ASIC
Australian Securities & Investments Commission

Insolvency: A guide for directors

This information sheet (INFO 42) provides general information on insolvency for directors whose companies are in financial difficulty, or are insolvent, and includes information on the most common forms of external administration.

It explains:

- who is a director
- directors' duties
- consequences of insolvent trading
- what to do if you suspect financial difficulty
- what to do if your company is insolvent
- consequences of external administration and receiverships
- where to get more information

An insolvent company is one that is unable to pay all its debts when they fall due for payment. The law prescribes serious penalties for allowing your company to trade while insolvent. You should consult an appropriately qualified specialist insolvency accountant or lawyer, a financial advice service or a registered liquidator about your company's financial situation as soon as possible if you suspect that you or your company cannot pay debts when they are due.

Who is a director?

A director is not just a person appointed to that role. Under the *Corporations Act 2001* (Corporations Act), a person may also be a director if they are not formally appointed but act in that role, or if the directors of the company act in accordance with their instructions or wishes.

Directors' duties

Generally, in addition to the requirement to ensure compliance with general and specific laws applying to your company's operations, your primary duty is to the shareholders. However, if your company is insolvent, or there is a real risk of insolvency, your duties expand to include creditors (including employees with outstanding entitlements).

General duties

General duties the Corporations Act imposes on directors and officers of companies include:

- the duty to exercise your powers and duties with the care and diligence that a reasonable person would have, which includes taking steps to ensure you are properly informed about the financial position of the company and ensuring the company doesn't trade if it is insolvent
- the duty to exercise your powers and duties in good faith in the best interests of the company and for a proper purpose
- the duty not to improperly use your position to gain an advantage for yourself or someone else, or to cause detriment to the company
- the duty not to improperly use information obtained through your position to gain an advantage for yourself or someone else, or to cause detriment to the company.

Duty to not trade while insolvent

As well as general directors' duties, you also have a positive duty to prevent your company trading if it is insolvent. A company is insolvent if it is unable to pay all its debts as and when they fall due. This means that before you incur a new debt you must consider whether you have reasonable grounds to suspect that the company is insolvent or will become insolvent as a result of incurring the debt.

An understanding of the financial position of your company only when you sign off on the yearly financial statements is insufficient. You need to be constantly aware of your company's financial position.

Regulatory Guide 217 *Duty to prevent insolvent trading: Guide for directors* (RG 217) sets out key principles to help directors understand and comply with their duty under s588G of the Corporations Act.

Duty to keep books and records

Your company must keep adequate financial records to correctly record and explain transactions and the company's financial position and performance. A failure of a director to take all reasonable steps to ensure a company fulfils this requirement contravenes 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.

Consequences of insolvent trading

There are various penalties and consequences of insolvent trading, including civil penalties, compensation proceedings and criminal charges.

The Corporations Act provides some statutory defences for directors. However, directors may find it difficult to rely on these if they have not taken steps to keep themselves informed about the company's financial position.

Civil penalties

Contravening the insolvent trading provisions of the Corporations Act can result in civil penalties against directors, including pecuniary penalties of up to $200,000.

Compensation proceedings

Compensation proceedings for amounts lost by creditors can be initiated 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 directors. The personal bankruptcy of a director disqualifies that director from continuing as a director or managing a company.

Criminal charges

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 2,000 penalty units 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.

Note: Section 4AA of the *Crimes Act 1914* defines a 'penalty unit'. The value of one penalty unit at the time of the release of this information sheet is $210.

ASIC has successfully prosecuted directors for allowing companies to incur debts when the company is insolvent, and has sought orders making directors personally liable for company debts.

The good news is that taking steps to ensure your company remains financially sound will minimise the risk of an insolvent trading action. It may also improve your company's performance.

