CREDIT ISSUES

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INSOLVENCY – THE WARNING SIGNS

Introduction

With increasingly difficult business conditions because of such factors as the sub prime crisis, share market volatility, inflation and global illiquidity, together with a decelerating GDP, tightening market conditions and the threat of recession, it is timely for Boards of Directors to focus on the solvency of their companies.

To say that an insolvent company is a problem for its directors is trite. Everyone, from its suppliers to its customers, are effected. However, it is the company's decision makers - its directors - who have the most to lose.

Risk

Directors of a company being wound up are exposed to:

(a) a claim for insolvent trading under Section 588G of the *Corporations Act*;

(b) a statutory indemnity to the Commissioner of Taxation pursuant to Section 588FGA of the *Corporations Act*, in relation to a Liquidator's successful preference recovery action against the Commissioner;

(c) guarantees given to lenders and suppliers;

(d) a host of claims in relation to other possible breaches of the *Corporations Act*, other Acts and law;

(e) a loss of equity, if a material shareholder; and,

(f) loss of a job, if an executive director.

If an insolvent company can be restructured and rescued from liquidation, there is much to be saved.

But, it is essential for directors to objectively analyse their company's financial position so that they can identify when the company is insolvent or nearing insolvency and thus take advice for remedial action.

Definition

So, the question is, when is a company insolvent?

The chestnut, not necessarily the old chestnut, to be considered first is the statutory definition found in Section 95A(2) of the *Corporations Act* which states that:

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"A person who is not solvent is insolvent."

Some guidance is found in subsection (1) which states that:

"A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable."

Analysis

To understand what this means, one must look at the relevant case law.

There are two tests of insolvency; the cash flow test and the balance sheet test. The balance sheet test considers whether all of a company's assets are sufficient to meet all its liabilities. The cash flow test considers whether a company's cash flow is sufficient to meet its liabilities as they become due and payable. Australian Courts have preferred the cash flow test.

Barrett J in *Austin Australia Pty Limited v De Martin & Gasparini Pty Ltd* [2007] NSWSC 1238 cited, with approval, Dodds – Streeton J in *Crema Pty Limited v Land Mark Property Developments Pty Ltd* (2006) 58 ACSR631:

"Section 95A of the Act enshrines the cash flow test of insolvency which, in contrast to a balance sheet test, focuses on liquidity and the viability of the business. Whilst an excess of assets over liabilities will satisfy a balance sheet test, if the assets are not readily realisable so as to permit the payment of all debts as they fall due, the company will not be solvent. Conversely, it may be able to pay its debts as they fall due, despite a deficiency of assets."

Barrett J went on to state that ".... a state of solvency requires that, at each such point, the cash and liquid assets be sufficient to cover the debts due and payable and to become due and payable within the immediate future …"

In *Sandell v Porter* [1966] HCA 28, Barwick CJ stated that in determining solvency, a company was not limited to cash on hand in considering whether it is able to pay its debts as and when they become payable. The Court will also have regard to what funds a company could raise, in a relatively short period of time, by selling or borrowing against its assets. In *Quick v Stoland Pty Ltd* [1998] FCA 1200, Emmett J stated that a Court will have regard to what arrangements a company had made with its financiers or shareholders. In *Lewis v Doran* [2005] NSWCA 243, the New South Wales Court of Appeal confirmed that resources from outside a company which were available to the company, is a matter of commercial reality and should be taken to account in considering solvency.

In considering whether a debt is due, Palmer J, in *Southern Cross Interiors Pty Limited v Deputy Commissioner of Taxation* [2001] NSWSC 621 stated that, when dealing with creditors' indulgences:

(a) the Court will have regard that creditors will not always insist on payment strictly in accordance with their terms of trade in assessing whether a company has an endemic shortage of working capital or a temporary cash flow shortage;

(b) the fact that creditors do not enforce their terms of trade does not mean that the debts only become payable on demand;

(c) in assessing insolvency, a Court acts upon the assumption that a contract debt is payable at the time specified in the contract unless there is evidence to the contrary e.g. an express or implied agreement to extend the terms of trade; and,

(d) it is for the party that asserts that the debts are not payable at the times contractually stipulated to make good that assertion with evidence.

In *Lewis v Doran* [2004] NSWSC 608 it was stated that:

"If one member of a group of companies has, as a matter of commercial reality, ready recourse to the assets of another member of the group for the payment of the first company's debts as they fall due, and that recourse will not result in the insolvency of the second company or in merely delaying the insolvency of the first, then the Court may have regard to that fact in assessing whether the first company is able to pay its debts as they fall due."

Conversely, in *Hall v Poolman* [2007] NSWSC 1330, Palmer J put it that "… the law does not condone robbing Peter to pay Paul."

This principle was considered closely in *Hall v Poolman*. In this case, the argument of insolvency turned on whether notices of assessment issued by the Australian Taxation Office ("ATO") two years earlier where due and payable. It was submitted by the Plaintiff that, regardless of any genuine dispute, the amount due to the ATO under the assessment is due on the day stated in the notice of assessment. This may be the case despite:

- a Court having stayed execution of a judgment debt based on the notice of assessment;
- a challenge of the assessment in the Administrative Appeals Tribunal; and,
- negotiations for a settlement being conducted, without a written agreement of the Commissioner to defer the time for payment in accordance with Parts 4 to 15, (Section 255-10) of schedule 1 of the Tax Administration Act, 1953 (Cth).

In *Austin Australia Pty Limited v De Martin & Gasparini Pty Ltd*, Barrett J referred to the Plaintiff's "analysis of the all-important matter of Austin's cash position." On a month to month basis, the Plaintiff demonstrated a deficiency in quick assets (excluding work in progress not invoiced) to meet current liabilities (trade creditors and accruals) calculated as follows:

Cash at bank, per bank statements
Less: unpresented cheques
Add: debtors' balance
Less: contract retention moneys
Less: provision for doubtful debts

Barrett J concludes that "cash and other liquid assts of Austin were always insufficient to meet debts due and payable and to become due and payable in the immediately future … the insufficiency was not a temporary or transient problem but a deep seated and continuing disability."

Checklist

Two useful checklists of indicia of insolvency referred by the expert witness in *ASIC v Plymin* [2003] VSC 123 and by Palmer J in *Lewis v Doran* are listed below:

- continuing losses;
- liquidity ratios below one;
- overdue Commonwealth and State taxes, superannuation and workers' compensation insurance;
- poor relationship with present bank, including inability to borrow further monies;
- no access to alternative finance;
- inability to raise further capital;
- suppliers placing the company on C.O.D. or otherwise demanding special payments before resuming supply;
- creditors paid outside trading terms;
- issuing post-dated cheques;
- dishonoured cheques;
- special arrangements with selected suppliers;
- solicitors' letters, summons, judgments or warrants issued against the company;
- payments to creditors of rounded sums which are not reconcilable to specific invoices; and,
- inability to produce timely and accurate financial information to display trading performance, financial position and make reliable forecasts.

Not all these indicia need to be present for a company to be insolvent. In *Woodgate v Picone* [Unreported] the Court found that the company was insolvent during the relevant period where there were only three indicia of insolvency, despite only one creditor being paid outside trading terms and with whom a special arrangement had been made.

Conclusion

Accordingly, it is recommended that directors regularly work through the indicia of insolvency so as to monitor their company's financial position and thus reduce their own risk and exposure. Where indicia are present, directors should take advice from an insolvency expert.

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