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14 January 2010

Review of Corporate Rescue Procedure Legislative Proposals

The Australian Compliance Institute (ACI) would like to thank the Financial Services and the Treasury Bureau (FSTB) for providing an opportunity for ACI to respond to its request for public comment in respect to its proposed Corporate Rescue Procedure Legislation.

ACI is the peak industry body for the practice of compliance in Australasia. Our members are compliance, risk and governance professionals actively engaged in the private, professional services and Government sectors within Australia, Hong Kong, New Zealand, Singapore, Thailand and Indonesia.

Having taken the opportunity to review the consultation paper issued by the FSTB, ACI believes that its comments should be restricted to questions 15 and 16 that were posed by the FSTB. That being said, ACI is aware that one of its long standing members, Mr. Angus Young has already made a submission to the FSTB (see attached) in this respect.

ACI has taken the opportunity to review the submission made by Mr. Young (and Ms Chu) and rather than submit another submission along similar lines, ACI would like to take this opportunity to add its support to the comments made by Mr. Young and Ms Chu.

Additionally, ACI would like to draw the FSTB's attention to a public consultation paper (CP124) that was recently issued by the Australian Securities & Investments Commission (ASIC) in respect to insolvent trading (see attached).

This consultation paper centers on a proposed guidance note that ASIC is about to release to ensure company directors fully understand their responsibilities when it comes to preventing insolvent trading. ACI believes that should the FSTB introduce its proposed insolvent trading provisions, that in future it should also give consideration to issuing a similar guidance note for Hong Kong based company directors.

Once again ACI would like to thank the FSTB for providing an opportunity to make a submission on these proposed legislative reforms. Should the FSTB require any further information or clarification on the content of this submission, then please do not hesitate to contact me on or via email

Yours sincerely

Martin Tolar

Chief Executive Officer

To: Division 4, Financial Services Branch, Financial Services and Treasury Bureau, Hong Kong.

RE: Consultation Paper on the Review of Corporate Rescue Procedure Legislative Proposals

Date of submission: 30th December 2009.

Part A: General Information of the Respondent

Submission Drafted by:

Angus Young, Lecturer in Business Law, School of Accountancy, Queensland University of Technology, email:

Tina Chu, LLM Student, Queensland University of Technology and Solicitor of the Supreme Court of Queensland, email:

Part B: Detailed Questions for Response

Question 15

Do you support the introduction of insolvent trading provisions? In case you do not, please explain and suggest alternatives to (a) encourage timely initiation of provisional supervision; and (b) deter irresponsible depletion of the company's assets.

Overall, we support the HKSAR government policy initiatives and objectives laid out in the *Companies Ordinance (Corporate Rescue) Bill* (CCR Bill) amidst the recent global financial crisis. We believed that the enactment of the CCR Bill will be beneficial to Hong Kong's economy and reputation as a financial hub in the Asia-Pacific region. The reason is simple, without robust insolvent trading laws, directors are more likely to engage highly risky or make reckless decisions out of desperation which would cause harm to the company and the company's creditors. This could also have a domino effect on other companies by causing financial distress as experienced in the Asian financial crisis over a decade ago.

In addition, the introduction of insolvent trading provisions holding directors personally liable for losses suffered by the company and creditors will enhance Hong Kong's corporate governance standards and accountability of directors to match other common law jurisdictions like Australia.[1]

This legal obligation could also have a positive effect on the quality of Hong Kong's directorship. By heightening the standard of care in line with the recommendations in the Draft Companies Bill – first phase consultation published in December 2009. Higher standards of care can and will instil greater confidence amongst shareholders and creditors because no company can afford to have directors acting negligently, as per Bokhary J in *Chingtung Fixtures Ltd (in Liquidation) v Arthur Lai Cheuk Kwan and Other*s[2].

[1] The Review of Corporate Rescue Procedure Legislative Proposals compared Hong Kong's insolvent trading regime with UK and Australian jurisdictions at 6.4.

[2] C*hingtung Fixtures Ltd (in Liquidation) v Arthur Lai Cheuk Kwan and Others* HCA005081/1989.

The higher standard would also mean directors could not claim that they were not familiar with the financial affairs of the company. It was held in *The Official Receiver v Ng Ting Ming*[3] that the respondent was an unfit director because he was, *"[u]nable to handle corporate affairs in any responsible or law-abiding manner"*.[4] The Court contended that, *"[i]t is very important to bear in mind that as the director of a company he has a very important duty to strictly comply with the accounting duties imposed on him. It is because without sufficient accounting records, any directors cannot act responsibly in making decisions whether to continue trading In my view, it is likely that it is as a result of the respondent's failure to keep proper accounts that led to the commission of the other misconduct such as insolvent trading."*[5]

These were some of the reasons why the Australian Federal government introduced a duty for directors to avoid insolvent trading under section 588G of the Australian Corporations Act 2001 (Cth). This provision was based on the recommendations of the General Insolvency Inquiry (Harmer Report 1988), which pointed out the needs for an insolvent trading provision includes the protection of company's interest and to provide adequate remedies to creditors.[6] The Harmer Report outlined the deficiencies of director's duties where the civil remedies sought by creditors were dependent upon prior conviction of the offence and its lengthy procedures.[7] Thus, to protect the companies' and creditors' interests, and speedy debt recovery, we contend that it is crucial for Hong Kong to have a similar provision in imposing a 'positive duty' for directors to prevent insolvent trading as opposed to focusing on each particular debt with individual complex examinations for creditor's recovery.[8]

Question 16

Do you agree with the proposed revised formulation of "insolvent trading"? If not, please suggest alternatives.

We disagree with the proposed revised formulation of "insolvent trading".

In particular, we are opposed to the proposed removal of (1) (b) because it would seriously weaken to operability of (2) to act as a preventive mechanism.

