

THE MEANING OF INSOLVENCY

GUIDANCE FOR PUBLIC PRACTITIONERS

Why have we produced this factsheet?

- The risk of corporate failure under the current and evolving COVID-19-related economic circumstances is unprecedented.
- The implications for both debtors and creditors are profound in the immediate and short term. At the same time consideration is being given to recovery measures that aim to return companies and their assets to productive economic gain.
- Over many decades corporate law has developed sophisticated mechanisms for resolving the affairs of failed companies whilst at the same time providing opportunity to return to profitable trading where practicable.
- The application of these mechanisms will play a central role in how efficiently and fairly the Australian economy transitions through the current crisis.
- Central to invoking the rules and processes of corporate insolvency is determining whether or not a company is insolvent – a matter of some complexity and now, more than at any other time, of great importance for companies under financial stress in charting a path forward and for their creditors.
- Both the condition and a progressing towards insolvency is the trigger for directors to take actions which protect themselvesⁱ and creditors, noting though that early action, supported by obtaining appropriately qualified adviceⁱⁱ, is preferred.

What the law says and how it's understood

Section 95A of the Corporations Act 2001 at subsection 1 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” and in subsection 2, some might think perhaps unhelpfully, that “A [person](#) who is not [solvent](#) is [insolvent](#)”.

A number of interconnected matters are apparent in these thirty-or-so words:

- This is a cash flow test
- The law takes a strict view - there is no apparent half-way state between solvency and insolvency
- And to use lawyers' language, insolvency is decided on the facts on a 'case-by-case' basis.

Australian corporate law takes a permissive approach and sets fairly wide boundaries within which directors exercise their powers of management.ⁱⁱⁱ Relatedly, directors' duties are owed to the company. However, in discharging those duties directors must have regard to the interests of the company's creditors, particularly where the company is nearing insolvency.^{iv}

The duty to consider the interests of creditors derives from the members privileges of limited liability and the predominantly non-proprietary contractual character of unsecured creditors' rights. The 'insolvency context' does not amount to an independent duty owed to creditors accompanied by a corresponding right for creditors.^v Rather the duty is found most directly in the directors' duty to prevent insolvent trading^{vi} and the accompanying personal liability for civil penalties^{vii} and compensation to the company^{viii}.

Although the duties around insolvency fall upon company directors, they are central to the day-to-day functions of accountants and are vital to the way accountants interact with and support directors and their companies. Bearing in mind also that accountants have separate ethical responsibilities centred on acting in the public interest.^{ix}

The 'cash flow test' of insolvency:

"The cash flow test provides that a company is insolvent when it is unable to pay its debts as they fall due. It is of no consequence, under this test, that assets exceed liabilities. The important point is: can the company pay its way in carrying on its business? The court, in examining whether a company is suffering cash flow insolvency, will consider whether the company is actually paying its debtors".^x

A further distinguishing between the cash flow and balance sheet tests, and the law's favouring of the former, can again be found in Mandie J's extensive analysis in *ASIC v Plymin*, here referencing the UK case *Re Tweed Garage* [1962] Ch 406:

"The particular indications of insolvency - - - are all instances of commercial insolvency, that is, the company being unable to meet current demands upon it. In such cases it is useless to say that if its assets are realized there will be ample to pay [100 cents in the dollar^{xi}]: this is not the test."

The commercial context for favouring the cash flow test is encapsulated by Austin and Ramsay the authors of *Ford, Austin and Ramsay's Principles of Corporation Law*:

The test relates to liquidity because the legislation is concerned with the failure of a unit in a trading environment. The basic question is whether the company's business is viable. The balance sheet does not answer that question. Although it shows a company's assets and liabilities at a particular time it does not show the viability of the company's business by reference to ability to trade.^{xii}

At risk of stating the obvious, accountants will doubtless recognise that cash flow is not static having temporal elements influenced by a wide range of commercial and economic factors impacting, over relevant timeframes, the availability and management of working capital. Case law has dealt with many of these practical considerations. The nature of these aspects of the cash flow tests, whilst not providing a pathway through the current crisis, do provide pointers to the nature of the risks and the potential impacts of misjudgements in a period of extremely heightened economic, and indeed personal, stress.

The rules as they stand are quite strict.

