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What to look for: Signs that a company may be insolvent

Summary

In the current climate, many businesses will suffer from financial difficulties, though this does not necessarily mean that the businesses are insolvent. There are a number of indicators that may suggest that a company is insolvent, rather than just suffering temporary financial issues. Whether you are a creditor, a company director or other stakeholder, you should be aware of these indicators and what a company's insolvency could mean for you.

What does it mean to be insolvent?

A company will be considered insolvent if it is unable to pay all its debts, as and when they become due and payable.[1] A similar definition applies in relation to the insolvency of individuals.[2]

In practical terms, this means that if a company has insufficient cash flow available to meet its short-term liabilities, and has no other means of obtaining immediate financing, it is likely to be insolvent.

However, it is important to consider the commercial realities of the company and the industry it operates in when forming a view as to whether it is insolvent.

In the current economic climate, and given the current and impending impacts of coronavirus (COVID-19), more regard should be given to the prevailing circumstances and whether a company is suffering from a temporary cash flow issue, which can be overcome, rather than being insolvent. The Federal Government has introduced numerous measures to help the economy through this difficult time, and lenders, landlords and other creditors may be allowing (or are required to allow) greater forbearance on repayment of debts due. However, it is important to note that there is no moratorium on insolvency itself and therefore there is nothing to prevent businesses from becoming insolvent during the COVID-19 crisis.

If a company is insolvent, the inevitable consequence should be that the company is placed into some form of external administration, whether by the company's directors or an unpaid creditor. The external administrator will often realise the company's assets and distribute the proceeds (if any) to the company's creditors.

What factors indicate a company may be insolvent?

There are several factors that can indicate whether a company is suffering from more than just a 'quiet' or 'slow' period and instead may be, or may soon become, insolvent.

While a company that displays one or two of these factors may not be insolvent, or may not even be experiencing financial difficulty, if a company is displaying a number of these factors, it may be reason for concern or at least further consideration.

Factors to look out for include the following:[3]

- suppliers placing the company on cash on delivery terms, or otherwise demanding special payments before resuming supply;
- special arrangements with selected creditors, such as those critical to continuing operations of the company's business;
- creditors unpaid outside trading terms (outside of the common practice in the particular industry which the company operates in);
- dishonoured payments or payments of rounded sums which are not referable to specific invoices;
- solicitors' letters requiring payment of debts, summons(es), statutory demands, legal proceedings for the payment of trade debts, or judgments or warrants issued against the company;

- increasing debt (more liabilities than assets) and continuing losses (not just seasonal);
- problems selling stock or collecting debts;
- board disputes and director resignations or loss of management personnel;
- overdue Commonwealth and State/Territory taxes, including group tax and payroll tax. This may be evidenced by caveats lodged against real property owned by the company in favour of the relevant Commissioner for Taxation or State Revenue Office;
- overdue workers compensation premiums or superannuation contributions;
- poor relationship with the company's current lender – including an inability to borrow further funds, demands from lenders, reduced overdraft limits or defaults on loan or interest payments;
- change of lender (for example use of subprime (second tier) lenders) or increased monitoring or involvement by lender;
- inability to access alternative finance;
- inability to raise further equity capital, from existing shareholders, directors or otherwise;
- liquidity ratios (which compare a company's short-term assets or cashflow against its short-term liabilities) below 1;
- inability to produce timely and accurate (or audited) financial information to display the company's trading performance and financial position, and make reliable forecasts;
- an absence of a business plan;
- unrecoverable loans to associated parties;
- increased level of complaints or queries raised with suppliers.

Naturally, a creditor of the company may not have all this information available to them, however, they may become aware of and should look out for a number of these factors.

What further matters should be considered?

Critically, insolvency is something more than a temporary challenge to cash flow: it is an endemic shortage of working capital.

Accordingly, whilst a company may be displaying a number of the factors set out above, it may not be insolvent and further consideration should be given to:

- the company's commercial realities. The classic example is that of a beachside ice-cream shop, which trades poorly during the winter but profitably during the summer months: overall, the business may not be insolvent;
- what assets may be able to be realised and what other financial support may be available to the company (for example, from directors or shareholders) to assist with cash flow;
- the industry that the company operates in. For example, it may be common in a particular industry for invoices to be paid outside the strict invoice terms and only once the debtor receives payment from its own customer;
- unusual transactions or events. Common examples are the company's involvement in litigation or the company's acquisition or disposal of assets, all of which effects the company's cash flow, management's time and focus on the other operations of the business;
- factors outside of the company's control, including those which may be having a temporary impact on its cash flow.

