Insolvency for directors

Information sheet – 42

Find out more about how personal bankruptcy and the liquidation of a company can interact (PDF 386 KB).

This is **Information Sheet 42 (INFO 42)**. It provides general information on insolvency for directors whose companies are in financial difficulty or are insolvent.

A company is insolvent when it cannot pay its debts when they are due. There are serious penalties for allowing your company to trade while insolvent. You should consult a registered liquidator, an appropriately qualified specialist insolvency accountant or lawyer, or a financial advice service about your company's financial situation as soon as you suspect your company cannot pay debts when they are due.

Who is a director?

A director is not just a person formally appointed to that role. Under the *Corporations Act 2001* (Corporations Act), a person may also be a director if they are not formally appointed but *act* in that role, or if the company's directors act in accordance with that person's instructions or wishes.

Directors' duties

Your primary duty is to the company's shareholders. You are also required to comply with general and specific laws applying to your company's operations. However, if your company is insolvent, or there is a real risk of insolvency, your duties expand to include creditors (including employees with outstanding entitlements).

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General duties

The Corporations Act imposes general duties on directors and officers of companies, including the duty:

- to exercise your powers and duties with the care and diligence a reasonable person would have, including taking steps to ensure you are properly informed about the company's financial position and the company doesn't trade if it is insolvent
- to exercise your powers and duties in good faith in the company's best interests and for a proper purpose
- not to improperly use your position to gain an advantage for yourself or someone else, or to cause detriment to the company, and
- not to improperly use information obtained through your position to gain an advantage for yourself or someone else, or to cause detriment to the company.

If dishonesty or recklessness is found to be a factor in your breach of general duties, the breach can be a criminal offence and substantial criminal penalties can apply, including up to 15 years' imprisonment.

Duty to prevent creditor-defeating dispositions

You have a duty to prevent your company from entering into a transaction that is a creditor-defeating disposition. This is a disposition of property (i.e. assets):

- for less than the lesser of the market value of the property or the best price reasonably obtainable, and
- that prevents, hinders or significantly delays the property from becoming available to benefit creditors in a winding up.

A creditor-defeating disposition, such as disposing of property for less than its market value, may place a director at risk of engaging in Phoenix activity.

Your duty to prevent a creditor-defeating disposition arises when your company is insolvent or becomes insolvent because of a disposition or several dispositions of company property or assets. You should seek appropriate legal advice because this area of the law can be complex.

This duty extends to other people who may be involved in or encourage such a disposition to take place, including pre-insolvency advisers, lawyers or others who assist or advise you to undertake such a disposition. Where there is recklessness in entering the transaction(s), a breach of the creditor-

defeating provisions is an offence under the Corporations Act and a court, subject to various exceptions, can order compensation to be paid to creditors equal to the loss or damage suffered.

Duty not to trade while insolvent

You also have a duty to prevent your company trading and incurring debts if it is insolvent. A company is insolvent if it is unable to pay its debts when they fall due. Before you incur a new debt you must consider whether you have reasonable grounds to suspect the company is insolvent or will become insolvent as a result of incurring the debt.

An understanding of the financial position of your company when you sign off on the yearly financial statements is not enough. You need to be constantly aware of your company's financial position.

Regulatory Guide 217 *Duty to prevent insolvent trading: Guide for directors* (RG 217) sets out guidance to help directors understand and comply with their duty under section 588G of the Corporations Act.

We have also provided guidance on the safe harbour protection below.

Duty to keep books and records

Your company must keep adequate financial records to correctly record and explain the company's transactions, its financial position and performance. A director contravenes the Corporations Act if they fail to take all reasonable steps to do so.

A creditor, ASIC or a liquidator can take legal action against a director for insolvent trading. Where it can be shown a company failed to keep adequate financial records for a period, the company will generally be presumed to have been insolvent throughout that period.

Consequences of insolvent trading

There are various penalties and consequences for insolvent trading, including civil penalties, compensation proceedings and criminal charges.

The Corporations Act provides some statutory defences for directors.However, directors may find it difficult to rely on these if they have not taken steps to stay informed about the company's financial position.

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Civil penalties

Contravening the insolvent trading provisions of the Corporations Act can result in civil penalties against directors.The maximum monetary penalty for individuals is the greater of:

- 5,000 penalty units, or
- three times the benefit obtained and detriment avoided.

Note: See fines and penalties for more information, including the value of a penalty unit.

Compensation proceedings

Compensation proceedings for amounts lost by creditors can be initiated by ASIC, a liquidator or a creditor against a director personally. A compensation order can be made in addition to civil penalties.

Compensation payments are potentially unlimited and could lead to the personal bankruptcy of directors. The personal bankruptcy of a director disqualifies that director from continuing as a director or managing a company.

