

Commercial Law Update

Directors in “denial”

Overdrawn facility and the bank “squeezing”? Managers departing? Hopeful that the next big “account” will be your company’s salvation?

These are just some of the early warning signs of corporate insolvency. Failure to proactively engage on these issues could mean that you are a director in “denial”.

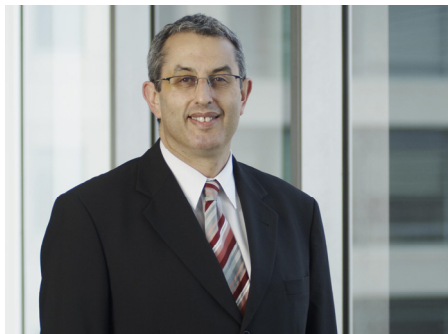
Economic uncertainty accompanied by the tightening of credit invariably place extra strain on companies already under pressure and, in this climate, some company directors will need to make some very critical decisions about the entity they oversee.

Expanded duties

A director has a positive duty to prevent the company trading if it is insolvent. When is a company insolvent? Put simply, when it is unable to pay all its debts as they fall due. What this means for a company director is that before a new debt is incurred, he or she must consider whether there are reasonable grounds to suspect that the company is insolvent or will become insolvent as a result of incurring the debt. Recent cases have shown that the courts are now prepared to take a more forensic approach in determining the point in time when a company could be said to be insolvent.

Therefore, the monitoring of the entity’s financial position is essential so that the company’s board is in a position to quickly identify adverse trends. A director is abrogating his or her duty if the company’s “financial health” is delegated to the accountant to worry about and is only considered when the annual financial statements are to be signed off.

If the company is insolvent, or there is a real risk of it becoming insolvent, the duties of directors extend beyond shareholders to include creditor stakeholders. Employees with outstanding accrued entitlements would belong in this category.



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Directors in “denial” Continued

The records tell the story

Insolvency has often been linked to poor accounting procedures and inadequately kept books and records. When such internal systems are allowed to fail, directors cannot hope to take preventative action until it is often too late.

A director who fails to take all reasonable steps to ensure that a company fulfils its record-keeping requirement breaches the *Corporations Act*. For the purposes of an insolvent trading action against a director, a company will generally be presumed to have been insolvent throughout a period where it can be shown to have failed to keep adequate financial records.

Act early

If a director suspects that the company has been “walking the line” or has become insolvent, the most important thing to do is to “act” by obtaining proper accounting and legal advice early and to stop the company incurring more debt. Professional advice will better acquaint a director with all the options which may be available to the company such as restructuring, refinancing, changing the company’s activities or putting the company into voluntary administration or liquidation – before an aggrieved creditor does so.

Other early warning signs

Directors in denial frequently ignore some of the other early warning signs which include:

- a trend of diminished cash flow
- ongoing losses
- no business plan, forecasts and budgets
- increasing debt
- difficulty collecting receivables owing to the company
- problems selling inventory
- having to pay creditors outside the usual trading terms
- solicitors’ demands and legal process issued against the company
- failure to pay for utilities and rent on time or at all
- overdue taxes, superannuation liabilities and unpaid BAS amounts
- inability to raise further equity from shareholders
- low staff morale
- board tensions and resignations
- increased level of complaints, queries or scrutiny from regulators
- receipt of section 222AOE penalty notice from the Commissioner of Taxation

Serious consequences

Insolvent trading can mean various penalties and consequences including civil penalties, compensation proceedings and criminal

charges. In certain circumstances, ASIC may also apply for orders disqualifying a person from managing corporations for up to 20 years. Statutory defences may not be available to the directorship if it has consistently failed to keep itself fully informed about how the company has been tracking.

Civil penalties

Contravention of the *Corporations Act* for insolvent trading can result in civil penalties against directors including pecuniary penalties of up to \$200,000.

Compensation

Compensation proceedings for amounts lost by creditors can be instituted by ASIC, a liquidator or a creditor against a director personally. A compensation order can be made in addition to civil penalties. Compensation payments are potentially unlimited and could lead to the personal bankruptcy of a director which disqualifies that director from continuing as a director or managing a company.

Dishonesty

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 five years, or both. Being found guilty of the criminal offence of insolvent trading will also lead to a director’s disqualification.

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