Presently, there is no doubt that many businesses are currently unable to pay their debts as and when they fall due, because their revenues have been severely impacted by restrictions introduced to combat the spread of COVID-19. Such businesses may be in the hospitality, tourism or travel industries, for example. There are also businesses that may appear less obviously affected by the restrictions but are equally impacted by the COVID-19 crisis, such as wholesale importers who hold stock for on-sale by retailers who have temporarily shut their doors.

These companies may demonstrate a number of factors outlined above and strictly fall within the definition of '*insolvent*' in the Corporations Act, notwithstanding that they were profitable and solvent before the Government imposed restrictions and may return to profitability once the restrictions are lifted.

In these circumstances, regard should be had to what assistance or relief may be available to companies from the Government, the Australian Taxation Office, lenders, landlords and other creditors. It may be that such assistance is sufficient to relieve a company from the imminent risk of being insolvent.

If, however, cash flow issues pre-dated the COVID-19 crisis and the long-term viability of the company is in question, then the company is likely to be suffering from more than temporary illiquidity and may be insolvent.

Why does it matter and what should I do?

For creditors

If a company is insolvent, or may soon become insolvent, the company's creditors are unlikely to be paid at all or in full.

In these circumstances, creditors should consider whether it wishes to continue to trade with the company, and if so, whether it should do so on a cash on delivery or upfront basis.

However, a company's insolvency also poses a risk to those creditors which ***have*** been paid by the company.

If a company is subsequently wound up, a liquidator appointed to that company will be able to claw back certain payments made by the company, including payments made otherwise legitimately to its unsecured creditors in the 6 months before the liquidator's appointment as an "unfair preference".[4]

If you become aware that a company that owes you money is displaying a number of factors listed above, or if you think it may be insolvent, you should seek legal advice on your options for recovery and potential risks (including for unfair preference payments).

If you have made a prepayment or the company is in possession of your goods

Unfortunately, it is common to hear of persons pre-paying for goods or services from a company, sometimes through gift vouchers or payment of deposits for goods on order, and losing their money when the company becomes insolvent.

Unless there is security (which in some cases, needs to be registered on a relevant register), then these pre-payments or deposits are not recoverable as a priority from an insolvent company. In this case, the person having made the payment will be an unsecured creditor.

If you are concerned that the company may be insolvent, you should seek a refund of any prepayment or seek to take possession of the goods ordered. Whilst this may require payment of the balance due, it alleviates the risk that you will be left without both the goods and the deposit paid.

For company directors

Company directors have a number of obligations to ensure that they act in the best interest of the company, including an obligation to prevent their company from trading while insolvent.[5] As such, knowledge of the factors that may indicate insolvency and monitoring them is essential for any company director.

This may also assist company directors in gaining temporary assistance or relief available as a result of the COVID-19 health crisis.

While the Federal Government has recently introduced legislation to provide directors with temporary relief from personal liability for insolvent trading in relation to debts incurred in the ordinary course of business, if you are a director of a company, you should vigilantly continue to monitor your company's financial performance. This will allow you to determine whether there is a need to seek advice from financial advisors or insolvency specialists, including whether you should or can avail yourself of safe harbour protections.

Further information

For further information in relation to certain matters referred to in this Alert, please see:

What are Directors' Duties during Uncertain Financial Times?

"Safe Harbour" Laws – How can Directors' Steer the Ship During Uncertain Financial Times?

Coronavirus (COVID-19): Important Temporary Relief in Insolvency Law

COVID-19 Legal Issues & Considerations

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This Alert is intended as general information only. It does not purport to be comprehensive advice or legal advice. Readers must seek professional advice before acting in relation to these matters.

[1] Section 95A of the *Corporations Act 2001* (Cth) (**Corporations Act**).
[2] Section 5(2) and 5(3) of the *Bankruptcy Act 1966* (Cth).
[3] See *Australian Securities and Investments Commission v Plymin & Ors* [2003] VSC 123 at [386] (Mandie J); *Lewis v Doran* [2004] NSWSC 608 at [75] (Palmer J); ASIC Information Sheet 42 (INFO 42).
[4] See sections 588FA, 588FC, 588FE and 588FF of the Corporations Act.
[5] Section 588G of the Corporations Act.