



**ASIC**

Australian Securities & Investments Commission

## REGULATORY GUIDE 217

# Duty to prevent insolvent trading: Guide for directors

July 2010

### **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

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 guide was issued on 29 July 2010 and is based on legislation and regulations as at 29 July 2010.

### 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.

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## 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 217.7–RG 217.22);
- the key principles that we consider directors need to take into account in order to comply with their 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.

The law in relation to insolvent trading involves complex legal and accounting issues. Directors should ensure that they understand their legal obligations and, if necessary, obtain appropriate advice.

### Scope of this guide

- RG 217.1 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 217.2 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 217.3 The actual steps taken by a director to comply with their duty to prevent insolvent trading will depend, in part, on all the circumstances of the company, including the size and complexity of the business as well as the skills and experience of the company's management and staff. Where a director is not involved directly in overseeing the company's financial situation (including preparation of the financial statements) and relies on advice from management, employees and external professional advisers about the financial position of the company, the director must ensure that:
- (a) the management, employees and external professional advisers relied on by the director have the required level of knowledge, skill and experience necessary to undertake their functions given the size and complexity of the company's business;

- (b) systems are in place and operating effectively to provide the information the director needs to keep themselves informed about the company's affairs and be able to assess the appropriateness of the advice they receive; and
- (c) they make appropriate inquiries to remain informed about the financial position and affairs of the company.

RG 217.4 In addition to directors and professional advisers, this guide may also be of interest to registered liquidators and creditors. A registered liquidator of a company or a creditor of a company (with the consent of the company's liquidator or the court) may bring proceedings against a director to recover compensation for loss resulting from insolvent trading. Nothing in this guide affects the legal rights of a liquidator or creditor of a company to bring such a proceeding against a director. A liquidator or creditor of a company can bring a claim against a director whether or not we have conducted an investigation or brought proceedings against the director for insolvent trading. In bringing proceedings against a director, a liquidator or creditor may consider factors other than those that we will take into account in assessing whether a director has complied with their duty.

RG 217.5 Any claim against a director for insolvent trading, whether brought by us, a liquidator or a creditor, must be determined by the court. A court may take into account some or all of the key principles in Section B, or other matters, when determining whether a director has breached their duty to prevent insolvent trading.

RG 217.6 This regulatory guide is intended to provide general guidance to directors about their duty to prevent insolvent trading. The law in relation to insolvent trading is complex and dependent on the facts of each case. Directors should ensure that they understand their legal obligations and, if necessary, obtain appropriate advice.

## Director's duty to prevent insolvent trading

RG 217.7 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 217.8 The duty applies to directors, both those who are appointed to the position and any alternate director they appoint and who is acting in that capacity.

RG 217.9 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 217.10 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 the debt is incurred; or
- (b) by incurring that debt, or by incurring a range of debts including that 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 217.11 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; and
- (b) secondly, s588G(3) sets out a criminal offence where:
  - (i) a director suspected at the time 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.

### What are the consequences of breaching the duty?

RG 217.12 If a director is found by a court to have contravened the civil penalty provision in s588G(2), the court may make one or more of the following orders:

- (a) **compensation order:** the court may order that the director is personally liable to pay compensation to the company equal to the amount of the loss suffered as a result of the director failing to prevent the company from incurring debts while it was insolvent (see s588J and 1317H);
- (b) **pecuniary penalty order:** the court may order that the director pay a pecuniary penalty to the Commonwealth of up to \$200,000 if the court finds that the director's failure to prevent insolvent trading is serious or materially prejudices the interests of the company or the company's ability to pay its creditors (see s1317G); and
- (c) **disqualification from managing a corporation:** the court may disqualify the director from managing a corporation for a period of time

that it considers appropriate, if is satisfied that the disqualification is justified (see s206C).

RG 217.13 If a director is found to have committed a criminal offence under s588G(3), the court may make one or more of the following orders:

- (a) that the director pay a penalty of up to 2,000 penalty units—which at the time of releasing this guide is equal to \$220,000; or
- (b) that the director be imprisoned for up to five years.

Note: Section 4AA of the *Crimes Act 1914* defines a ‘penalty unit’. The value of one penalty unit at the time of the release of this guide is \$110.

