What are a director's obligations when insolvency looms?

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The recent high profile administration of an Australian company has thrown the spotlight on the obligations of directors of financially stressed companies. In this particular matter, the two directors may be investigated for potentially breaching their duties.

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.

"Often people start a company due to a passion, but they're ignorant of the basic fiduciary duties and obligations set out in the Corporations Act," says Peter Moore, Jirsch Sutherland Partner. "Normally a director's duties are owed to the company and any shareholders, but when a company is insolvent, directors' fiduciary duties are extended, requiring them to have regard for the interest of the company's creditors."

So, what should directors be aware of?

Section 180 of the Corporations 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 of time [s 206C]," explains Moore.

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 (s 184).

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.

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 including overdue taxes, cash flow shortages, 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," says Moore. "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 also 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," adds Moore. "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."