BusinessPlus+ Newsletter

Issue – September 2023

Director's Obligations When Business Insolvency Threatens

Recent high-profile administrations of Australian companies (particularly in the building industry) has thrown the spotlight on the obligations of directors of financially stressed companies.

Amid the turbulent macroeconomic environment, Australia is experiencing an increase in corporate insolvencies, which reinforces the need for directors to understand their duties and obligations if their business is in financial distress or at risk of insolvency, and what immediate actions need to be taken.

What Should Directors Be Aware Of?

Section 180 of the Corporations Act (the "Act") sets out the general rule that a company officeholder must exercise their powers and duties with care and diligence. **This duty is subject to a business judgement rule that requires a director making a business judgement to:**

- make the judgement in good faith and for a proper purpose
- not to have a material personal interest in the subject matter of the judgement
- inform themselves about the subject matter of the judgement to the extent they believe to be appropriate
- rationally believe that the judgement is in the best interests of the corporation.

Furthermore, the Act sets out the duties of a director and other company officers:

- They must act in good faith in the best interests of the company and for a proper purpose (s 181);
- They are prohibited from using their position to gain an advantage for themselves or someone else, or to cause detriment to the company (s 182);
- They cannot use information obtained in their role within the company to gain an advantage for themselves or someone else (s 183).

What Are The Consequences If There's A Breach?

While the duties of a director and other company officers as outlined above are civil obligations, they may also attract civil penalties. If a court declares that a company officeholder has breached their duties, it can impose a financial or pecuniary penalty. The court may also order that the director compensate the company. In addition, the court may also disqualify the person from managing corporations for a period.

It's important to note that it's also a criminal offence for a director or other officer to act recklessly or is intentionally dishonest in their failure to exercise their powers and discharge their duties in good faith and in the best interests of the company or for a proper purpose.

Under the Act, it's crucial to keep proper books and records. Section 286 sets out that a Company must keep written financial records that:

- correctly record and explain its transactions and financial position and performance;
- would enable true and fair financial statements to be prepared and audited (only if required).

These financial records must be retained for seven years after the transactions covered by the records are completed. Failure to maintain these records can result in the company being presumed to be insolvent.

Duty To Prevent Insolvent Trading

If a company is at risk of **insolvent trading (i.e., when it continues to trade even though it's unable to pay its debts)**, it's even more important for directors to understand their obligations and duties and what immediate actions need to be taken. That's also where directors need to be aware of the warning signs of insolvency.

There are many red flags of potential insolvent trading, including:

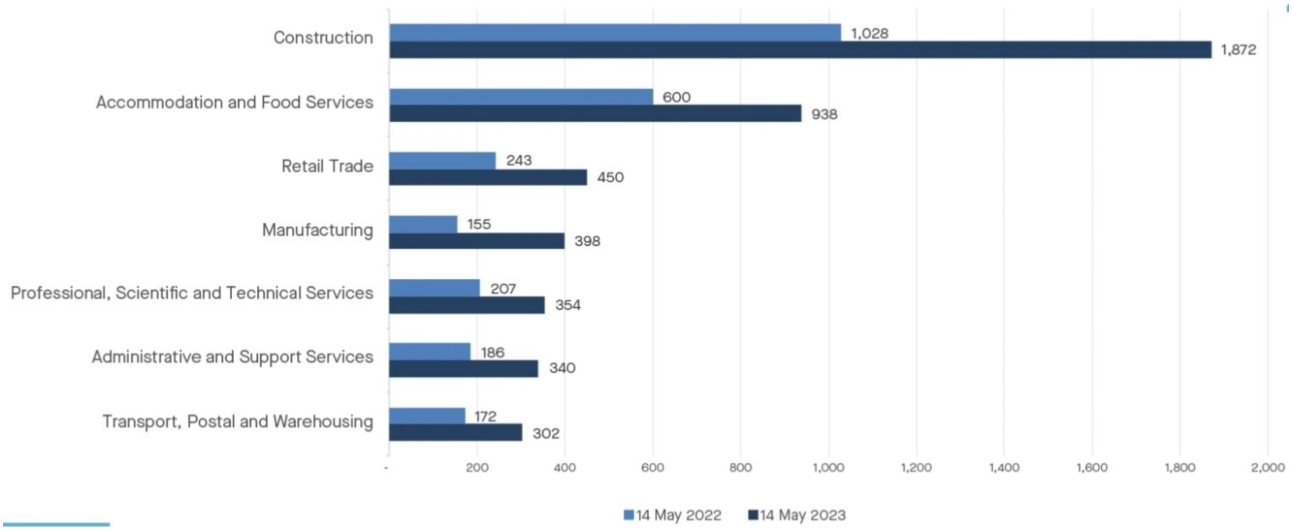
- overdue tax payment obligations - federal and state,
- cash flow shortfalls,
- falling sales,
- loss of significant customers,
- a poor relationship with current bank and the inability to borrow further funds,
- inability to raise further equity capital,
- greater pressure from creditors,
- inability to provide timely and accurate financial information or to make reliable forecasts,

