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INSOLVENCY & BUSINESS ADVISORY

# “WHAT IS INSOLVENT TRADING?”

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## WHAT IS INSOLVENT TRADING?

Directors have many duties, one of which is to prevent their company from trading whilst insolvent. Pursuant to section 588G of the Corporations Act 2001 (“the Act”), a director breaches that duty if they cause the company to incur a debt in circumstances where they knew, or ought to have known, that the company is insolvent, or likely to become insolvent as a result of that transaction.

If proven, directors can become personally liable for the debts incurred by the company whilst it was insolvent and/or face criminal prosecution.

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## 2.1 DEFINITIONS

Section 95A of the Act states:

1. **A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable."**
2. **"A person who is not solvent is insolvent."**

Unfortunately, the usefulness of these definitions is limited except to the extent that the wording of the legislation recognises the availability of cash and credit resources as the primary determination of solvency. For further guidance in defining or recognising insolvency, it is necessary to refer to case law.

## 2.2 ASSESSING A COMPANY'S SOLVENCY

The importance of cash flow in determining solvency was articulated by His Honour Dodds-Streeton J. in his judgment in the matter of Crema Pty Ltd v LandMark Property Developments Pty Ltd (2006) 58 ACSR 631, where he stated that:

**"Section 95A of the Act enshrines the cash flow test of insolvency which, in contrast to a balance sheet test, focuses on liquidity and the viability of the business. While an excess of assets over liabilities will satisfy a balance sheet test, if the assets are not readily realisable so as to permit the payment of all debts as they fall due, the company will not be solvent. Conversely, it may be able to pay its debts as they fall due, despite a deficiency of assets."**

The assessment of the solvency of a company requires an analysis of the totality of the company's circumstances, including industry norms and available credit. O'Brien Palmer was involved in the often reported case, Southern Cross Interiors Pty Ltd (In Liquidation) & Anor v The Deputy Commissioner of Taxation (2001) 188ALR 114.

In his judgment, His Honour Palmer J. stated that the following propositions could be drawn from the established authorities:

- i. A company's solvency is a question of fact to be ascertained from considering its financial position as a whole.
- ii. In considering a company's financial position as a whole, the Court must have regard to relevant commercial realities, such as what resources are available to a company to meet its liabilities as they fall due.
- iii. In assessing whether a company's position as a whole reveals surmountable temporary illiquidity or insurmountable endemic illiquidity, it is proper to have regard to the commercial reality that creditors will not always insist on payment strictly in accordance with their terms of trade but that does not constitute a cash or credit resource available to the company.

- iv. The commercial reality that creditors will normally allow some latitude for payment of their debts does not warrant a conclusion that the debts are not payable at the contracted time.
- v. In assessing solvency, the Court acts upon the basis that a contract debt is payable at the time stipulated for payment in the contract.

These propositions, whilst informative, are somewhat broad. A further and useful commentary on solvency was given by His Honour Mandie J. in a judgment delivered in the high profile case of ASIC v Plymin & Anor (2003) 46 ACSR 126 (otherwise known as the Waterwheel Case).

Justice Mandie adopted 14 indicia of insolvency which are now often utilised in assessing the solvency of a company. However, this list is not exhaustive. The Australian Securities & Investments Commission has also published a guide on the warning signs of Insolvency. O'Brien Palmer has previously published a newsletter entitled **'Recognising the Insolvency Warning Signs in Your Business'** that provides an analysis of the warning signs of insolvency that can be obtained from the O'Brien Palmer website ([www.obp.com.au](http://www.obp.com.au))

## TEMPORARY OR ENDEMIC CASH FLOW INSOLVENCY

**A company is insolvent where its available resources are insufficient to meet its debts. These resources include cash, assets readily convertible to cash and available credit such as an unused bank overdraft facility.**

It is relevant to distinguish between a company that is insolvent and a company that is experiencing temporary cash flow issues. In the judgement of His Honour Jacobs J. in the matter of Hymix Concrete Pty Ltd v Garrity (1977) 13 ALR 321, it was acknowledged that:

**"a temporary lack of liquidity is to be distinguished from an endemic shortage of working capital where liquidity can only be restored by a successful outcome of business ventures in which the existing working capital has been deployed."**

An endemic shortage of working capital will be apparent where the company is utilising credit funds on terms that it cannot comply with or at debt levels beyond that which it can service.

