Insolvency for directors

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 company's directors act in accordance with that person's instructions or wishes.

Directors' duties

Your primary duty is to the company's shareholders. You are also required to comply with general and specific laws applying to your company's operations. However, if your company is insolvent, or there is a real risk of insolvency, your duties expand to include creditors including employees.

General duties

The Corporations Act imposes general duties on directors and officers of companies, including the duty:

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

- 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.

If dishonesty or recklessness is found to be a factor in your breach of general duties, the breach can be a criminal offence and substantial criminal penalties can apply, including up to 15 years' imprisonment.

Duties of director

You have a duty to prevent your company from entering into a transaction that is a creditor-defeating disposition. This is a disposition of property:

- for less than the market value of the property or the best price reasonably obtainable, and
- that prevents, hinders or significantly delays the property from becoming available to benefit creditors in a winding up.

You also have a duty to prevent your company trading if it is insolvent. A company is insolvent if it is unable to pay its debts when they fall due. Before you incur a new debt you must consider whether you have reasonable grounds to suspect the company is insolvent or will become insolvent as a result of incurring the debt.

Your company must keep adequate financial records to correctly record and explain the company's transactions, its financial position and performance. A director contravenes the Corporations Act if they fail to take all reasonable steps to do so.

A creditor, ASIC or a liquidator, can take legal action against a director for insolvent trading. Where it can be shown a company failed to keep adequate financial records for a period, the company will generally be presumed to have been insolvent throughout that period.

What to do if you suspect financial difficulty

If you suspect your company is in financial difficulty, get professional accounting and/or legal advice as early as possible. This increases the likelihood the company will survive. Do not take a 'head in the sand' attitude, hoping that things will improve – they rarely do. Warning signs of insolvency include:

- 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 terms
- 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.

A registered liquidator can conduct a solvency review of your company and outline available options. You need to be aware of your options so 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.

If an adviser contacts you, or your existing solicitor or accountant suggests you do something which you aren't sure about, consider obtaining a second opinion from an independent, appropriately qualified specialist insolvency accountant or lawyer or a registered liquidator.

Forms of external administration

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

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

Director penalty notice

Australian Taxation Office under Section 222AOE of the Income Tax Assessment Act 1936 which makes directors personally lianle for two types of tax debts, Pay as You Go withholding and Superannuation Guarantee Charge.

If you receive a Section 222AOE 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 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, your options are to appoint a liquidator or voluntary administrator.

Consequences of external administration
As well as the possibility of insolvent trading action, there are other consequences for directors when a company goes into external administration or receivership. These vary depending on the type of external administration.

Directors' powers

Directors lose control of the company when the company enters voluntary administration or liquidation. If a company goes from voluntary administration into a

DOCA, return of the director's powers will depend on the DOCA's terms. When the DOCA is completed, the directors regain full control of the company unless the DOCA provides the company goes into liquidation.

Directors' obligations

Directors have an obligation to assist the external administrator by:

- advising them of the location of the company's property and delivering the property in their possession to the external administrator
- providing the company's books and records to the external administrator (voluntary administration and liquidation)
- advising the external administrator where other company records are held
- providing a Report on Company Activities and Property within five business days (creditors' voluntary liquidation and voluntary administration)
- meeting with, or reporting to, the external administrator to help them with their inquiries, as reasonably required.

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

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, Australian Securities and Investments Commission (ASIC) may disqualify them from managing corporations for up to five years. This effectively bans a person from acting as a director.

ASIC may also disqualify company directors from managing corporations for up to five years where a person is, or has been, an officer of to two or more companies within seven years that have relied on the Fair Entitlements Guarantee (FEG) scheme to pay employee entitlements.

This can happen where the Commonwealth paid employee entitlements under the FEG scheme and has received minimal or no return – and is unlikely to receive more than a minimal repayment of funds paid under the FEG scheme.

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.

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If any products are discussed, you should obtain a Product Disclosure Statement relating to the products and consider its contents before making any decisions.It is recommended to seek advice from a qualified professional relevant to your particular needs or interests. (For instance, Tax Advice from a Tax Agent, Financial Advice from a Licensed Financial Adviser and so on and so forth). Information has been sourced from Australian Securities & Investments Commission and Australian Restructuring Insolvency and Turnaround Association.

CN-RRI | National Office Locations

Melbourne
Suite 203, 517 Flinders Lane Melbourne, VIC 3000

Brisbane
Level 19, 10 Eagle Street, Brisbane, QLD 4000

Sydney
Level 26, 44 Market Street, Sydney, NSW 2000

P: 1300 904 946
E: enquiries@cnrri.com.au