### What defences are available?

RG 217.14 Section 588H provides a director with a number of defences to a civil claim for insolvent trading under s588G(2).

Note: The business judgement rule in s180(2) does not apply to a breach of s588G.

RG 217.15 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 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 that, based on the information that person provided to the director, the company was, and would remain, solvent even if it incurred the debt, or incurred a range of debts including that 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)).

Note: A court may also relieve a director from liability (either wholly or in part) if it appears to the court that the director has acted honestly and, taking into account all the circumstances of the case, ought fairly to be excused: see s1317S and 1318.

RG 217.16 These defences do not apply to a criminal offence under s588G(3).

## When is a company insolvent?

RG 217.17 Generally, a company is insolvent if it is unable to pay all its debts when they fall due.

Note: See s95A for a definition of ‘solvent person’ and ‘insolvent person’.

RG 217.18 The company’s ability to pay its debts should be determined by reference to the actual circumstances of the company. Determining whether a company is insolvent predominantly involves applying a cash flow test. This requires realistically assessing whether the company’s anticipated current and future cash flows will be sufficient to enable current and future liabilities to be paid as and when they fall due for payment.

RG 217.19 In addition, it may be relevant to look at the financial position of the company as a whole and consider other commercial factors when assessing solvency (commonly referred to as the ‘balance sheet’ test). For example, it may be relevant to consider:

- (a) the company’s assets and liabilities as a whole, including the company’s ability to collect debts owed to it within agreed terms, 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 issue 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 and its ability to pay all its debts when they fall due.

RG 217.20 There are a variety of factors that should be taken into account in considering whether a company is insolvent: see Table 2 in the Appendix for further details.

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. Garrity* (1977) 13 ALR 321 and *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.

RG 217.21 If a company fails to keep proper financial records, and an insolvent trading claim is made against a director, the court may presume in a civil penalty proceeding (unless the director can prove otherwise) that the company was insolvent for the period of time that the company failed to keep proper financial records: s588E.

RG 217.22 Whether a company is insolvent involves the consideration of complex legal and accounting issues. Directors need to obtain and take into account all relevant information about the company’s financial position and should consider obtaining appropriate advice if they have reasonable grounds to suspect the company is in financial difficulty: see RG 217.39.



## 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, obtain 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 217.23 A director must ensure proper financial 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 217.24 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 informed about the financial affairs of the company, and regularly assess the company's solvency (see RG 217.27–RG 217.36);
  - (b) immediately on 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 217.37–RG 217.38);
  - (c) a director should obtain appropriate advice (see RG 217.39–RG 217.42); and
  - (d) a director should consider and act appropriately on advice received in a timely manner (see RG 217.43–RG 217.51).
- RG 217.25 If a director does not actively monitor the solvency of the company, investigate financial difficulties, obtain appropriate advice where necessary, and consider and act appropriately on that advice in a timely manner, they are at serious risk of breaching their duty to prevent insolvent trading.

- RG 217.26 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 comply with their duty.

## Key principle 1: Directors must remain informed

- RG 217.27 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 proper financial 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 217.28 Unless there is a good reason, a director is never excused or relieved from actively monitoring the financial position of the company and its affairs.

### Example 1

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

Similarly, 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, during the period of their absence, the company incurs a debt 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 217.29 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. 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 217.30 Some of the activities a director may need to undertake 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.

RG 217.31 The actual steps taken by a director to ensure they are kept informed will depend, in part, on all the circumstances of the company, including the size and complexity of the business as well as the skills and experience of the company's management and staff. Where a director is not involved directly in overseeing the company's day-to-day activities, they should ensure that appropriate systems are in place, that they make adequate inquiries to keep informed about the financial position and affairs of the company, and that it is appropriate to rely on the information and advice provided to them.

### **Relying on information provided by third parties**

RG 217.32 A director may rely on information about the solvency of the company provided by others in certain circumstances.

RG 217.33 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 217.34 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:

- (a) understand the financial effect of the advice they receive; and
- (b) be satisfied that the information on which the advice is based is up to date, accurate and complete.

RG 217.35 A director is only able to rely on information provided by a third party if the party relied on is fully briefed and is given sufficient information by the director or the company to properly and adequately perform their task.

