



Preventing insolvent trading could well be the most important of all company directors' duties.

Trading while insolvent is bad for Australia. According to ASIC, it causes hardship to the business community and imposes significant costs to the economy through unpaid taxes, superannuation and losses to legitimate business. And can be very bad indeed for directors. Contravening the insolvent trading provisions in section 588G of the Corporations Act can attract civil penalties, compensation proceedings and criminal charges. Civil penalties include fines of up to \$200,000. Compensation payments are potentially unlimited and could lead to personal bankruptcy. If dishonesty is found to be a factor, a director may also be subject to criminal charges resulting in a fine of up to \$220,000, imprisonment for up to five years or both.

Paul James, a Litigation Partner at Clayton Utz, believes that preventing insolvent trading is also one of the most controversial duties.

“Those who support the duty argue that it provides appropriate protection for the unsecured creditors of companies,” he says. “Those who oppose the duty argue that it has the effect of making directors unduly risk adverse.”

The AICD sits in the second camp, concerned that that the trend towards making directors and senior executives personally liable for corporate fault is encouraging more cautious and conservative decision making. The was made clear in a recent submission to Treasury reviewing sanctions for directors in corporate law. One point raised was that, where a company is experiencing liquidity problems, directors may choose to call in an administrator to protect themselves before the company is insolvent when the interests of shareholders would have been better served by the company's continuing to trade.

The AICD is also pressing for a general defence for directors based on acting in good faith, being fully informed and behaving in a way which they reasonably believe is in the best interests of the corporation. This could apply to various provisions of the Act including insolvent trading.

One of the most contentious issues is the grey area between solvency and insolvency. Once the decision has been made that a company is insolvent the decision to stop trading is easy. But directors are also charged with preventing the company from trading they have reasonable grounds to suspect that the company is insolvent or will become insolvent as a result of incurring the debt.

This is not even judged in terms of whether the director suspected the insolvency but whether or not a director of ordinary competence would have had that suspicion. Second-guessing another director with the fear of personal liability hanging over your head is not the best circumstance for making bold or entrepreneurial decisions.

“There really is little incentive to do something somewhat aggressive in an attempt to effect a successful restructure,” says Chris Campbell, Head of Deloitte’s Corporate Re-organisation Group. “But you have to balance that against rogue directors who will continue just to take people’s money.”

A question of liability

Events around the collapse of the Reynolds Group of wine producers brought some of these issues to the fore.

In 2003, the company went into liquidation owing secured and unsecured creditors a total of approximately \$130 million. The company was accused of trading for 10 months while insolvent and the subsequent court case focused on the liability of chairman Malcolm Irving – one of Australia’s most qualified company directors who was described by Justice Palmer as having had a long and highly distinguished career as a director of many substantial companies, including Caltex Australia Ltd and Telstra Corporation.

During the period under scrutiny Irving was negotiating a disputed tax liability with the Australian Taxation Office (ATO). The outcome of this dispute had the potential to tip the balance between solvency and insolvency, and Justice Palmer acknowledged the frustration inherent in such uncertainty. Nevertheless, the court concluded that the company had been insolvent throughout the whole of the 10 month period.

Irving called on available defences and Justice Palmer conceded that he had acted honestly, had relied on the advice of external experts and had made some difficult commercial judgments. Justice Palmer also used his discretion in identifying a point during February 2003 when, having had an unsuccessful meeting with the ATO, Irving should have appreciated that there was no reasonable prospect of a favourable resolution to the dispute. Irving was exonerated from liability for the period up to the date of the ATO meeting, but no further.

“It is difficult for a director of a trading company which is suffering from liquidity problems to decide whether, and when, to abandon hope,” says Mike Lyons, Principal of VPro Lawyers. “As the court noted in this case, there are often pressing interests involved in the decision, such as the jobs of employees which would be lost and the investment of shareholders which would evaporate. On the other hand, creditors whose business depends on payment could be ruined if the Company were to continue to trade while insolvent.”

Input from professionals

If directors have any doubt as to the solvency of their company, Morgan Kelly, a Partner at Ferrier Hodgson, recommends a professional review.

