When is a company insolvent?

‘Solvency’ is defined in s 95A (1) of the Corporations Act 2001 as the ability to pay all debts as and when they become due and payable. A person or organisation who is not solvent is ‘insolvent’ (s 95A(2)). The Corporations Act 2001 does not provide any guidance on how to assess whether debts can be paid by the corporation. In Sutherland v Hanson Construction Materials Pty Ltd (2009) the New South Wales Supreme Court made the point that:

“...solvency is to be determined primarily according to the company’s cash flows. It is important to note, however, that the state of the balance sheet, although not the primary test, remains relevant to the [question of solvency].”

The definition of ‘debt’ includes dividends, share buybacks, capital reductions and issuing redeemable preference shares. A debt happens on the date on which it was incurred, not when it is due to be paid.

When does a director breach s 588G?

Section 588G sets out a director’s duty to prevent insolvent trading by a company. Under this section, a director has a duty to prevent insolvent trading where:

- he or she is a director of the company at the time the company incurs a debt; and
- the company is insolvent at that time (or becomes insolvent by incurring that debt or by incurring at that time debts including that debt); and
- at that time there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.

If the director fails to prevent the company from incurring the debt in the circumstances set out above, the director contravenes s 588G of the Corporations Act 2001 if:

- the director is aware at that time that there are such grounds for suspecting the insolvency; or
- a reasonable person in a like position would be so aware.

Further, the director commits an offence if the failure to prevent the company incurring the debt was ‘dishonest’ (s 588G (3)).

The onus of proof is on the person trying to make a director liable for insolvent trading.
What are some warning signs of insolvency?

Directors are responsible for monitoring performance and informing themselves of the company’s true financial position. If problems are caught early, there is a greater chance of remedying them and ensuring the company's survival. In the Australian Securities and Investments Commission’s (ASIC's) Regulatory Guide 217 – Duty to Prevent Insolvent Trading: Guide for Directors (2010), Table 2 lists the following as potential indicators of insolvency:

- “The company has a history of continuing trading losses.
- The company is experiencing cash flow difficulties.
- The company is experiencing difficulties selling its stock or collecting debts owed to it.
- Creditors are not being paid on agreed trading terms and/or are either placing the company on cash on-delivery terms or requiring special payments on existing debts before they will supply further goods and services.
- The company is not paying its Commonwealth and State taxes when due (for example pay-as-you-go instalments are outstanding, goods and services tax is payable or superannuation contributions are payable).
- Cheques are being returned dishonoured.
- Legal action has been threatened or has been commenced against the company, or judgments are entered against the company, in relation to outstanding debts.
- The company has reached the limits of its funding facilities and is unable to obtain appropriate further finance to fund operations – for example, through:
  - negotiating a new limit with its current financier; or
  - refinancing or raising money from another party.
- The company is unable to produce accurate financial information on a timely basis that shows the company’s trading performance and financial position or that can be used to prepare reliable financial forecasts.
- Company directors have resigned, citing concerns about the financial position of the company or its ability to produce accurate financial information on the company’s affairs.
- The company auditor has qualified their audit opinion on the grounds there is uncertainty the company can continue as a going concern.
- The company has defaulted, or is likely to default, on its agreements with its financier.
- Employees, or the company’s bookkeeper, accountant or financial controller, have raised concerns about the company’s ability to meet, and continue to meet, its financial obligations.
- It is not certain that there are assets that can be sold in a relatively short period of time to provide funds to help meet debts owed, without affecting the company’s ongoing ability to continue to trade profitably.
- The company is holding back cheques for payment or issuing post-dated cheques.”

ASIC's national insolvency trading program (see below) is of the view that a director is less likely to breach their duties under the *Corporations Act 2001* if they take into account the following key principles in carrying out their role:

- Maintain appropriate books and records
- Identify insolvency concerns and assess available options
- Seek professional advice
- Act in a timely manner

What are the key principles directors should keep in mind?

