

### Insolvent Trading

Many businesses are currently facing financial pressure, either directly or indirectly because of the credit crunch. This can lead to concerns about solvency. The immediate issue which may spring to mind for directors is their potential personal liability, especially for insolvent trading. This has been a hot topic in the media with many companies being wound up with substantial debts.

Directors, or persons who could be deemed to be directors, can be held personal liable for debts of the Company where:

- the Company incurs a debt; and
- the Company is insolvent at that time or becomes insolvent by incurring that debt; or
- when that debt is incurred, there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.

### Who is a director?

A director may not only be a person registered as a director on the ASIC register, but may also include a person:

- on whose instructions the company is accustomed to act (a "shadow director"), or
- if that person acts in the position of a director by making decisions on behalf of the company in respect of matters normally the function of a director (a "de facto director").

Importantly, persons giving advice whilst properly performing functions when acting in a professional capacity or business relationship are not be included in the definition of "director". It is particularly important for financiers, investors, and other professional persons such as accountants and lawyers to ensure that they are not overstepping professional or business boundaries.

### Incurring a debt

Generally speaking the relevant debts are those incurred in the nature of the day to day operations of the company. This includes not only actual debts but contingent debts such as guarantees. Liabilities for unliquidated claims such as damages arising from misleading or deceptive conduct do not count as "debts".

### Definition of insolvency

Insolvency is the position of being unable to pay debts as and when they become due and payable. This requires a cash flow test as opposed to a balance sheet test. The balance sheet together with a

number of other factors will, however, be relevant to determining whether or not a company is insolvent on the cash flow test.

Other indications of insolvency include:

- continuing losses
- overdue taxes
- poor relationship with the bank
- no access to alternative finance or further equity
- cash on delivery terms
- payment of creditors in rounded amounts (as opposed to the invoiced amount)
- unmet demands
- dishonoured cheques.

Whilst the presence of only a few of these factors may not necessarily mean a company is insolvent, a number of them would tend to suggest insolvency.

The global financial crisis and subsequently the credit crunch means that it has become difficult for a company to find alternative sources of finance. It has also led to a company's debtors being unable to pay the company, affecting the company's cash flow and therefore its solvency.

### **Reasonable grounds for suspecting insolvency**

A director breaches their duty to prevent insolvent trading by the company if there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, and they incur a debt. This is an objective test. Whether the director actually suspected the insolvency will be less relevant than whether or not a director of ordinary competence would have had that suspicion.

### **Defences**

There are a number of defences available to directors charged with insolvent trading. The directors will not be liable if, at the time the debt was incurred:

- the director had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts at that time

- the director had reasonable grounds to believe, and did believe, that a competent and reliable person was providing adequate information about the solvency of the company, was fulfilling that responsibility and expected that the company was solvent even if the debt were incurred
- the director was unable, because of illness or some other good reason, to take part in the management of the company at the time the debt was incurred, or
- the director took reasonable steps to prevent the debt being incurred

### Conclusion

The defences to an insolvent trading claim by a liquidator or ASIC are notoriously difficult to establish. It is therefore important for directors or for persons at risk of being deemed to be directors to ensure that there are no objective grounds for them to suspect that the company is insolvent.

Should the suspicion of insolvency arise at a time when the company is in fact insolvent, directors are at risk of being personally liable for the debts which the company incurs. In those circumstances, it is important to obtain professional accounting and legal advice as to the possibilities of a restructure or, if necessary, to consider the appointment of either a liquidator or voluntary administrator to prevent the incurring of further debts and the possible breach of directors' duties.

If you have any concerns about the potential liabilities of directors or any other duties of directors of companies please contact Tony Pattinson at Ferguson Cannon Lawyers for expert advice.