What to do if you suspect financial difficulty

If you suspect your company is in financial difficulty, get professional accounting and legal advice as early as possible, as this increases the likelihood of the company surviving. One of the most common reasons for the inability to save a company in financial distress is that professional advice was sought too late. Do not have a 'head in the sand' attitude, hoping that things will improve – they rarely do. The below list sets out some of the warning signs of insolvency:

- 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
- creditors unpaid outside usual terms
- solicitors' letters, demands, summonses, judgements or warrants issued against your company
- suppliers placing your company on cash-on-delivery (COD) 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.

An insolvency practitioner can conduct a solvency review of your company and outline available options. You need to be aware of your options so that you can make informed decisions about your company's future. Options may include refinancing, restructuring or changing your company's activities, or appointing an external administrator.

Some advisers contact directors whose businesses may be in financial distress. These advisers may be unknown to you, and contact you 'out of the blue'. While not all of these advisers do the wrong thing, some suggest that directors take actions which could be considered illegal (such as suggesting you transfer assets of your company into another company without paying for them – known as 'phoenixing'). If either an unknown adviser contacts you, or your existing solicitor or accountant suggests you take actions which you aren't sure of, you should consider obtaining a second opinion from an independent and appropriately qualified specialist insolvency accountant or lawyer.

The two most common forms of external administration available to directors are:

- voluntary administration (which may lead to a deed of a company arrangement)
- liquidation.

A company can also have a receiver, or receiver and manager, appointed over its property. This option is not normally available to a director as a receiver, or receiver and manager, is usually appointed by a secured creditor. A scheme of arrangement may result in another form of external administration, but this information sheet does not cover schemes of arrangement.

ASIC maintains a register of registered liquidators, and information about registered liquidators in each state. The Australian Restructuring Insolvency & Turnaround Association (ARITA) website also contains information about registered liquidators.

Australian Taxation Office s222AOE penalty notice

If you receive a s222AOE penalty notice, also known as a director penalty notice, from the Commissioner of Taxation for your company's unpaid tax, you should immediately seek professional advice. Failure to take appropriate steps within 14 days may result in the Commissioner of Taxation taking recovery action against you personally for an amount equivalent to the unpaid tax.

What to do if your company is insolvent

If your company is insolvent, do not allow it to incur further debt. Unless it is possible to restructure, refinance or obtain equity funding to recapitalise the company, generally your options are to appoint a voluntary administrator or a liquidator.

Voluntary administration

Voluntary administration is designed to resolve the company's future direction quickly. An independent and suitably qualified person (the voluntary administrator) takes full control of the company to try to work out a way to save either the company or the company's business.

If it isn't possible to save the company or its business, the aim is to administer the affairs of the company in a way that results in a better return to creditors than they would have received if the company had instead been placed straight into liquidation.

A mechanism for achieving these aims is a deed of company arrangement.

Putting a company into voluntary administration is a simple and quick process. It can be done by the board of the company resolving that the company is insolvent, or likely to become insolvent, and an administrator should be appointed. The directors also need to obtain the written consent of a registered liquidator to act as voluntary administrator before any appointment is made.

Liquidation

The purpose of liquidation of an insolvent company is to have an independent and suitably qualified person (the liquidator) take control of the company so that its affairs can be wound up in an orderly and fair way for the benefit of its creditors.

An insolvency professional will be able to advise you of the steps required to appoint a liquidator. Generally, a director-initiated liquidation involves calling a meeting of members to vote on winding up the company and the appointment of a liquidator.

Receivership

A company most commonly goes into receivership when a receiver is appointed by a secured creditor who holds a security interest in some or all of the company's assets. The receiver's primary role is to collect and sell enough of the company's collateral (property) to repay the debt owed to the secured creditor. The court may also appoint a receiver over a company's assets.

A director who is also a secured creditor should seek advice before appointing a receiver.

Consequences of external administration and receiverships

As well as the possibility of insolvent trading action (as discussed earlier), there are other consequences for directors of a company that goes into external administration or receivership. These vary depending on the type of appointment.