According to an Australian case "suspect" means, *"[m]ore than a mere idle wondering whether [insolvency] exists or not, it is a positive feeling of actual apprehension or mistrust, amounting to a slight opinion, but without sufficient evidence*".[9] Also in *Metropolitan Fire*

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[3] *The Official Receiver v Ng Ting Ming* HCMP 2441/2007.

[4] Ibid at 32.

[5] Ibid at 28.

[6] The Law Reform Commission. (1988) *General Insolvency Inquiry (Harmer Report).* 45 Vol 1. Canberra. Australian Government Publishing Service at 280- 286.

[7] Ibid at 279.

[8] Ibid at 280.

[9] *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303 per Kitto J.

Systems Pty Ltd v Miller, Einfled J held that reasonable grounds to suspect, *"[m]ust be judged by the standard appropriate to a director of ordinary competence."*[10]

This denotes any prudent director must investigate further into the likelihood of insolvency, if he or she believed that there were sufficient grounds to do so. Thus concerns by Hong Kong's business sector that (1)(b) would discourage directors from taking any risk might be overstated and unfounded.

As held in the case of *Re: Goldcone Properties*, the directors have been taking significant risks to enter in purchase of a RMB 43 million liability and loans to its directors totalling HKD 36.5 million even when the company is in apparent deficiency of current assets against current liabilities and resulted in liquidation of the company. [11] Therefore, the inclusion of (1)(b) would encourage better risk management.

Furthermore, in 6.4 of the Review, the FSTB held the view that insolvent trading provisions are implemented to encourage directors to act on insolvency earlier rather than later to prevent further erosion of the distressed company's assets at the detriment of creditors. But without (1)(b), how or when would a director is expected to take reasonable steps to prevent insolvency. If the aim of (2) is for directors to act when he or she knows the company in a serious financial distress, this might be too late, since having systems in place to prevent insolvency is to inform a director there is cause for concern, and this is prompted when a directors have doubts about the company's financial viability, not when he or she is certain.

Without this heightened alert in (1)(b), we contend that it is unfair to demand directors to act when he or she knows the company is in financial difficulty and hold them personally liable for the dents incurred. By acting earlier - that is, as soon as any suspicion occurs, it can prompt directors in immediate action. We hold the view that the sooner they act, the more they can resolve in the light of corporate rescue.

We also agree with Professor Smart's submission in 2001, [12] that the word "any" in subsection (2) should be replaced by "all", hence construed as:

*"the responsible persons failed to take **all** steps to prevent the insolvent trading".*

We contend that in order for the director to rely on this defence, he or she must have demonstrated sufficient effort in protecting the company's interests in prevention of insolvent trading. Individual steps of prevention ought to be exercised in every possible way and be examined in light of the entire financial situation of the company.

[10] *Metropolitan Fire Systems v Miller* (1997) 23 ACSR 699 at 703 per Einfeld J.

[11] *Re: Goldcone Properties Ltd* [1999] HKCFI 980; HCCW000391/1999, 4 November 1999.

[12] Smart, P, (2001) *Submission Paper in response to Companies Ordinance Corporate Rescue Bill 2001*.

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Queensland Bacon Pty Ltd v Rees (1966) 115 CLR 266

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ASIC
Australian Securities & Investments Commission

CONSULTATION PAPER 124

Duty to prevent insolvent trading: Guide for directors

November 2009

About this paper

This consultation paper seeks feedback from directors, professional advisors and other interested parties on our proposed guidance to help directors understand and comply with their duty to prevent insolvent trading.

It includes a draft regulatory guide that:

- sets out the key principles that we consider directors need to take into account in order to comply with their duty to prevent insolvent trading; and
- provides guidance on how we will assess whether a director has breached their duty.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 24 November 2009 and is based on the Corporations Act as at 24 November 2009.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

Contents

The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our proposed guidance for directors on the duty to prevent insolvent trading. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Business Cost Calculator report and/or a Regulation Impact Statement: see Section C, 'Regulatory and financial impact'.

Making a submission

We will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any financial information) as confidential.

Comments should be sent by 22 January 2010 to:

Adrian Furby
Senior Accountant
Insolvency Practitioners and Liquidators
Australian Securities and Investments Commission
GPO Box 9827
Brisbane QLD 4001
facsimile: 07 3867 4725
email: policy.submissions@asic.gov.au

What will happen next?

Stage 1	24 November 2009	ASIC consultation paper released
Stage 2	22 January 2010	Comments due on the consultation paper
Stage 3		ASIC will consider feedback received during the consultation process and conduct further consultation if necessary before finalising our policy

A Overview

Key points

The *Corporations Act 2001* (Corporations Act) imposes on directors a positive duty to prevent insolvent trading: see s588G.

This consultation paper seeks your feedback on our proposed guidance to help directors understand and comply with their duty. The paper and the attached draft regulatory guide deal with:

- the relevant legal background;
- key principles that we consider a director needs to take into account in order to comply with the duty to prevent insolvent trading; and
- guidance on how we will assess whether a director has breached their duty.

1 There is evidence that some directors, particularly of small-to-medium enterprises (SMEs) in financial difficulty, do not fully understand their duty to prevent insolvent trading.

2 With the number of corporate insolvencies estimated to increase as a result of the current economic conditions, we think that the market would benefit from clarification about the factors we consider when deciding to commence an investigation in relation to possible insolvent trading.

3 This consultation paper outlines our proposals to help directors understand and comply with their duty to prevent insolvent trading.

4 A draft regulatory guide covering our proposed guidance to directors is attached to this paper.

5 Nothing in the draft regulatory guide will affect the ability of a liquidator of a company to bring proceedings against the company's directors to recover compensation for loss resulting from insolvent trading, or that of the company's creditors to bring similar action if they have first obtained the liquidator's consent or the leave of the Court.