“That will give some clarity regarding their position and insolvent trading, and also some level of comfort that the strategies, plans and milestones being negotiated or developed by the management team are appropriate,” he says.

When directors are faced with the toughest of all commercial decisions, it’s easy to panic.

“It’s difficult but it’s also vital to keep a balanced view and seek advice,” says Campbell. “When you find yourself in this kind of situation you really need to be talking to someone who lives and breathes the detail.”

Campbell likens going it alone to doing your own dentistry, yet he finds time and time again that directors fail to get help – usually with disastrous consequences.

“They might be concerned about having to pay more bills when there’s no cash anyway,” he says. “They might not want to admit to someone else that there’s a problem, or they might be worried that making the problem public will damage the company’s reputation too badly for there to be any chance of recovery. In some cases, there’s a strong CEO who says ‘I can deal with all of this’ and won’t allow anyone in.

“Directors also tend to think that, if they’ve got their lawyer sitting beside them, everything’s OK. But lawyers may not be able to give a commercial perspective.”

When a company is in trouble, the first thing a director needs to know is why.

“They have to ask themselves ‘how did I get here?’ And ‘what’s going to change?’, continues Campbell. “Over the past couple of years we’ve seen enterprises in trouble because a fairly free flow of cash has enabled them to keep on borrowing more money on the premise that they’re doing something to fix the business. Then, when you get to the bottom line, nothing has happened.”

Even when directors are confident that their restructuring plans will fix the problems they need to be sure they have enough cash and asset resources to get through to that level. If, at any point, they decide that the business cannot trade out of its troubles and insolvency is likely, they must call in a voluntary administrator.

If a director is alone in believing there’s no hope for recovery, a dissenting vote is no defence if any future trading should be deemed insolvent. In this case, every director is held personally liable, including de facto and passive directors who have never been formally appointed but whose opinions carry sway.

Breathing space – or self-fulfilling prophecy?

The Voluntary Administration (VA) regime was established in 1993 as an alternative to liquidation for companies facing cash flow and other financial difficulties. The process is designed to provide companies with breathing space, a chance to reorganise their financial and operating structure and to solve problems causing financial difficulty with the added benefit of statutory protection from creditors. If recovery is not achievable, it allows for early intervention and, as far as possible, prevents asset erosion, maximising returns to creditors.

What it doesn’t do is provide a personal service for directors.

“It is important for directors to understand that the administrator’s duty is to creditors,” says Kelly. “Directors must obtain independent advice if they are concerned or want advice regarding their personal position. The administrator cannot advise them.”

In America, Chapter 11 bankruptcy allows a company’s assets to be sold off to remunerate past due creditors. Since the collapse of Ansett there has been growing support for this approach – Malcolm Turnbull recently proposed that our business insolvency laws be changed to run more along these lines in order to place a greater emphasis on reconstruction and rehabilitation.

Meanwhile, Ansett’s administrators, Korda and Mentha, don’t believe such a system would have saved the airline. And, while there’s a perception that Chapter 11 gives companies a better chance of survival, the reality is that only around 6.5 per cent are successfully rehabilitated.

Kelly feels strongly that we already have the tools we need within the workings of our legal system.

“Voluntary administration is like giving directors a pause button,” he says. “Everything is put on hold while an experienced and independent practitioner assesses whether the business can be saved. Creditors have an opportunity to vote on any plans, so they have a lot of sovereignty over the outcome. The whole process works within a very strict timeframe, so

everyone always knows where they stand. And, even if liquidation is unavoidable, that doesn't mean the business will automatically be destroyed. In cases where only the corporate shell needs to be liquidated the business can be sold intact and, often, most or all employees keep their job."

Looming insolvency – the warning signs

Morgan Kelly suggests that directors stay alert to the following warning signs:

- ongoing losses
- poor cash flow
- absence of a business plan
- incomplete financial records or disorganised internal accounting procedures
- lack of cash-flow forecasts and other budgets
- increasing debt (liabilities greater than assets)
- problems selling stock or collecting debts
- unrecoverable loans to associated parties
- solicitors' letters, demands, summonses, judgements or warrants issued against your company
- suppliers placing your company on cash-on-delivery 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