

Insolvent Trading:

- Directors Duties/Assessment
- Insurer Assessment

John Kelly
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Corporate Insolvency?

Insolvency is defined in the Corporations Act as the inability of a corporation to **pay all their debts as and when they fall due.**

Type	1st Qtr 2008	1st Qtr 2009	% Change	2nd Qtr 2008	2nd Qtr 2009	% Change
External Administration	1746	2408	38%	2221	2451	10%

Director's duty to prevent insolvent trading by company

CORPORATIONS ACT 2001 - SECT 588G

A director will have committed an offence if they were aware, or a reasonable person in a like position would have been aware, that:

- The company was insolvent when incurring a debt
- The company becomes insolvent by incurring that debt
- The director did not prevent the company from incurring that debt

Defences

CORPORATIONS ACT 2001 - SECT 588H

Prove that, at the time when the debt was incurred:

- Person 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
- Relied on information from competent and reliable person(s)
- They did not take part in management through illness or other reason.
- Took all reasonable steps to prevent the company from incurring the debt.

Consequences of insolvent trading

- Civil penalties against directors, including pecuniary penalties of up to \$200,000
- Compensation proceedings for amounts lost by creditors
- If dishonesty is found to be a factor in insolvent trading, a director may also be subject to criminal charges (which can lead to a fine of up to \$220,000 or imprisonment for up to 5 years, or both).

Insolvency and going concern

- **Going concern** is when a company is able to pay its debts as and when they are due and continue in operation for at least the next 12 months without any intention or necessity to liquidate or otherwise wind up its operations.
 - Directors assess a company's ability to continue as a going concern when half-yearly and annual financial reports are approved for issuance.
- A company is **insolvent** when it is unable to pay all its debts when they become due and payable.
 - The assessment of solvency is effectively a day-to-day activity.

