What exactly is insolvent trading?

The rising number of external administrations and the media's focus on business insolvencies over the past 18 or so months has put the term 'insolvent trading' firmly in the spotlight. However, many directors and advisers might not fully understand what it is. Here we provide some clarity.

Section 588G of the Corporations Act 2001 ("the Act") outlines that a company is insolvent when it cannot pay its debts when they are due and payable. And if the business continues to trade and incur debt even though it is unable to pay its debts, that's insolvent trading. It's vital for directors to understand their legal obligations in preventing a company from trading while insolvent. Allowing a company to trade while insolvent could have serious implications for directors (if proven), including being held personally liable for the debts incurred and required to compensate the company, or even being found guilty of criminal action.

So, how do you determine insolvency?

Under the balance sheet test, a company is insolvent if its total liabilities exceed the total value of its assets. However, that is not enough to establish insolvency. The test of solvency also incorporates the 'cash flow test', which assesses the liquidity and viability of the company's business. It determines the ability of a company to pay its debts as they become due or payable (or its ability to liquidate its assets quickly enough to pay its debts).

Here are some typical indicators of insolvency:

- overdue taxes and superannuation liabilities
- ongoing losses
- poor cash flow
- incomplete financial records
- lack of cash-flow forecasts / budgets
- problems collecting debts
- creditors paid outside usual terms
- letters of demand, judgements or warrants issued against the company
- suppliers placing company on cash-on-delivery terms
- special arrangements with selected creditors
- payments to creditors of rounded sums
- overdraft limit reached / defaults on loans
- issues obtaining finance / poor relationship with financiers

To determine insolvent trading, it must be established that:

- the person was a director of the company at the time the company incurred the debt
- the company was insolvent or became insolvent because of the debt
- there were reasonable grounds to suspect insolvency.

It should be noted (from a practical viewpoint), that during the pandemic, the Federal Government introduced the Coronavirus Economic Response Package Omnibus Act 2020, which provided relief in respect of debts incurred in the ordinary course of business during the period March-December 2020. Consequently, the value of potential insolvent trading claims identified were impacted.

Defences to insolvent trading claim

We're often asked if there are any defences available to a director in respect of an insolvent trading claim. Yes, there are – Section 588H of the Act provides for the following defences:

- there were reasonable grounds for a director to expect solvency (where the director actually expected that the company was solvent and was at no risk of becoming insolvent).
- there was an expectation of solvency based on advice provided by a competent and reliable person who was responsible for providing information about whether the company was solvent and was fulfilling this responsibility.
- the director did not take part in management at the time when the debt was incurred due to illness or for some other good reason.
- the director has taken all reasonable steps to prevent the company from incurring the debt: (e.g., appointing an administrator).

Safe Harbour is another defence to a claim by a registered liquidator or creditor against a director personally, for debts incurred by the company while it was insolvent. The law (section 588GA of the Act) enables a company to continue trading while protecting directors from personal liability for insolvent trading if they are developing an action plan that is 'reasonably likely' to lead to a better outcome for the company than becoming insolvent.

The purpose of the Safe Harbour legislation is to encourage company directors to keep control of their company, engage early with possible insolvency, and take reasonable risks to facilitate the company's recovery.

If you're concerned about possible insolvent trading, want to determine whether your company is at risk or discuss possible solutions, please don't hesitate to reach out to our us. We have 17 registered liquidators and an extensive support team ready to help around Australia.

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