Our proposals

6 The draft regulatory guide is intended to provide guidance to directors to help them understand and comply with their duty to prevent insolvent trading. It discusses:

(a) the relevant legal background to the director's duty to prevent insolvent trading;

(b) the following four principles which we consider directors should follow when endeavouring to meet their obligation to prevent insolvent trading:

1. directors must keep themselves informed about the company's financial affairs, and regularly assess the company's solvency;
2. directors should investigate financial difficulties immediately they identify concerns about the company's financial viability;
3. directors should seek appropriate professional advice to help address the company's financial difficulties; and
4. directors should consider and act appropriately on the advice received, in a timely manner; and

(c) some of the factors we will take into account in assessing whether directors have contravened the Corporations Act by allowing a company to trade while insolvent, in light of the key principles set out above.

B Our guidance for directors

Key points

We propose to release guidance for directors on the nature and scope of the duty to prevent insolvent trading.

The director's duty to prevent insolvent trading

Proposal

B1 We propose to release the attached draft regulatory guide to provide guidance on the nature and scope of the director's duty to prevent insolvent trading.

Your feedback

B1Q1 Do you think we should provide guidance to directors to help them understand and comply with their duty to prevent insolvent trading? If not, please give reasons.

B1Q2 Do you think the scope and nature of the director's duty to prevent insolvent trading is adequately summarised in the draft regulatory guide? If not, what further guidance should be provided?

B1Q3 Is the guidance about determining when a company is insolvent sufficient? If not, what further guidance should be provided?

B1Q4 Are the indicators of potential insolvency set out in Table 2 in the draft regulatory guide sufficient? If not, what further guidance should be provided?

B1Q5 Do you consider the guidance provided will assist directors of both SMEs and large or listed enterprises? If not, what additional guidance would you suggest we provide, if any?

Rationale

7 A director has a positive duty to prevent the company from incurring a debt if the company is insolvent at the time the debt is incurred, or becomes insolvent by incurring the debt or by incurring debts including that particular debt: s588G.

8 The duty not only applies to persons who are formally or validly appointed as a director but also to persons who act in the position of director, or in accordance with whose instructions or wishes the company's directors are accustomed to act.

9 A director has a defence against a civil claim for insolvent trading if they can prove one of the defences set out in the Corporations Act: s588H.

10 Determining whether a company is insolvent predominantly involves using a cash flow test, but must be determined by reference to the facts of each case. A number of factors that a reasonable person would take into account in determining whether a company is insolvent are set out in the Appendix of the draft regulatory guide attached to this consultation paper.

Directors must inform themselves

Proposal

B2 We propose to give guidance on the extent to which directors must inform themselves on an ongoing basis about the financial position and cash flow requirements of the company.

Your feedback

B2Q1 Is the proposed guidance helpful? If not, explain how it could be improved.

B2Q2 Is further guidance required? If so, what further guidance is needed?

B2Q3 Are the examples provided helpful? If not, what should the examples illustrate?

Rationale

11 Directors must ensure proper books and records are kept by the company, and actively monitor these and take reasonable steps to keep themselves fully informed about the financial position and cash flow requirements of the company at all times.

12 A director should generally monitor the company's financial position for any indication that it might not be able to pay its debts as they fall due.

13 A director may rely on information about the solvency of the company provided by another person, to help them with their inquiries if:

(a) the director first establishes that the person is suitably qualified, competent and reliable to provide the information about the company's solvency; and

(b) the director takes reasonable steps to be satisfied that they fully understand the advice received and that information on which the advice was based was accurate and complete.

Directors should investigate financial difficulties

Proposal

B3 We propose to issue guidance that, where there are reasonable grounds to suspect the company is in financial difficulty, or is insolvent or will become insolvent, a director should investigate the company's financial position and realistically assess the options available to the company to deal with the financial difficulties.

Your feedback

B3Q1 Is the proposed guidance helpful? If not, explain how it could be improved.

B3Q2 Is further guidance required about the nature of the inquiries the director should undertake? If so, what further guidance is needed?

B3Q3 Is the example provided helpful? If not, what should the example illustrate?

Rationale

14 If a director has reasonable grounds to suspect the company is in financial difficulty, or is insolvent or will become insolvent by incurring a debt, they should:

(a) take positive steps to investigate the company's financial position and realistically assess the options available to deal with the company's financial difficulties; and

(b) carefully consider the company's solvency before the company incurs each new debt.

Directors should seek professional advice

Proposal

B4 We propose to issue guidance that directors should seek appropriate advice from a suitably qualified, competent and experienced person to help them assess the options available to deal with the company's financial difficulties.

Your feedback

B4Q1 Do you agree with our proposal that a director should seek advice from a suitably qualified, competent and reliable person to help them assess the options available to deal with the company's financial difficulties? If not, please give reasons.

B4Q2 If yes, is the proposed guidance helpful? If not, explain how it could be improved.

B4Q3 Is further guidance required? If so, what further guidance is needed?

B4Q4 Is the example provided helpful? If not, what should the example illustrate?

Rationale

15 We consider that, when a director's inquiries identify solvency concerns, the director should also seek appropriate advice from a suitably qualified, competent and reliable person. This may include seeking advice on:

(a) the solvency of the company and whether there is a risk that the company is trading while insolvent;

(b) the alternatives available to deal with the company's financial difficulties; and

(c) whether it is realistically possible for the company to continue to trade while attempting to restructure the company's affairs to enable it to meet its obligations (including whether it can renegotiate its obligations) and return the company to long-term financial health.

Directors should act in a timely manner

Proposal

B5 We propose to give guidance that a director should consider the advice they receive and take appropriate action in a timely manner.

Your feedback

B5Q1 Is the proposed guidance helpful? If not, explain how it could be improved.

B5Q2 Is further guidance required? If so, what further guidance is needed? For example, is guidance required to help directors understand when they need to get advice and how quickly they should act to obtain advice?

B5Q3 Is the example provided helpful? If not, what should the example illustrate?

Rationale

16 A director should consider the advice they receive and take appropriate action in a timely manner.

17 When considering the advice the director must consider any qualifications made to the advice and the reasonableness of any assumptions on which the advice is based.