Criminal charges

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 2,000 penalty units or imprisonment for up to five years, or both). Being found guilty and convicted of the criminal offence of insolvent trading may also lead to a director's disqualification.

ASIC has successfully prosecuted directors for allowing companies to incur debts when the company is insolvent – and has sought orders making directors personally liable for company debts.

The good news is that taking steps to ensure your company remains financially sound will minimise the risk of an insolvent trading action against you. It may also improve your company's performance.

What to do if you suspect financial difficulty

If you suspect your company is in financial difficulty, get professional accounting and/or legal advice as early as possible. This increases the likelihood the company

will survive. Do not take a 'head in the sand' attitude, hoping that things will improve – they rarely do. Warning signs of insolvency include:

- ongoing losses
- poor cashflow
- absence of a business plan
- incomplete financial records or disorganised internal accounting procedures
- lack of cashflow forecasts and other budgets
- increasing debt (liabilities greater than assets)
- problems selling stock or collecting debts
- unrecoverable loans to associated parties
- creditors unpaid outside usual terms
- solicitors' letters, demands, summonses, judgements or warrants issued against your company
- suppliers placing your company on cash-on-delivery terms
- special arrangements with selected creditors
- payments to creditors of rounded sums that are not reconcilable to specific invoices
- overdraft limit reached or defaults on loan or interest payments
- problems obtaining finance
- change of bank, lender or increased monitoring/involvement by financier
- inability to raise funds from shareholders
- overdue taxes and superannuation liabilities
- board disputes and director resignations, or loss of management personnel
- increased level of complaints or queries raised with suppliers, and
- an expectation that the 'next' big job/sale/contract will save the company.

A registered liquidator or other suitably qualified adviser can conduct a solvency review of your company and outline available options. You need to be aware of your options so you can make informed decisions about your company's future. Options may include refinancing, restructuring or changing your company's activities, or appointing an external administrator.

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Pre-insolvency advisers

Some advisers may initiate contact with directors whose businesses may be in financial distress 'out of the blue'. While not all advisers do the wrong thing, some suggest directors take actions that could be illegal (e.g. suggesting you transfer your company's assets into another company without paying for them – known as 'phoenixing' or phoenix activity).

If an adviser contacts you, or your existing solicitor or accountant suggests you do something which you aren't sure about, consider obtaining a second

opinion from an independent, appropriately qualified specialist insolvency accountant or lawyer or a registered liquidator.

Forms of external administration

The two most common forms of external administration available to directors are:

- liquidation, and
- voluntary administration, which may lead to a deed of a company arrangement (DOCA) or liquidation.

A director of a company operating a small business experiencing financial difficulties can also appoint a restructuring practitioner. There are eligibility criteria for a company to be eligible for a small business restructuring.

A company can also have a receiver, or receiver and manager, appointed over its property. This option is not normally available to a director, because a receiver, or receiver and manager, can only be appointed by a secured creditor or court. A scheme of arrangement may result in another form of external administration. This information sheet does not cover schemes of arrangement.

ASIC maintains a register of registered liquidators, and information about registered liquidators in each state. The Australian Restructuring Insolvency & Turnaround Association (ARITA) website also contains information about registered liquidators.

ATO director penalty notice

The Commissioner of Taxation can send you a notice, issued under section 269-25 of Schedule 1 to the *Taxation Administration Act 1953*, for your company's unpaid debts (also known as a 'director penalty notice'). If you receive this notice, you should immediately seek professional advice. Depending on the nature of the notice issued, failure to take appropriate steps within 21 days may result in the Commissioner of Taxation taking recovery action against you personally for the unpaid debts. Failure to take appropriate steps within 14 days may result in the Commissioner of Taxation taking recovery action against you personally for the unpaid debts.

What to do if your company is insolvent

If your company is insolvent, do not allow it to incur further debt. Unless it is possible to restructure, refinance or obtain equity funding to recapitalise the company, your options are to appoint a restructuring practitioner if your company meets the eligibility criteria, a voluntary administrator or a liquidator.

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Safe harbour

If your company is insolvent, or may become insolvent, you may be able to protect yourself from civil liability for insolvent trading by establishing a 'safe harbour'.

You may have safe harbour protection if:

- after you start to suspect the company may become or be insolvent, you begin developing one or more courses of action that are reasonably likely to lead to a better outcome for the company than the immediate appointment of an administrator or liquidator, and
- the debt is incurred directly or indirectly in connection with any such course of action, or the debt is incurred in the ordinary course of the company's business.

RG 217 sets out guidance to help directors understand the safe harbour regime.

Restructuring

The small business restructuring process allows eligible companies to enter into a restructuring plan with creditors with the assistance of a restructuring practitioner. There are certain eligibility criteria for a company to enter a restructuring process. The restructuring process allows the directors to retain control of the company's business, property and affairs while it develops a plan to restructure the company's affairs. Affected creditors decide whether a restructuring plan should be accepted.