RG 217.36 If information about the solvency of the company is not provided to the director as requested, or the provision of that information is repeatedly delayed or presented in an unsatisfactory or unprofessional manner, a director should consider making any necessary changes to the processes and persons responsible for providing this information, including obtaining appropriate 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, Mr X should consider hiring a suitably qualified bookkeeper or accountant to maintain adequate financial records and provide regular updates of this information.

Reviewing information about the company's financial position every six months is not sufficient and monthly information may be more appropriate for most businesses where there are no solvency concerns. If there are solvency concerns, more regular information about the company's financial position is needed.

## Key principle 2: Directors should investigate financial difficulties

RG 217.37 As soon as there are reasonable grounds to suspect that the company is in financial difficulty, or that there is a risk 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) ensure that systems are in place to carefully consider the company's solvency before the company incurs each new debt.

RG 217.38 Table 2 in the Appendix sets out some of the 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, and then consider and act appropriately on that advice when received.

## Key principle 3: Directors should obtain advice

RG 217.39 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 advice in circumstances where the 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 217.40 In addition to relying on suitably qualified, competent and reliable management and staff (where available), a director may obtain appropriate professional advice 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 217.41 Directors should consider obtaining advice on:

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

- (b) the options 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 217.42 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 debts (including outstanding employee entitlements and superannuation contributions) can be paid as and when they fall due, while also 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 obtain 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 217.43 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 217.44 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 217.45 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 obtaining further advice and preventing the company from incurring further debts.

RG 217.46 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.

RG 217.47 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.

### **Where the company is already insolvent**

RG 217.48 If the advice received is that the company is insolvent, the director must take immediate action. This may involve obtaining further advice from an accountant or lawyer or other person who ordinarily provides advice on how to deal with companies in financial distress.

RG 217.49 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) obtaining 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 217.50 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 options available to them to deal with the company's financial difficulties.

RG 217.51 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.

**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 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 immediately obtain 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 217.52 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 into account the key principles set out in Section B, and consider the extent to which a director has followed them.
- RG 217.53 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.
- RG 217.54 Both the liquidator of a company, or a creditor of the company with the liquidator's consent, can bring proceedings against a director to recover compensation for loss resulting from insolvent trading. These parties may consider factors other than those set out in Table 1 when assessing whether to bring proceedings.
- RG 217.55 Any claim against a director for insolvent trading, whether brought by us, a liquidator or a creditor, must be determined by the court. A court may consider some or all of the key principles in Section B, or other matters, when determining whether a director has breached their duty to prevent insolvent trading.

**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
<b>Key principle 1: Directors must remain informed</b>	The information the director had at their disposal to form the view that the company was solvent, and how accurate that view was	<p>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:</p> <ul style="list-style-type: none"> <li>• a bank reconciliation prepared on a regular basis that shows what cash at bank is available to pay debts;</li> <li>• a list of debtors and creditors, showing the age and size of all debts and amounts owing;</li> <li>• regular profit and loss, balance sheets and cash flow statements; and</li> <li>• a report of any arrangements or negotiations with creditors whose debts are outside normal trading terms.</li> </ul>
	Whether the director monitored the financial affairs of the company and made sufficient inquiries into its financial affairs on a regular basis	<p>Of the information that was available to the director, we will look at what the director actually obtained and reviewed, including:</p> <ul style="list-style-type: none"> <li>• the available financial information;</li> <li>• information about whether debts owed to the company can be collected and are being collected;</li> <li>• information about when debts are due to be paid and whether they are being paid on time;</li> <li>• information presented to directors about the financial operations and position of the company;</li> <li>• actual trading performance and, by comparison, projections; and</li> <li>• the assumptions on which cash flow projections are based (and whether these were updated, if necessary).</li> </ul>
	Whether the director took part in the management of the company at the time the debt was incurred	<p>If the director did not take part in the management of the company at the time the debt was incurred, we will look at:</p> <ul style="list-style-type: none"> <li>• the reasons given by the director to explain the absence; and</li> <li>• whether these reasons are adequate to excuse the director (e.g. because the director was ill).</li> </ul>