18 If the advice received is that the company, although not yet insolvent, may become insolvent in the near future, the director should:

(a) take steps to address the cause of any temporary lack of liquidity; and

(b) continue to monitor the financial position of the company closely and be prepared to take further action as soon as they suspect the company may be experiencing financial difficulties.

19 If the advice received is that the company is insolvent, the director must take immediate action. If a director has reasonable grounds to suspect that the company is incurring debts it will not be able to pay, they should take reasonable steps to prevent incurring further debts. They should also consider obtaining advice about the alternatives available to them to deal with the company's financial difficulties, assess that advice and take appropriate action in a timely manner. This may include considering the immediate appointment of an external administrator to the company.

20 If, based on advice received, the director implements a restructuring plan, they should carefully monitor trading to ensure the company's ability to meet its debts as they fall due does not deteriorate.

Our approach to insolvent trading

Proposal

B6 We propose to give guidance on how we will assess whether a director has breached their duty to prevent insolvent trading.

Your feedback

B6Q1 Is the proposed guidance helpful? If not, explain how it could be improved.

B6Q2 Is the information in Table 1 of the draft regulatory guide, about evidentiary material we will look for when assessing whether a director has breached their duty, helpful? If not, explain how it can be improved.

B6Q3 Is further guidance required? If so, what further guidance is needed?

Rationale

21 Whether a director has breached their duty to prevent insolvent trading involves looking at the specific facts of each case

22 We set out in Table 1 of the draft regulatory guide some of the specific factors we will take into account in assessing whether there has been insolvent trading and the evidentiary material we will look for.

C Regulatory and financial impact

23 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:

(a) providing guidance to directors to help them understand and comply with their duty to prevent insolvent trading;

(b) reducing the risk of directors breaching their duty to prevent insolvent trading;

(c) protecting the interests of creditors; and

(d) not unduly placing additional and burdensome costs on directors in complying with their duties.

24 Before settling on a final policy, we will comply with the requirements of the Office of Best Practice Regulation (OBPR) by:

(a) considering all feasible options;

(b) if regulatory options are under consideration, undertaking a preliminary assessment of the impacts of the options on business and individuals or the economy;

(c) if our proposed option has more than low impact on business and individuals or the economy, consulting with OBPR to determine the appropriate level of regulatory analysis; and

(d) conducting the appropriate level of regulatory analysis, that is, completing a Business Cost Calculator report (BCC report) and/or a Regulation Impact Statement (RIS).

25 All BCC reports and RISs are submitted to the OBPR for approval before we make any final decision. Without an approved BCC report and/or RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.

26 To ensure that we are in a position to properly complete any required BCC report or RIS, we ask you to provide us with as much information as you can about:

(a) the likely compliance costs;

(b) the likely effect on competition; and

(c) other impacts, costs and benefits,

of our proposals or any alternative approaches: see ‘The consultation process’, p. 4.

ASIC
Australian Securities & Investments Commission

REGULATORY GUIDE 000

Duty to prevent insolvent trading: Guide for directors

November 2009

About this guide

This guide is for directors and their professional advisers. It may also be of interest to registered liquidators and creditors.

The guide sets out key principles to help directors understand and comply with their duty under s588G of the *Corporations Act 2001* to prevent insolvent trading.

About ASIC regulatory documents

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Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This draft regulatory guide was issued on 24 November 2009 and is based on legislation and regulations as at 24 November 2009.

Disclaimer

This guide does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples in this guide are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

A Overview

Key points

This guide is intended to help directors understand and comply with their duty to prevent insolvent trading.

It sets out:

- the relevant legal background (see RG 000.4–RG 000.15);
- key principles that we consider directors need to take into account in order to comply with the duty to prevent insolvent trading (see Section B); and
- guidance on how we will assess whether a director has breached their duty (see Section C).

While compliance with the guide may avoid a breach of duty, we reserve our right to fully investigate the factual circumstances of each case of suspected insolvent trading and take action if we consider it appropriate.

Scope of this guide

RG 000.1 This regulatory guide is intended to help directors understand and comply with their duty to prevent insolvent trading. It sets out some of the key principles that we consider directors need to take into account in order to comply with this duty: see Section B.

RG 000.2 Section C contains guidance on some of the factors we will take into account in assessing whether a director has complied with their duty.

RG 000.3 In addition to directors and professional advisers, this guide may also be of interest to registered liquidators and creditors. It should be noted, however, that nothing in this guide affects the legal rights of a liquidator of a company to bring proceedings against the company's directors to recover compensation for loss resulting from insolvent trading, or that of the company's creditors to bring similar action with the liquidator's consent or with leave of the Court.

Director's duty to prevent insolvent trading

RG 000.4 A director has a positive duty to prevent insolvent trading under s588G of the *Corporations Act 2001* (Corporations Act).

Who does the duty apply to?

RG 000.5 The duty applies to directors, both those who are formally appointed to the position and any alternate director they appoint and who is acting in that capacity.

RG 000.6 The duty also applies to persons who are not formally or validly appointed as directors, but who act in the position of a director, or in accordance with whose instructions or wishes the company's directors are accustomed to act.

> Note: See s9 of the Corporations Act for the definition of 'director', which encompasses persons who are formally appointed to the position and those who act as de facto and shadow directors.

What does the duty require?

RG 000.7 Section 588G requires a director of a company to prevent the company from incurring a debt if:

(a) the company is *already* insolvent at the time when the debt is incurred; or

(b) by incurring that debt, or by incurring a range of debts including that particular debt, the company becomes insolvent,

and, at the time of incurring the debt, there are reasonable grounds for suspecting that the company is already insolvent, or would become insolvent by incurring the debt: s588G(1).

RG 000.8 Section 588G sets out two levels of contravention:

(a) Firstly, under s588G(2), a civil penalty provision applies to a director who fails to prevent the debt being incurred where they are aware that there are grounds for suspecting insolvency, or where a reasonable person in a similar position would suspect insolvency.