It would also be evident in circumstances where a company is otherwise displaying numerous signs of insolvency.

## 4.1 STEPS TO PROVE THE DATE OF INSOLVENCY

**In order to determine the date on which a Company is deemed to have become insolvent, an insolvency practitioner will review the available books and records of a company, as well as records obtained from third party sources such as creditors, banks and statutory authorities. In conducting this review, the practitioner is looking for evidence of indicia of insolvency. The key indicia of insolvency include the following;**

- i. overdue trade creditors
- ii. overdue taxation liabilities
- iii. recovery action being initiated by creditors
- iv. no access to alternate finance
- v. payment of debts by way of installments

As a result of this review, it can become apparent that at a certain point in time, sufficient indicia of insolvency are present to justify a conclusion that the company was insolvent at that time.

Section 588E(3) of the Act provides that where the evidence supports a determination that a company became insolvent at a time within 12 months prior to the company being wound up, then it is presumed

that the company was insolvent throughout the period between that time and the date that the company is wound up.

If the company has not maintained adequate books and records in compliance with section 286 of the Act, then a presumption of insolvency arises for the period in which the books and records have not been properly maintained. Section 588E(4) of the Act states:

*"If a company does not keep comprehensive and correct records of its accounts and financial position, or if it does not keep records of a transaction for seven years after its completion, then that company will be presumed to be insolvent during the period to which the records relate."*

Not only is the inability to maintain financial records an indicator of insolvency, but failure to maintain proper books and records may render a company legally insolvent from a date that is earlier than that at which it actually became insolvent.

## 4.2 DEBTS INCURRED

After a date of insolvency is established, the liquidator will then assess the debts incurred after that date, in order to determine the quantum of the personal liability of a director for trading whilst insolvent.

## CLAIM FOR TRADING WHILST INSOLVENT

### 5.1 PROSECUTION OF INSOLVENT TRADING

**Where it is determined that a company has traded whilst insolvent, an insolvency practitioner will, in the ordinary course, report this alleged contravention to the Australian Securities & Investments Commission ("ASIC") in accordance with either sections 422, 438D or 533 of the Act.**

A liquidator appointed may also take steps to seek compensation from the director(s) for the quantum of the debts incurred by the company after it became insolvent. These steps usually involve the issuance of a letter of demand to the director(s) for repayment of a fixed sum of money.

The Liquidator may also instruct a solicitor to further pursue the claim where the initial demand is ignored or commercial settlement cannot be reached.

The Liquidator may be required to commence proceedings against the director(s) to seek compensation orders.

The commerciality of commencing such action may ultimately be dependent upon the ability of the director to meet any judgement that might be obtained.

In circumstances where there are multiple directors, the Liquidator is entitled to recover from whichever of the directors is most commercial to pursue.

That director has a right of indemnity against their fellow directors to recover an equitable share of the amount recovered by the Liquidator.



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## CLAIM FOR TRADING WHILST INSOLVENT (CONTINUED)

### 5.2 DEFENCES AVAILABLE TO DIRECTORS

Directors may have defences to a claim made for insolvent trading. Section 588H of the Act states that a director can claim a defence where he or she:

- had reasonable grounds to believe that the company was solvent at the time it incurred the debt, and that it would remain solvent even after incurring the debt;
- can prove that the person in charge of providing accurate information concerning the company's financial status and solvency was performing this task, and led the director to believe that the company was solvent and would remain to be so even after incurring the debt;
- had good reasons not to be involved in the management of the company when it incurred the new debt, such as a result of a serious illness.
- can prove that they took all reasonable steps to prevent the company from incurring the debt.

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## CONSEQUENCES OF INSOLVENT TRADING

If a director is found to be guilty of trading whilst insolvent, there are many consequences other than becoming personally liable for the debts so incurred. These potential consequences may include the following;

### 6.1 CIVIL PENALTIES

Company directors may face fines of up to \$200,000 in circumstances where their breach was not dishonest.