Directors' powers

Directors of companies in voluntary administration or liquidation lose control of the company. If a company goes from voluntary administration into a deed of company arrangement, the powers of the directors depend on the deed's terms. When the deed is completed, the directors regain full control unless the deed provides for the company to go into liquidation on completion.

In a receivership, the powers of the directors depend on the powers of the receiver, as detailed in the security agreement or court order, and the extent of the assets over which the receiver is appointed. If the receiver is appointed over all or most of the assets of a company, the receiver effectively has control, although the directors still have certain responsibilities and duties, and may retain residual control.

Directors’ obligations

Generally, directors have an obligation to assist the external administrator or receiver by:

- advising the external administrator or receiver of the location of company property and delivering any such property in their possession to the external administrator
- providing the company’s books and records to the external administrator (voluntary administration and liquidation) or giving access to the books and records to the receiver
- advising the external administrator or receiver of the whereabouts of other company records
- providing a written report about the company’s business, property and financial circumstances within either five business days (voluntary administration and creditors’ voluntary liquidation) or 10 business days (receivership and court liquidation) of the appointment of the external administrator or receiver
- meeting with, or reporting to, the external administrator or receiver to help them with their inquiries, as reasonably required.

Directors, officers and other people with relevant books and records must not obstruct external administrators and receivers in carrying out their duties.

Creditors’ meetings

Meetings of creditors are held in voluntary administrations and liquidations.

Both a voluntary administrator and liquidator can also require a director to attend a creditors’ meeting to provide information about the company and its business, property, affairs and financial circumstances.

Public examination

A voluntary administrator or liquidator has the power to apply to the court to conduct a public examination, under oath, of a director. A receiver can also apply for a public examination, if ASIC consents.

Being summonsed to appear for a public examination is a serious matter and should not be ignored. Seek immediate legal advice if you are in any way concerned about the public examination process or your rights.

The external administrator conducting the public examination may be interested in your personal financial position or further details about assets or transactions the company undertook. Often the need for a public examination can be avoided by cooperating with the external administrator.

Disqualification

If a director has been involved with two or more companies that have gone into liquidation within the last seven years and paid their creditors less than 50 cents in the dollar, ASIC may disqualify them from managing corporations for up to five years. This effectively bans a person from acting as a director.

ASIC can also apply for orders disqualifying a person from managing corporations for up to 20 years if they have been an officer of two or more companies that have failed within the last seven years, and the way in which the companies were managed contributed to the failures.

Employee entitlement proceedings

It is an offence for anyone, including a director, to enter into an agreement or transaction with the intention of avoiding employee entitlements of a company. The maximum penalty is 1,000 penalty units or 10 years imprisonment, or both.

Note: Section 4AA of the *Crimes Act 1914* defines a ‘penalty unit’. The value of one penalty unit at the time of the release of this information sheet is $210.

If the company is in liquidation and the employees suffer damage or loss as a result of a person entering into such an agreement or transaction, that person is liable to pay compensation for the loss suffered. This liability can arise even if the person has not been convicted of an offence for the contravention. A recovery action for compensation can be taken by the liquidator or, in certain circumstances, by an employee.

Where can I get more information?

For an explanation of terms used in this information sheet, see Information Sheet 41 *Insolvency: A glossary of terms* (INFO 41).

For more on voluntary administration, liquidation and receivership, see the related information sheets listed in Information Sheet 39 *Insolvency information for directors, employees, creditors and shareholders* (INFO 39).
Further information is available from the ARITA website. The ARITA website also contains the ARITA Code of Professional Practice for Insolvency Practitioners.

Important notice

Please note that this information sheet is a summary giving you basic information about a particular topic. It does not cover the whole of the relevant law regarding that topic, and it is not a substitute for professional advice. You should also note that because this information sheet avoids legal language wherever possible, it might include some generalisations about the application of the law. Some provisions of the law referred to have exceptions or important qualifications. In most cases your particular circumstances must be taken into account when determining how the law applies to you.

This is **Information Sheet 42 (INFO 42)** updated on 1 September 2017. Information sheets provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

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