> Note: The consequences of contravening a civil penalty provision include that a court may make a pecuniary penalty order (s1317G), an order disqualifying the person from managing a corporation (s206C) or a compensation order (s588J).

(b) Secondly, s588G(3) sets out a criminal offence where:

(i) a director suspected at the time when a company incurred the debt that the company was insolvent or would become insolvent as a result of incurring that debt; and

(ii) the director's failure to prevent the company incurring the debt was dishonest.

> Note: Contravention of s588G(3) attracts a penalty of 2000 penalty units, or imprisonment for five years, or both.

What defences are available?

RG 000.9 Section 588H provides a director with a number of defences to a civil claim for insolvent trading under section 588G(2).

RG 000.10 A director has a defence if it is proved that, at the time the debt was incurred, the director:

(a) had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if it incurred the debt, or incurred a range of debts including that particular debt (s588H(2));

(b) had reasonable grounds to believe, and did believe, that a competent and reliable person who was responsible for providing adequate information about the company's solvency was fulfilling that responsibility, and the director expected, based on the information that person provided to the director, that the company was, and would remain, solvent even if it incurred the debt, or incurred a range of debts including that particular debt (s588H(3));

(c) because of illness or other good reason did not take part in the management of the company at that time (s588H(4)); or

(d) took all reasonable steps to prevent the company incurring the debt. Matters that may be considered when determining whether this defence is made out include but are not limited to any action the director took to appoint an administrator to the company, when that action was taken and the results of that action (s588H(5) and (6)).

RG 000.11 These defences do not apply to a criminal offence under section 588G(3).

When is a company insolvent?

RG 000.12 Generally, a company is insolvent if it is unable to pay all its debts when they fall due.

RG 000.13 Determining whether a company is insolvent predominantly involves applying a cash flow test.

RG 000.14 The company's ability to pay its debts should be determined by reference to the facts of each case, and taking into consideration:

(a) the company's assets and liabilities as a whole, including the company's ability to collect debts owed to it, and whether arrangements have been negotiated with creditors to defer payment of outstanding debts;

(b) whether additional money can realistically be raised in a timely manner from the introduction of additional share capital, or from future borrowings; and

(c) whether there are surplus assets that can be sold in a relatively short period of time to help pay debts without damaging the company's ability to trade.

RG 000.15 There are a variety of factors that should be taken into account in determining whether a company is insolvent: see the Appendix for further detail.

Note: Insolvency, or a severe shortage of liquid assets to meet debts as and when they fall due, is to be distinguished from a temporary lack of liquidity: *Hymix Concrete Pty Ltd v Garritty* (1977) 13 ALR 321, *Hall v Poolman* (2007) 65 ACSR 123. A temporary lack of liquidity may be overcome in the short term due to the successful outcome of the company's normal business activities.

B Key principles for directors

Key points

This section sets out the key principles that directors should consider in carrying out their role.

Directors should actively monitor the solvency of the company, investigate financial difficulties, seek advice from an appropriately qualified person where necessary, and consider and act appropriately on that advice, in a timely manner.

Where a director follows these key principles, they are less likely to breach their duty to prevent the company from trading while insolvent.

What directors must do

RG 000.16 A director must ensure proper books and records are kept by the company and take reasonable steps to remain properly and fully informed about the financial affairs of the company at all times, so that they can reasonably form a view about:

(a) the company's present financial viability; and

(b) the impact of incurring any further debts.

RG 000.17 A director is less likely to breach their duty to prevent insolvent trading where they take into account the following key principles in carrying out their role:

(a) A director must keep themselves informed about the financial affairs of the company, and regularly assess the company's solvency: see RG 000.20–RG 000.28.

(b) Immediately upon identifying concerns about the company's financial viability, a director should take positive steps to confirm the company's financial position and realistically assess the options available to deal with the company's financial difficulties: see RG 000.29–RG 000.30.

(c) A director should obtain appropriate professional advice: see RG 000.31–RG 000.34.

(d) A director should consider and act appropriately on advice received, in a timely manner: see RG 000.35–RG 000.43.

RG 000.18 If a director does not actively monitor the solvency of the company, investigate financial difficulties, where appropriate seek advice, and consider and act appropriately on that advice, they are at serious risk of breaching their duty to prevent insolvent trading.

RG 000.19 On the other hand, where a director does follow the key principles set out in this guide and has a reasonable expectation that the company is solvent and will remain solvent, they are more likely to be able to demonstrate that they took reasonable steps to meet their obligations.

Key principle 1: Directors must inform themselves

RG 000.20 Both executive directors and non-executive directors must actively monitor, and keep themselves informed about, the financial position of the company. This means that they must ensure that the company maintains adequate books and records and prepares relevant financial information. The directors must also make all reasonable inquiries to enable them to have an understanding of the financial position and cash flow requirements of the company at all times.

RG 000.21 Unless there is a good reason, a director is never excused or relieved from actively participating in the company's management.

Example 1

A director who is seriously ill and unable to attend to the affairs of the company might be excused if the company incurs a debt during the period of their absence that cannot be paid.

Alternatively, if a director is overseas and appoints an alternate director to act in their place while they are absent, they may also be excused if the company incurs a debt during the period of their absence that cannot be paid.

A director will not be excused if they rely on others to monitor the solvency of the company without taking an active and considered interest in the business and informing themselves of the company's financial affairs.

What directors need to do

RG 000.22 A director should generally monitor the company's position for any indication that it might not be able to pay its debts as they fall due. In order to do so, a director will need to ensure that they are kept informed on an ongoing basis; relying solely on financial statements at the end of each financial year is not sufficient.