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	<p>We will look at whether:</p> <ul style="list-style-type: none"> <li>• the person relied on was, in fact, responsible for providing information about the company's solvency to the director;</li> <li>• the director took reasonable steps to establish that the person was suitably qualified to provide such information about the company's solvency;</li> <li>• the director provided sufficient information to enable the third party to adequately and properly perform their task;</li> <li>• the director trusted the third party to provide the information; and</li> <li>• the director asked sufficient questions to understand the financial effect of the advice they received and be satisfied that the information on which the advice was based was accurate and complete.</li> </ul>
<b>Key principle 2: Directors should investigate financial difficulties</b>	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	<p>We will look at:</p> <ul style="list-style-type: none"> <li>• 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;</li> <li>• whether the director considered the company's solvency before incurring new debts; and</li> <li>• what evidence there is that the director acted quickly after becoming aware of potential indicators of insolvency.</li> </ul>

Key principle	Factors we take into account	Evidentiary method
<b>Key principle 3: Directors should obtain advice</b>	Whether the director sought advice immediately on identifying concerns about the company's viability	We will look at: <ul style="list-style-type: none"> <li>• whether the director obtained appropriate advice, including external professional advice if necessary, from a suitably qualified person as soon as the concerns about the company's financial viability were identified;</li> <li>• whether the director gave full, complete, accurate and up-to-date information to the adviser (or ensured that such information was given to the adviser by the company) to enable the adviser to provide appropriate and competent advice;</li> <li>• what steps the director took to consider the effect and reasonableness of the advice they received; and</li> <li>• what steps the director took to act on the advice.</li> </ul>
<b>Key principle 4: Directors should act in a timely manner</b>	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: <ul style="list-style-type: none"> <li>• board minutes and correspondence indicating whether the director expressed concern at the incurring of further debts; and</li> <li>• 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.</li> </ul>

## Appendix: Indicators of potential insolvency

RG 217.56 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 investigate the financial position of the company, and consider obtaining appropriate 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 considering 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 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.

## Key terms

Term	Meaning in this document
ASIC	Australian Securities and Investments Commission
Corporations Act	<i>Corporations Act 2001</i> , 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.
external administrator	A person formally appointed to control a company or its property—this includes a provisional liquidator, liquidator, voluntary administrator, deed administrator, controller, managing controller, receiver, receiver and manager, and scheme administrator
financial records	Written records that correctly record and explain a company's transactions and financial position and performance, and enable true and fair financial statements to be prepared and audited, including: <ul style="list-style-type: none"> <li>• invoices, receipts, orders for the payment of money, bills of exchange, cheques, promissory notes and vouchers;</li> <li>• documents of prime entry; and</li> <li>• working documents that explain how the financial statements have been prepared and adjustments made in preparing the financial statements</li> </ul> Note: See also the definition of 'financial records' in s9 and the obligation to keep financial records in s286. Section 286 requires that financial records are kept for 7 years.
insolvent person	A person (including a company) is insolvent if they are not solvent—that is, they are unable to pay all their debts as and when they fall due for payment Note: See also the definition in s95A.
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)

## 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, 1317S, 1318

*Crimes Act 1914*

### Cases

*Sandell v. Porter* (1966) 115 CLR 666, *Lewis v. Doran* (2005) 219 ALR 555, *Metropolitan Fire Systems Pty Ltd v. Miller* (1997) 23 ACSR 699, *Shapowloff v. Dunn* (1981) 148 CLR 72, *Edwards v. ASIC* (2009) 235 FLR 207, *Morley v. Statewide Tobacco Services Ltd* [1993] 1 VR 423, *Commonwealth Bank of Australia v. Friedrich* (1991) 5 ACSR 115, *Group Four Industries Pty Ltd v. Brosnan* (1991) 56 SASR 234, *Group Four Industries Pty Ltd v. Brosnan* (1992) 59 SASR 22, *ASIC v. Plymin (No. 1)* (2003) 175 FLR 124, *Elliott v. ASIC* (2004) 185 FLR 245, *Southern Cross Interiors Pty Ltd (in liq) v. Deputy Commissioner of Taxation* (2001) 53 NSWLR 213, *Manpac Industries Pty Ltd v. Ceccattini* (2002) 20 ACLC 1304, *Hall v. Poolman* (2007) 215 FLR 243, *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. Garrity* (1977) 13 ALR 321, *McLellan (in his capacity as liquidator of The Stake Man Pty Ltd) (ACN 006 602 919) and Another v. Carroll* (2009) 76 ACSR 67