In July 2010, ASIC released *Regulatory Guide 217 – [Directors] Duty to Prevent Insolvent Trading: Guide for Directors*. The regulatory guide contains four key principles that ASIC considers directors need to take into account in performing their duty to prevent insolvent trading:

- Keep themselves informed about the company’s financial position and affairs;
- Regularly assess the company’s solvency and investigate financial difficulties immediately;
- Obtain appropriate professional advice to help address the company’s financial difficulties where necessary; and
- Consider and act in a timely manner on the advice.
What should be done if insolvency is suspected?

A range of options is available to directors who suspect insolvency in their organisations:

- **Seek professional advice** – the advice might be to use voluntary administration with a view to restructuring affairs and continuing trade or to invite a secured creditor to appoint a receiver or appoint a liquidator.

- **Do not incur further debts**

- **Possibly cease trading**

- **Obtain financial support**

> Company directors must ensure, as they deal with their company’s affairs, especially when the company faces financial uncertainty, that they do not allow the company to trade while insolvent, nor incur a debt that would lead the company to insolvency.

This is in addition to a director’s general duties to act with care and diligence, in good faith in the best interests of the organisation and not to improperly use their position or information received for personal gain (ss 180-183).

Are there any defences?

The following defences are available to a director under s 588H of the Corporations Act 2001 for failing to prevent insolvent trading:

- At the time when the debt was incurred, the director had reasonable grounds to expect, and did expect, that the corporation was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

- At the time when the debt was incurred, the director did not take part in the management of the corporation because of illness or for some other good reason.

- The director took all reasonable steps to prevent the corporation from incurring the debt — the matters which will be considered include but are not limited to any action the person took with a view to appointing an administrator of the corporation, when that action was taken and the results of that action.

These defences are not available in criminal proceedings based on dishonesty.

What are the penalties for insolvent trading?

Insolvent trading leaves a director open to civil and criminal penalties as well as being personally liable to compensate for losses. Directors are defined as those duly appointed, including de facto and shadow directors and those managing while disqualified.

Note that s 588G only applies to directors and not to management.

If insolvency occurs, directors must take the interests of creditors into account. This includes helping the administrators in every required way. Creditors make the decision as to whether to save the company.

The liability for debts after a company becomes insolvent lies with those who were directors at the time of acquiring the debt.

ASIC can exact civil penalties against directors. These include:

- Disqualification from managing a company

- Substantial fines

- Paying compensation to the company equivalent to the loss suffered by the creditors (s 588J).

Criminal proceedings for insolvent trading may be brought if dishonesty is involved. Directors can be ordered under s 588K to pay compensation to the company for the loss suffered by the creditor.

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What is ASIC’s national insolvency trading program (NITP)?

Directors should be aware of the NITP. This is a focused approach by ASIC to deal with possible insolvent trading before it occurs. It involves a review of a company to ensure compliance by directors of their duty of care under s 180 (1) and insolvent trading.

A number of sources are used to identify the companies selected for the program, including:

- Complaints received from the public, including complaints from credit managers and company employees
- Listed companies that have their annual accounts reviewed as part of ASIC’s accounts surveillance program and are identified as financially-stressed
- Information from liquidators
- Referrals from other areas within ASIC

A director is required to provide all documents requested under a notice issued under the Australian Securities and Investment Commission Act 2001. Generally the review will take place at the principal place of business of the company, however, in certain circumstances, notices can also be complied with by delivering records directly to an ASIC office. The managing director should attend a review. However, where appropriate, other directors, finance staff, external accountants and lawyers may also attend.

On completion of the review, ASIC may write to the company setting out concerns about its potential insolvency. To assist with the assessment of a company’s financial position, ASIC may ask that the company prepare up-to-date management accounts. Where appropriate, ASIC may ask that the company approach an insolvency professional for advice on the possible appointment of an external administrator.

In certain cases, ASIC may take action directly. Cases of suspected breaches of the insolvent trading provisions of the Corporations Act 2001, and where directors are not seeking to comply with their responsibilities in this area, are considered for possible enforcement action.