RG 000.23 Some of the activities a director may need to undertake in order to ensure that they are sufficiently informed about the company's position may include:

(a) being involved in or overseeing the preparation of profit and cash flow budgets and regular management accounts, and monitoring actual results against budget expectations;

(b) reviewing the company's ability to collect debts owed to it and to realise other current assets, including stock, on a regular basis;

(c) monitoring when creditors are due to be paid and the company's ability to comply with normal terms of trade; and

(d) reviewing the current level of bank lending facilities and the ability to access additional funding if required.

Relying on information provided by third parties

RG 000.24 A director may rely on information about the solvency of the company provided by others in certain circumstances.

RG 000.25 This will generally be a person who is specifically responsible for providing information about the company's solvency to the director (e.g. another director, chief financial officer or internal/external accountant).

RG 000.26 To rely on the information provided by a particular person, the director should first establish that the person is suitably qualified, competent and reliable to provide information about the company's solvency. The director should also ask sufficient questions of the person to be satisfied that:

(a) the director fully understands the financial effect of the advice they receive; and

(b) the information on which the advice was based was accurate and complete.

RG 000.27 A director is only able to rely on information provided by a third party if the party relied upon is fully briefed and is given sufficient information by the director to properly and adequately perform their task.

RG 000.28 If information about the solvency of the company is not provided to the director as requested, the provision of that information is repeatedly delayed or it is presented in an unsatisfactory or unprofessional manner, a director should consider making any necessary changes to the persons and processes responsible for providing this information, including obtaining professional advice as necessary.

Example 2

Mr X is a director actively involved in the day-to-day running of the company. He spends most of his time marketing and growing the business and developing relationships with customers. He relies on staff to pay creditors on time. Every six months he reviews information about the financial position of the company that is prepared by one of his employees. He makes few inquiries into the information provided to him.

Mr X is not diligently monitoring the financial affairs of the company. He should ensure there are systems in place to let him know at all times:

- the realistic value of the assets and liabilities of the company;
- whether the company can pay its debts as they fall due and is doing so; and
- whether the business is trading profitably.

This might include:

- ensuring realistic profit and cash flow budgets are prepared and monitoring cash available to pay debts;
- reviewing regular management accounts and comparing actual performance to budgets; and
- reviewing the aged listing of debtors and creditors to ensure that trade terms are being met.

If Mr X or his staff do not have the skills to prepare this information, consideration should be given to hiring a suitably qualified bookkeeper or accountant to maintain adequate records to provide regular updates of this information.

Key principle 2: Directors should investigate financial difficulties

RG 000.29 As soon as there are reasonable grounds to suspect that the company is in financial difficulty, or that the company is insolvent or will become insolvent as a result of incurring a debt, directors should:

(a) take positive steps to confirm the company's financial position and realistically assess the options available to deal with the company's financial difficulties, so the company can meet its obligations; and

(b) carefully consider the company's solvency before the company incurs each new debt.

RG 000.30 The Appendix sets out a number of factors that a reasonable person would take into account when monitoring the company's position and assessing whether a company is insolvent.

Example 3

XYZ Pty Ltd is being pushed for payment by a number of creditors and a few cheques have been returned by the bank because there were insufficient funds. Although most of the critical supplier creditors are being paid on normal terms, the company is unable to pay a creditor with whom it had negotiated an extended repayment arrangement. In addition, the company has recently received a notice from the Australian Taxation Office detailing an outstanding debt.

Outstanding statutory liabilities, cheques being returned dishonoured and trade creditors not being paid on agreed terms are all significant indicators of potential insolvency. The directors should fully inform themselves about all the relevant facts and the financial position of the company, realistically assess the options available, obtain appropriate advice about how they might deal with the current financial difficulties, then consider, and act appropriately on, that advice when received.

Key principle 3: Directors should seek professional advice

RG 000.31 As soon as there are reasonable grounds to suspect that the company is in financial difficulty, a director should consider obtaining appropriate advice from a suitably qualified, competent and reliable person about the financial position of the company and how the financial difficulties can be addressed. A director is potentially able to rely on appropriate professional advice in circumstances where the professional adviser is given full, complete, accurate and up-to-date instructions by, or on behalf of, the director to enable the adviser to properly and adequately provide competent advice.

What directors need to do

RG 000.32 Advice might be sought from a number of sources, including an appropriately experienced accountant, lawyer or other person whose business involves advising directors and companies about solvency issues and the options available for dealing with financial difficulties.

RG 000.33 Directors should consider seeking advice on:

(a) the solvency of the company and whether there is a risk that the company is trading while insolvent;

(b) the alternatives available to the company to deal with its financial difficulties; and

(c) whether it is realistically possible for the company to continue to trade while attempting to restructure the company's affairs to enable it to meet its obligations (including whether it can renegotiate its obligations) and return the company to long-term financial health.

RG 000.34 Advisers may also be able to assist directors to prepare cash flow budgets and negotiate with creditors.

Example 4

PQR Pty Ltd is in financial distress and is negotiating with its banker to extend its banking facility. The bank has appointed an investigative accountant to advise the bank on whether the extension should be granted and further funds advanced to the company.

The directors of PQR Pty Ltd have other factors to consider beyond the company's financial standing with the bank. PQR Pty Ltd also has a large debt to unsecured noteholders due at the end of the year and a number of trade creditors are outside of trading terms. Directors need to consider the solvency of the company as a whole and ensure that all creditors (including outstanding employee entitlements and superannuation contributions) can be paid as and when they fall due, including ensuring that sufficient funds will be available to repay unsecured noteholders at the end of the year.

The directors should not rely on the bank's advisers, but should make their own inquiries and seek their own advice concerning the company's solvency and ability to meet its debts as they fall due.

Key principle 4: Directors should act in a timely manner

RG 000.35 Once they have obtained advice, directors should consider the advice (including any qualifications and the reasonableness of any assumptions on which the advice is based) and take appropriate action in a timely manner.

What directors need to do

Where there are doubts about the company's solvency

RG 000.36 If the advice received is that the company, although not yet insolvent, is experiencing financial difficulties and may become insolvent in the near future, action is still likely to be required on the director's behalf; for example, to address the cause of any temporary lack of liquidity.