These and other key indicators are crucial in determining whether a director suspects or ought to suspect that a company is currently insolvent or in danger of becoming insolvent. As a company nears insolvency or if directors are concerned about their company's solvency, it's vital they shift their focus to their obligations and duties, especially those relating to creditors.

Early Intervention Is Critical

Directors concerned about a company's financial position should seek professional advice regarding the state of their business and their legal obligations, in addition to identifying potential solutions to address the company's financial position. Delaying decisions or delaying taking steps to try to resolve your company's financial distress may lower the prospect of recovery, particularly while the business's financial position continues to deteriorate. Company directors must understand their duties and obligations and the potential consequences if the right actions aren't taken. **There are formal insolvency processes that allow a company to restructure its debts and continue to trade. Don't put your head in the sand – seek help at the first sign of trouble.**

According to ASIC recent publications, business shutdowns are now on the rise and are growing in momentum as shown in the diagram below:



Source: ASIC - May 2023

According to ASIC, 51% of businesses fail within the first four years of operation, a sobering number. ARITA (Australian Restructuring Insolvency and Turnaround Association) TA says are the top 4 reasons why companies fail are:

(1) **Poor Financial Management:** This can include overspending, not having a solid financial plan in place, or failing to adapt to changes in the market. It is common to see companies failing to account for tax obligations or leveraging ATO's slow reaction times and using funds set aside for tax to cover other expenses. Then the ATO calls in the debt and you have no means to pay the loan.

(2) **High Debt And Insufficient Cash Flow:** One can be obsessed with a grand business idea and assume it will be immune to the normal risks of business, only to see it fall flat on its face in the first year. The business could potentially be salvaged and even make good money, however, if it owes money one may have a hard time balancing the priorities. Business loan interest rates are typically high and you could fall into the profit-sucking debt trap, that is paying the minimum monthly due payments only and the loan may take many years to pay off. During economic challenges, too much debt can expose your business to unnecessary risks.

(3) **No Strategic & Risk Management Plans:** If you fail to plan, you plan to fail as the saying goes. It's critical for you to plan your business operations with built-in flexibility and contingencies on your tactical and strategic directions. In saying this, nothing ever goes to plan and you must be able to pivot your operations to suit the temperature of the moment. Keep what works, throw away what doesn't so that you can chart your way forward.

(4) **No Marketing Plan:** You have an office, services/products, and a phone, but why is the phone not ringing? Sound familiar? The truth is nobody knows, or cares, that you are there. A huge number of businesses fail because their marketing if it exists at all, is tone-deaf to their target audience. That is, people are not listening to your marketing messaging. A good marketing plan will help you get your services in front of your target audience, will be clear on what messaging customers will respond to, and convince them you are the best there is to deliver the services/products they need.

Checklist For Distressed Businesses

- Identify where and why business performance has deteriorated since the last accounting period.
- Check actual performance against what you would expect to see from a business of this type.
- Keep on top of overdue debtors and seek explanations.
- Ensure the business has "good hygiene" around its terms of trade.
- Review the business model and identify opportunities for reorientation if required.
- Examine overheads and look for opportunities to reduce the costs where appropriate.
- Review financing and check the level of equity and forms of debt financing that are appropriate for the business.
- Get expert insolvency and bankruptcy advice at an early stage of recognising financial difficulties. The sooner the better, to provide you with a broader range of possible restructuring options.

Summary

Warning Signs of a Business in Financial Difficulty

Additional Resources

- ***"Warning Signs your business might be in trouble: early signs"*** from CPA Australia can be accessed HERE

Our liability may be limited by a scheme approved under Professional Standards Legislation.