company is well drafted. However it is rare for liquidators to engage in litigation to pursue the available insolvent trading claims against directors. Whereas, claims are often made by liquidators against directors for insolvent trading.

According to statistics from liquidators reporting to ASIC, about 50 per cent of the 10,000 companies that go into liquidation each year traded when insolvent.

However 95 per cent of those companies will not have sufficient assets to pay a dividend to creditors because most of the available assets have been spent. For small companies, the director's personal wealth is also usually lost in the corporate failure.

It follows that there is no benefit to creditors in pursuing available claims for insolvent trading if the director does not have the capacity to pay.

The cost of litigation is also a material barrier to pursuing an insolvent trading action.

This cost of litigation can, in certain circumstances, be offset by the availability of litigation funders who will pay the lawyers 30 to 50 per cent of any successful settlement sum or judgement. In practice, however, litigation funders are only interested in large-scale matters.

Consequently, only about a dozen insolvent trading cases are determined by the Courts each year. The vast majority of insolvent trading claims are either abandoned or settled out of Court without litigation.

HOW CAN DIRECTORS PREVENT INSOLVENT TRADING?

Directors can prevent insolvent trading by:

- Actively monitoring the solvency of their company and investigating any financial difficulties
- Obtaining advice from an appropriately qualified person where necessary and
- Considering and acting appropriately on that advice in a timely manner

A liquidator is an ideal person to engage to conduct a solvency review of a company and outline available options if it is in financial distress.

Liquidators can also organise informal standstill agreements with suppliers. Debtors and creditors will often cooperate well with a liquidator acting prior to a formal appointment. In addition, parties with a vested interest will work together when they know the alternative is to crystalise a loss that arises from a liquidation.
Most liquidators are reluctant to do significant pre-appointment work, because it precludes them from being formally appointed as the liquidator of a company should it fail, which is generally a more lucrative source of income. But if you can find the right liquidator, they can do great pre-appointment work.

For more information on the options for insolvent companies, see our links on refinancing, a prepack guide voluntary administration.

THE LIMITATION PERIOD

Liquidators have six years to commence an insolvent trading action.

DIRECTOR RESPONSE TO INSOLVENT TRADING CLAIM

There's a classic song by the Australian band The Cruel Sea that includes the lyrics "Better get a lawyer, son, better get a real good one".

And that advice is particularly good. However, we would suggest a director save some money by inviting the liquidator to prove the insolvent trading case as it is common for liquidators to make claims from directors but decline to litigate.

We would further encourage directors to:

- Invite the liquidator to detail his solvency report to test the quality of his work
- Test his assumptions and facts
- Determine what debts were incurred and the timing of these debts
- Verify the director's appointment
- Investigate available sources of finance and
- Realisable valuable assets.
- It's also a good idea to engage another liquidator and a lawyer to critique the work of any liquidator in due course.

DO YOU NEED HELP?

As experts in corporate and personal insolvency, we specialise in turnaround and restructuring services. Our partners have worked on more than 1,000 liquidations.

We invite you to give us a call, all initial discussions are free of cost or obligation. Talk to our in-house liquidators, bankruptcy trustees, lawyers or accountants about your circumstances and options.

We have offices in Sydney, Melbourne and Byron Bay together with affiliated offices in each capital city. Our nationwide network lets us service our clients' needs throughout Australia.