### 6.2 CRIMINAL PENALTIES

If trading whilst insolvent is proven to be of a dishonest nature, then directors can face criminal convictions for this breach.

A criminal charge carries a maximum penalty of \$220,000 and five years imprisonment. A person may also be disqualified from managing corporations.

### 6.3 COMPENSATION ORDERS

If a liquidator suspects a person may have breached their duty in preventing the company from trading whilst insolvent, then he or she, a creditor, or ASIC can take action against the director pursuant to Section 588M of the Act.

A Court may order that the director repay the company to the value of the debts incurred from trading whilst insolvent.

It should be noted that a creditor can only take this action with the permission of the liquidator or leave of the court, and may only pursue the director for the value of its debt.

### 6.4 HOLDING COMPANY LIABILITY

Section 588V of the Act provides that a holding company may be liable for the insolvent trading of its subsidiary in circumstances where the directors of the holding company were aware, or should have been aware, of the insolvency of the subsidiary company.

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## SMITH V BONÉ, IN THE MATTER OF ACN 002 864 002 PTY LTD (IN LIQ) [2015] FCA 319 - THE IMPACT OF REPAYMENT ARRANGEMENTS ON SOLVENCY

### 7.1 BACKGROUND

Mr Barry Boné was the sole company director of Petrolink Pty Ltd ("Petrolink"). In December 2011, Mr Smith was appointed as Liquidator of the Company.

The Liquidator brought an action against the director seeking compensation for insolvent trading pursuant to section 588G of the Act for the losses suffered by Petrolink's creditors.

In this dispute, the Liquidator claimed that Petrolink was insolvent from 30 June 2009 until the date on which the winding up commenced and that Petrolink continued to trade and incur debt throughout this period. However, the Director argued that his company was only insolvent from July 2011.

Relevant to the outcome of the case was the fact that Petrolink had entered into a payment arrangement with the Australian Tax Office (ATO), its main creditor, in order to discharge its outstanding debts.

### 7.2 THE DIRECTOR'S DEFENCE

The director argued that any reasonable person would have believed that the company was solvent based on the payment arrangement he had established with ATO, which he argued deferred the debts of the Company such that they were no longer due and payable. He also stated the company was generating significant revenue throughout the period.

### 7.3 THE RULING

His Honour, Gleeson J, found that any reasonable person in the position of the director would have grounds to believe that the company was insolvent and that despite the revenue being generated by the company, its debts remained unpaid. In regard to the payment arrangement, the Court found that the;

*"payment arrangements negotiated with the ATO did not have a material effect on the solvency of Petrolink because of the shortness of their duration and the fact that none of them had the effect that Petrolink was not required to pay its outstanding tax liability imminently. The payment arrangements in fact demonstrated that Petrolink was continuing to experience common features of insolvency"*

Ultimately, His Honour determined that Petrolink was insolvent from 12 May 2010 and the director was found to be liable to the Liquidator for an amount of \$669,582.86.

In addition, while the Court did not find that the director had acted or conducted himself dishonestly, it did not exempt him from being held personally liable for insolvent trading.

The Court ruled that the director did not seek professional advice about the company's financial position despite being advised in June 2010 that if Petrolink continued to trade, it may be trading whilst insolvent.

### 7.4 THE PRINCIPLE

Directors should be aware that entering into payment arrangements does not provide relief from the underlying debt being due and payable, and the arrangement may simply be considered an assistance mechanism for companies requiring short-term relief.

Director's should be aware that in entering into repayment arrangements with the ATO, they may be providing evidence to a subsequently appointed liquidator that the company was insolvent and that the director was aware of the insolvency.

**As such, caution should be exercised by directors when entering into repayment arrangements that they only take on repayment commitments that the company can comply with else they risk incurring a personal liability for insolvent trading.**



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## CONCLUSION

**Directors need to be aware of the serious consequences of trading whilst insolvent, and the importance of seeking early, professional advice about their company's status and financial position.**

Taking the appropriate steps to deal with a company's insolvency is not only a defence to any proceedings, but may be essential to the survival of the company. Where directors are not adequately informed or fail to deal with the potential insolvency of their companies in accordance with their duties as a director, then they have a greater risk of becoming personally liable for the debts of their companies and/or incurring other serious penalties.

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