Insolvency as opposed to a temporary lack of liquidity

"In *Sandell v Porter* [1966] HCA 28 the High Court - - - observed that it was important not to confuse insolvency with a temporary lack of liquidity and said (per Barwick CJ): 'Insolvency is expressed in s 95 as an inability to pay debts as they fall due out of the debtor's own money. But the debtor's moneys are not limited to cash resources immediately available. They extend to moneys which he can procure by realising by sale or mortgage or pledge of his assets within a relatively short time - relative to the nature and amount of debts and to the circumstances, including the nature of the business, of the debtor'.^{xiii}

The nature of due and payable

"[T]he commercial reality that creditors will normally allow some latitude in time for payment does not, in itself, warrant a conclusion that the debts are not payable at the times contractually stipulated and have become debts payable only on demand".^{xiv}

Relationships between debtor and creditor, and the course of commercial dealing

“If, as a matter of substance, the company is not able to pay its debts as they become due, the circumstance that the relevant creditor may give the company some time before they actually seek to enforce their remedies, and that the company may be able to pay them out, given that time, will not negate application of the [reckless trading] section.”^{xv}

Indicators of Insolvency

The words of judges aside, there are useful sources of guidance drawn from these analyses which provide a checklist of indicators of potential insolvency. One of which is ASIC’s Regulatory Guide 217 *Duty to prevent insolvent trading: Guide for directors*^{xvi} and Table 2 of the Appendix:

- 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 being threatened or has 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.
- 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.

Despite its universal application, the cash flow test has been criticised as being vague and uncertain^{xvii} and presenting difficult questions with regard timing, centred most particularly on distinguishing between a temporary lack of liquidity and an endemic shortage of working capital. The challenges in predicting such matters is encapsulated in one further decision, particularly pertinent given the uncertainties ahead:

“The first is an embarrassment, the second is a disaster. It is easy enough to tell the difference in hindsight, when the company has weathered the storm or foundered with all hands; sometimes it is not so easy when the company is still contending with the waves.”^{xviii}

The need for, and risks associated with not, seeking expert advice in matters of corporate insolvency is fully explained in the resource prepared for us by the Australian Restructuring, Insolvency & Turnaround Association (ARITA): <https://www.cpaaustralia.com.au/-/media/corporate/allfiles/document/training/dealing-with-financial-distressv02?la=en&rev=d20580707d0615801c74>

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- ⁱ Refer Corporations Act 2001 section 588H(6) which forms part of the defences to the director's duty to prevent insolvent trading (Div 3 of Pt 5.7B Recovery of property or compensation for the benefit of creditors of insolvent company)
- ⁱⁱ Refer Corporations Act 2001 section 588GA Safe harbour – taking course of action reasonably likely to lead to a better outcome for the company
- ⁱⁱⁱ See for example Corporations Act s 198A and cases such as *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1.
- ^{iv} See for example *Walker v Wimborne* (1976) 137 CLR 1 and *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1.
- ^v See for example *Spies v R* (2000) 201 CLR 603 and *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722. Unsecured creditors rights in insolvency are predominantly by way of entitlement to prove their debts (section 553) and to stand equal and rateably (*pari passu*) (section 555) with equally ranking creditors in a priority of distributions (section 556).
- ^{vi} Corporations Act Part 5.7B Div 3. Issues of solvency are relevant also to other decisions by directors including payment of dividends (section 254T) and share capital reductions and share buy-backs (Part 2J.1).
- ^{vii} Corporations Act Part 9.4B section 1317E Item 6.
- ^{viii} Corporations Act Part 5.7B Div 4.
- ^{ix} Refer APES 110 Code of Ethics (latest edition effective 1 January 2020) issued by the Accounting Professional & Ethics Standards Board, including reference also to NOCLAR (Non-compliance with Laws and Regulations).
- ^x *ASIC v Plymin, Elliot & Harrison (No 1)* [2003] VSC 123 at 370, Mandie J quoting A.R Keay "The insolvency factor in avoidance of antecedent transactions in corporate liquidations" (1995) 21 *Monash University Law Review* 305 at 307. NOTE: "debtors" or "debts", Professor Keay goes in to state: If a company fails the test it means, in effect, that it has **insufficient resources available to pay creditors**. The test has been in equity jurisprudence for hundreds of years and is a classical concept of civil law" (emphasis added).
- ^{xi} The liberty has been taken to express this in Australian currency.
- ^{xii} R. P Austin and I. M Ramsay *Ford, Austin and Ramsay's Principles of Corporations Law* (17th ed) (2018) LexisNexis Australia [20.100] p. 1308. The authors of Ford's do importantly point to the relevance of balance sheet considerations citing analysis by Professor Andrew Keay concluding that "it would be wrong to dismiss the balance sheet test as irrelevant, as it can be useful in providing contextual evidence of a proper application of the cash flow test" (at p. 1309).
- ^{xiii} *ASIC v Plymin, Elliot & Harrison (No 1)* [2003] VSC 123 at 374
- ^{xiv} *Southern Cross Interiors Pty Ltd (in liq) v DCT* (2001) 53 NSWLR 213 at [54] per Palmer J.
- ^{xv} *Standard Chartered Bank v Antico* (1995) 13 ACLC 1381 per Hodgson J.
- ^{xvi} <https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-217-duty-to-prevent-insolvent-trading-guide-for-directors/> (accessed April 2020)
- ^{xvii} R. P Austin and I. M Ramsay *Ford, Austin and Ramsay's Principles of Corporations Law* (17th ed) (2018) LexisNexis Australia [20.100] p. 1309.
- ^{xviii} *Hall v Poolman* (2007) NSWSC 1330 at [266] per Palmer J.