SHERIDANS
CHARTERED ACCOUNTANTS

FACT SHEET
Insolvent Trading

What is insolvent trading?

Insolvent trading is when directors allow their company to incur debts when the company is insolvent. A director risks being held personally liable to pay compensation for the unpaid debts if the company later goes into liquidation.

Directors' duty

Pursuant to Section 588G of the Corporations Act 2001, directors have a positive duty to prevent insolvent trading. Directors will contravene this section if they allow their company to incur a debt when there are reasonable grounds to suspect the company is insolvent.

Elements of an insolvent trading claim

- The company subsequently goes into liquidation.
- The person acted in the capacity of a director of the company at the time when the company incurred the debt.
- The debt remains unpaid at the date of liquidation.
- The company was insolvent when the debt was incurred or became insolvent due to incurring the debt.
- There were reasonable grounds for suspecting at the time the debt was incurred that the company was insolvent, or that it would become insolvent as a result of incurring the debt.
- The director was aware, or ought reasonably to have been aware, that the company's circumstances showed grounds to anticipate insolvency.
- The director failed to prevent the company from incurring debt.

When is a company insolvent?

A company is insolvent when it cannot pay its debts as and when they become due and payable.

Section 95A of the Corporations Act states that a person (including a company) is insolvent if they are not solvent. It also states that a company is solvent only if it is able to pay all of its debts as and when they become due and payable. The emphasis is on all of one's debts rather than merely particular debts.

Cash-flow is critical when considering insolvency. However, the commercial reality of the overall financial circumstances should also be considered, including the balance sheet, asset values and realisability, and the ability to raise funds in the form of equity or debt.

The term 'debt' has a wide meaning which often varies according to the context in which it is used.

For an insolvent trading claim, the debt must be incurred, not just accrued, when the company is insolvent. Incurring a debt is the legal creation of a debt that did not previously exist.

Who makes insolvent trading claims?

Usually liquidators.

Liquidators have the first opportunity to make insolvent trading claims. Under the provisions of the Corporations Act liquidators are obliged to investigate whether an insolvent trading claim exists, and if so to take appropriate action, as long as suitable funding is available.

Can creditors take an insolvent trading action?

Yes. If a liquidator does not pursue an insolvent trading claim, the creditors of a company (individually or in a group) can take an insolvent trading action themselves. Creditors need the liquidator's consent, or failing that, leave of the court.

Importantly, creditors can take action against directors only for their own debts whereas a liquidator can pursue an insolvent trading claim on behalf of all creditors. A creditor cannot commence action when a liquidator has already begun proceedings.

How do directors become liable for insolvent trading claims?

If a director contravenes Section 588G of the Corporations Act, Section 588M allows a liquidator, or a creditor, to recover compensation from the director for an amount equal to the amount of the loss or damage.

Defences to an insolvent trading claim

Section 588H of the Corporations Act provides four statutory defences for a director:

- The director had reasonable grounds to expect (not just suspect) that the company was solvent.
- The director relied on information provided by a competent and reliable person (another person) that led to the view that the company was solvent.
- The director because of illness or for some other good reason did not take part in the management of the company at the relevant time. There must be some connection between the non-participation and the 'good reason'.
- The director took all reasonable steps to stop the company from incurring the debt.

Directors bear the onus of proving the defences under the Corporations Act.

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Some of the detail

Consequences of insolvent trading

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

The consequences can include:

- Fines of up to $200,000.
- An order to pay compensation equivalent to the loss suffered by creditors (potentially unlimited).
- Disqualification from managing a company.
- Criminal proceedings if dishonesty is found to be a factor in insolvent trading.

Who is a director?

A director is not just a person appointed to that role. A person may also be a director even if they are not formally appointed but act in that role, or if the appointed directors of the company act in accordance with the person's instructions or wishes.

The definition excludes people who give advice as part of their normal professional role. In addition, the insolvent trading laws are not usually applicable to managers.

How long after liquidation can a liquidator commence an insolvent trading claim?

A liquidator has six years from the beginning of the liquidation to commence an action for insolvent trading. It is not sufficient for the liquidator to have issued a letter of demand within the six-year period; proceedings must have been commenced.

Holding company

A holding company can also be liable for the debts of a subsidiary if it allows the subsidiary to trade while insolvent.

What if the director did not know that the company was trading while insolvent? Or was merely unsure if the company was solvent or not?

Directors have a duty of care and diligence, including the duty to keep informed about the company's solvency. Ignorance or uncertainty is unlikely to be a valid defence as a director will not have discharged their duty of care and diligence if they have not made the appropriate enquiries.

Is a director automatically liable for all debts of the company?

No, just the new debts incurred after the date the company became insolvent and during the period of their directorship.

Two rebuttable presumptions of insolvency

1. Where the company failed to keep proper accounting records.
2. Where the company is proved to be insolvent within 12 months of the 'relation-back day'.

Is my company insolvent?

Determining insolvency can be a complicated matter involving a range of accounting and legal issues. However, if a director is asking the question, indicators of insolvency probably exist.

See Sheridans Fact Sheet – Indicators of Insolvency.

What should directors do to prevent insolvent trading?

ASIC's Regulatory Guide 217 *'Duty to prevent insolvent trading: Guide for directors'* is a useful resource.

1. Ensure proper financial records are maintained.
2. Remain informed of the financial affairs and position of the company, and monitor for any indication that the company may not be able to pay its debts as they fall due.
3. Investigate financial difficulties and on identifying concerns, immediately take positive steps to confirm the company's financial position and realistically assess the options available to deal with the company's financial difficulties.
4. Obtain advice from a suitably qualified, competent and reliable person about the financial position of the company and how the financial difficulties can be addressed.
5. Act in a timely manner to address the question of solvency. Avoid "a head in the sand" mentality.

The actual steps taken by a director to comply with their duty to prevent insolvent trading will depend, in part, on all the circumstances of the company, including the size and complexity of the business, as well as the skills and experience of the company's management and staff.

What should a director do if a liquidator makes an insolvent trading claim?

Immediately seek professional advice.

A liquidator should be asked to demonstrate:

- That the company was insolvent in the relevant period.
- That the debts were incurred after that time.
- Proof of director status at that time, if not readily apparent.

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