RG 000.37 If there are reasonable grounds to expect that the financial position of the company will further deteriorate, the director is at risk of breaching their duty to prevent insolvent trading if they do not take immediate steps. This may include preventing the company from incurring further debts, and seeking further advice.

RG 000.38 The director should continue to monitor the financial position of the company closely and be prepared to take further action as soon as they suspect the company's ability to meet its debts as they fall due is deteriorating.

Where the company is already insolvent

RG 000.39 If the advice received is that the company is insolvent, the director must take immediate action. This may involve seeking further advice from an accountant or lawyer or other person who ordinarily provides advice on how to deal with companies in financial distress.

RG 000.40 Above all, if a director knows, or has reasonable grounds to suspect, that the company is incurring debts that it will not be able to pay, they should take all reasonable steps to prevent incurring further debts. These steps must be clear, positive and unequivocal. Such steps might include:

(a) actively seeking to persuade, in writing, the other directors not to incur the debt;

(b) convening a meeting of the board of directors to discuss and resolve that the debt should not be incurred, and ensuring that the minutes accurately reflect the attempts made to prevent the debt being incurred;

(c) seeking appropriate advice as to what they should do if the other directors resolve to incur the debt despite the director's dissent; or

(d) consider reporting the circumstances to us.

RG 000.41 Where there are reasonable grounds to suspect that the company is insolvent, as well as taking steps not to incur further debts, directors should obtain and consider advice about the alternatives available to them to deal with the company's financial difficulties.

RG 000.42 Where there are reasonable grounds to expect that the company cannot pay its debts as they fall due, based on the advice the directors receive, the directors should consider the immediate appointment of an external administrator to the company.

RG 000.43 If, based on advice, the directors implement a restructuring plan, they should carefully monitor trading to ensure the company's ability to meet its debts as they fall due does not deteriorate.

Example 5

DEF Pty Ltd has experienced cash flow difficulties and is considering the restructure of its affairs. It is considering a marketing program to sell certain business assets to raise sufficient cash to repay its debts, which are now due for payment. As markets are currently depressed, asset values are down. DEF Pty Ltd has been unable to borrow further money to help pay its debts. Depending on the amount realised from the sale of business assets, DEF Pty Ltd may not be able to pay all of its debts.

In circumstances where a company needs to sell off its business assets to pay its debts and it is likely that there will not be enough to repay all the creditors, there is a significant risk of insolvency and directors run the risk

of trading while insolvent during the period of any attempted restructuring. The directors of DEF Pty Ltd would need to consider the time it will take the company to realise the assets, the effect of the sale of assets on the company's ability to continue to trade and the effect the sale of assets will have on future cash flows. The directors should obtain appropriate legal and accounting advice to consider whether they are able to satisfy their director's duties and obligations.

The directors must carefully monitor the success of the restructure plan. If a restructuring plan is implemented (which would require negotiating a deferral in repayment of existing debts during the period of the restructuring) and it appears that the plan cannot be fully implemented and the company returned to long-term financial health, the directors should seek further advice about the various courses of action available to them. Such action may include considering the appointment of an external administrator.

C Our approach to insolvent trading

Key points

To assess whether a director has breached their duty to prevent insolvent trading, we will look at a number of factors, including the extent to which a director has followed the key principles set out in Section B.

This section describes some of these factors in detail: see Table 1.

RG 000.44 Whether a director has breached their duty to prevent insolvent trading involves looking at the specific facts of each case. In assessing this in a particular case, we will take the key principles set out in Section B into account, and consider the extent to which a director has followed them.

RG 000.45 Table 1 sets out some of the specific factors we will take into account in assessing whether there has been insolvent trading, and the evidentiary material we will look for.

Table 1: Factors ASIC will take into account in assessing whether a director has breached their duty to prevent insolvent trading

Key principle	Factors we take into account	Evidentiary method
Key principle 1: Directors must inform themselves	The information the director had at their disposal to form the view that the company was solvent, and how accurate that view was	We will look at the systems and processes that the director has put in place and used to allow them to actively monitor the solvency of the company, including the documents that were available to the director to obtain and review. For example, we will look at whether the following documents were available: • a bank reconciliation prepared on a regular basis that shows what cash at bank is available to pay debts; • a list of debtors and creditors, showing the age and size of all debts and amounts owing; • regular profit and loss, balance sheets and cash flow statements; and • a report of any arrangements or negotiations with creditors whose debts are outside normal trading terms.
	Whether the director monitored the financial affairs of the company and made sufficient inquiries into its financial affairs on a regular basis	Of the information that was available to the director, we will look at what the director actually obtained and reviewed, including: • the available financial information; • information about whether debts owed to the company can be collected and are being collected; • information about when debts are due to be paid and whether they are being paid on time; • information presented to directors about the financial operations and position of the company; • actual trading performance and, by comparison, projections; and • the assumptions on which cash flow projections are based (and whether these were updated, if necessary).
	Whether the director took part in the management of the company at the time the debt was incurred	If the director did not take part in the management of the company at the time the debt was incurred, we will look at: • the reasons given by the director to explain the absence; and • whether they are adequate to excuse the director (e.g. because the director was ill).

Key principle	Factors we take into account	Evidentiary method
	Where the director relied on a third party to provide information about the solvency of the company, whether the director made diligent and timely inquiries of them	We will look at whether: • the person relied on was, in fact, responsible for providing information about the company's solvency to the director; • the director took reasonable steps to establish that the person was suitably qualified to provide such information about the company's solvency; • the director provided sufficient information to enable the third party to adequately and properly perform their task; • the director trusted the third party to provide the information; and • the director asked sufficient questions to be satisfied that they fully understood the financial effect of the advice they received and that the information on which the advice was based was accurate and complete.
Key principle 2: Directors should investigate financial difficulties	Whether there were indicators of potential insolvency that a reasonable person would have taken into account in determining whether the company was insolvent	The Appendix sets out some of the common indicators of potential insolvency. We will look at whether any of these, or other indicators not listed, were present.
	Whether the director took positive steps to confirm the company's financial position and realistically assess the options available to deal with the company's financial difficulties	We will look at: • what information was available to the director, and the steps they took and inquiries they made, to investigate and confirm the company's financial position and assess the options to deal with the company's financial difficulties; • whether the director considered the company's solvency before incurring new debts; and • what evidence there is that the director acted quickly after becoming aware of potential indicators of insolvency.