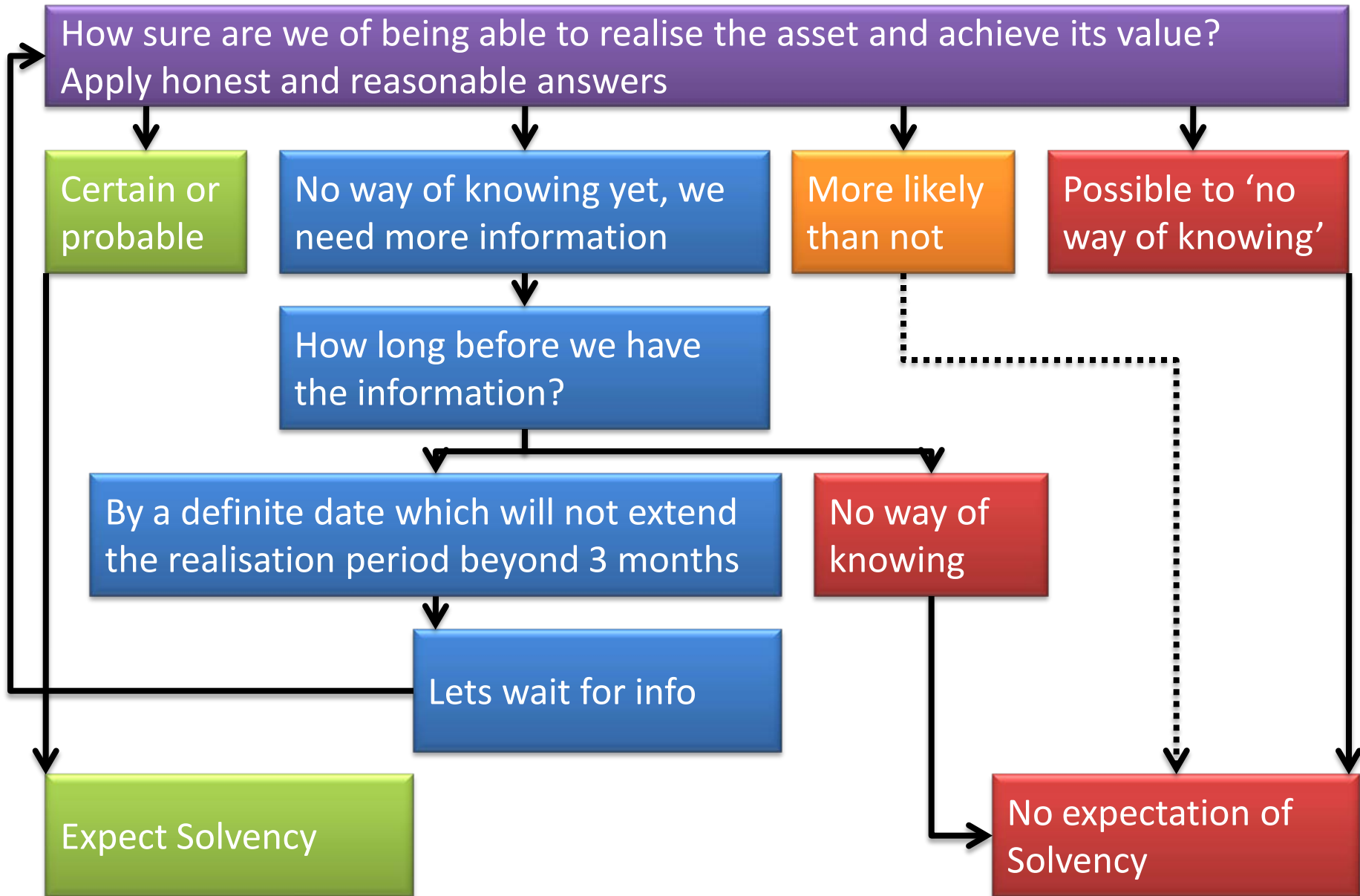
Methods to assess solvency

Cash Flow:

- Preferred method
- Working capital used as proxy
- What money is available within short space of time to discharge debts during that period

Balance Sheet:

- If total liabilities exceed total assets a company will be deemed insolvent for the purposes of this test
- Helps determine whether a company's problems indicate chronic insolvency or merely a temporary lack of liquidity



Based on Palmer J in *Hall v. Poolman* (2007)

Early Warning Signs

ongoing losses

absence of a business plan

liquidity ratios below 1 / poor cash flow

incomplete financial records

increasing debt (liabilities greater than assets)

lack of cash-flow forecasts and other budgets

problems selling stock or collecting debts

solicitors' letters, demands, summonses, judgements or warrants issued

unrecoverable loans to associated parties

issuing post-dated cheques or dishonouring cheques

creditors unpaid outside usual terms

payments to creditors of rounded sums that are not reconcilable to specific invoices

Insurer Theory

A company becoming insolvent increases the chance of a D&O Claim. Therefore assess for likelihood of Insolvency and apply exclusion.

- Intuitively: Yes
- Data: ?

Insurer Assessment

- Each Insurer has own rating model
- Blunt tool (often excel based) generates some key ratio's
- Limited financial analysis. Rely on experienced personnel
- At time of entering contract, if a client effectively states its solvent, then who is Insurer to second guess? But this is what occurs – because there is information asymmetry

Available Information

- Assess risk based on data prepared on a 'Going Concern' basis plus publicly available information.
- Client has obligation to disclose material information – this would include worsening financial position/insolvency.
- Does Insurer have same risk of assessment as any shareholder? Yes, but can take more conservative position by applying exclusion (especially in hard market)

Insurance outcomes for directors

- Dilemma - only relevant for those that need it!
- Focus on factors and quality of assessment. Outline process/steps/advice received to make the constant assessment of solvency.
- Review the warning signs and outline why they don't apply.
- Continuous disclosure rules. Can Underwriters be advised information that is not disclosed to market?