Key principle	Factors we take into account	Evidentiary method
Key principle 3: Directors should seek advice	Whether the director sought advice immediately upon identifying concerns about the company's viability	We will look at: • whether the director obtained appropriate professional advice from a suitably qualified person as soon as the concerns about the company's financial viability were identified; • whether the director gave full, complete, accurate and up-to-date information to the adviser to enable the adviser to provide appropriate and competent advice; • what steps the director took to consider the effect and reasonableness of the advice they received; and • what steps the director took to act on the advice.
Key principle 4: Directors should act in a timely manner	Where the director knew, or had reasonable grounds to suspect, that the company was not able to meet its debts, whether the director took active, timely and genuine steps to prevent the debt being incurred	We will examine a range of company material including: • board minutes and correspondence indicating whether the director expressed concern at the incurring of further debts; and • internal documents, such as working papers from the in-house or external accountant (including financial statements and cash flow forecasts), that indicate whether the company has sufficient cash flow to pay its debts as they fall due.

Appendix: Indicators of potential insolvency

RG 000.46 Table 2 sets out some of the factors that a reasonable person would take into account when determining whether a company is insolvent. Should the financial position of a company display one or more of these indicators of potential insolvency, a director should seek professional advice about the financial position of the company, and how any financial difficulties can be addressed.

> Note: The list contained in this table is not intended to be exhaustive. There may be other factors that would indicate to a reasonable person that a company may be insolvent.

Table 2: Factors to take into account in determining whether a company is insolvent

Indicators of potential insolvency
• The company has a history of continuing trading losses. • The company is experiencing cash flow difficulties. • The company is experiencing difficulties selling its stock, or collecting debts owed to it. • Creditors are not being paid on agreed trading terms and/or are either placing the company on cash-on-delivery terms or requiring special payments on existing debts, before they will supply further goods and services. • The company is not paying its Commonwealth and state taxes when due (e.g. Pay-as-you-go instalments are outstanding, Goods and Services Tax (GST) is payable, or Superannuation Guarantee Contributions are payable). • Cheques are being returned dishonoured. • Legal action is threatened or commenced against the company, or judgements are entered against the company, in relation to outstanding debts. • The company has reached the limits of its funding facilities and is unable to obtain appropriate further finance to fund operations—for example, through: – negotiating a new limit with its current financier; or – refinancing or raising money from another party. • The company is unable to produce accurate financial information on a timely basis that shows the company's trading performance and financial position or that can be used to prepare reliable financial forecasts. • Company directors have resigned, citing concerns about the financial position of the company or its ability to produce accurate financial information on the company's affairs. • The company auditor has qualified their audit opinion on the grounds there is uncertainty that the company can continue as a going concern. • The company has defaulted, or is likely to default, on its agreements with its financier. • The company's financier has appointed an investigative accountant to advise the financier about its funding exposure to the company. • Employees, or the company's bookkeeper, accountant or financial controller, have raised concerns about the company's ability to meet, and continue to meet, its financial obligations. • It is not certain that there are assets that can be sold in a relatively short period of time to provide funds to help meet debts owed, without affecting the company's ongoing ability to continue to trade profitably. • The company is holding back cheques for payment or issuing post-dated cheques.

Key terms

Term	Meaning in this document
ASIC	Australian Securities and Investments Commission
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
creditor	A person who is owed money
director	A natural person appointed as a director of a company who is then responsible for directing and managing the affairs of a company, or a de facto or shadow director Note: See also the definition in s9 of the Corporations Act.
external administrator	A person formally appointed to control a company or its property. Includes a provisional liquidator, liquidator, voluntary administrator, deed administrator, controller, managing controller, receiver, receiver and manager, and scheme administrator
insolvent	Unable to pay all debts when they fall due for payment
registered liquidator	A natural person appointed to administer the liquidation of a company, being a person who is registered with ASIC as a liquidator
s766E (for example)	A section of the Corporations Act (in this example, numbered 766E)
SME	Small-to-medium enterprise

Related information

Headnotes

creditors, directors, duty to prevent insolvent trading, insolvent trading, registered liquidators

Information sheets

INFO 42 *Insolvency: a guide for directors*

INFO 79 *Your company and the law*

Regulatory guides

RG 22 *Directors' statement as to solvency*

Legislation

Corporations Act Ch 5, s9, 206C, 588G, 588H, 588J, 1317G

Cases

Sandall v Porter (1966) 115 CLR 666, *Lewis v Doran* (2004) 50 ACSR 175, *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699, *Dunn v Shapowloff* (1978) 2 NSWLR 235, *ASIC v Edwards* (2005) 220 ALR 148, *Morely v Statewide Tobacco Services* (1990) 2 ACSR 405, *Commonwealth Bank of Australia v Friedrich* (1991) 8 ACLC 946, *Group Four Industries Pty Ltd v Brosnan* (1991) 10 ACLC 1437, *ASIC v Plymin (No. 1)* (2003) 175 FLR 124, *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213, *Manpac Industries Pty Ltd v Ceccantini* (2002) 20 ACLC 1304, *Hall v Poolman* (2007) 65 ACSR 123, *Tourprint International Pty Ltd v Bott* (1999) 32 ACSR 201, *Williams (As Liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* (2008) QCA 94, *Hymix Concrete Pty Ltd v Garritty* (1977) 13 ALR 321.