Voluntary administration

Voluntary administration is designed to resolve the company's future direction quickly. An independent registered liquidator (the voluntary administrator) takes full control of the company to try to work out a way to save the company or the company's business.

The voluntary administrator aims to administer the company's affairs to obtain a better return to creditors than if the company had been placed

straight into liquidation. A better return may be achieved through a DOCA, which is generally proposed by the directors or other third parties, usually in consultation with the voluntary administrator.

Putting a company into voluntary administration is simple and quick. The company's director(s) resolve that the company is insolvent, or likely to become insolvent, and that an administrator should be appointed. The directors also need to obtain a registered liquidator's written consent to act as voluntary administrator before appointing an administrator.

Liquidation

The purpose of liquidation of an insolvent company is to have an independent registered liquidator (the liquidator) take control of the company so its affairs can be wound up in an orderly and fair way to benefit its creditors.

A registered liquidator can advise you of the simple and quick steps required to appoint a liquidator. Generally, a director-initiated liquidation involves holding a meeting of members to vote on winding up the company and to appoint a liquidator.

If the directors initiate the liquidation and certain eligibility criteria are met, the liquidator may consider whether to adopt a simplified liquidation process.

Receivership

Receivership occurs when a receiver is appointed by a secured creditor who holds a security interest over some or all of the company's assets or property. The receiver's primary role is to collect and sell enough company property to repay the debt owed to the secured creditor. The court may also appoint a receiver over a company's assets.

A director who is also a secured creditor can appoint a receiver and should seek advice before doing so.

Consequences of external administration and receiverships

As well as the possibility of insolvent trading action, there are other consequences for directors when a company goes into external administration or receivership.

These vary depending on the type of external administration.

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Directors' powers

Unless the directors appoint a restructuring practitioner to the company, they lose control of the company when it enters voluntary administration or liquidation. If a company goes from voluntary administration into a DOCA, return of the director's powers will depend on the DOCA's terms. When the DOCA is completed, the directors regain full control of the company unless the DOCA provides for the company to go into liquidation.

In a receivership, the powers retained by a director will depend on the powers of the receiver, and the extent of the assets over which the receiver is appointed. This is detailed in the security agreement or court order. If the receiver is appointed over all or most company assets, the receiver effectively has control, although the directors still have certain responsibilities and duties, and may retain residual control.

Directors' obligations

Directors have an obligation to assist the external administrator or receiver by:

- advising them of the location of the company's property and delivering the property in their possession to the external administrator or receiver
- providing the company's books and records to the external administrator (voluntary administration and liquidation) or giving the receiver access to the books and records
- advising the external administrator or receiver where other company records are held
- providing a report on company activities and property (ROCAP) within five business days (creditors' voluntary liquidation and voluntary administration) or 10 business days (receivership and court liquidation) of the external administrator or receivers' appointment, and
- meeting with, or reporting to, the external administrator or receiver to help them with their inquiries, as reasonably required.

Directors, officers and other people with relevant books and records must not obstruct external administrators and receivers in carrying out their duties.

Creditor meetings

Creditor meetings are held in voluntary administrations and may be held in liquidations.

Both a voluntary administrator and liquidator can require a director to attend a creditor meeting to provide information about the company and its business, property, affairs and financial circumstances.

Public examination

A voluntary administrator or liquidator has the power to apply to the court to conduct a public examination of a director, under oath. A receiver can also apply for a public examination, if ASIC consents.

Being summoned to appear for a public examination is serious and should not be ignored. Seek immediate legal advice if you are in any way concerned about the public examination process or your rights.

The external administrator conducting the public examination may be interested in your personal financial position or further details about assets or transactions the company undertook. Often the need for a public examination can be avoided by cooperating with the external administrator.

Disqualification from managing corporations

If a director has been involved with two or more companies that have gone into liquidation within the last seven years and paid their creditors less than 50 cents in the dollar, ASIC may disqualify them from managing corporations for up to five years. This effectively bans a person from acting as a director.

ASIC may also disqualify company directors from managing corporations for up to five years where a person is, or has been, an officer of two or more companies within seven years that have relied on the Fair Entitlements Guarantee (FEG) scheme to pay employee entitlements.

This can happen where the Commonwealth has paid employee entitlements under the FEG scheme and has received minimal or no return – and is unlikely to receive more than a minimal repayment of funds paid under the FEG scheme.

ASIC can also apply for orders disqualifying a person from managing corporations for up to 20 years if they have been an officer of two or more

companies that have failed within the last seven years, and the way in which the companies were managed contributed to the failures.

ASIC maintains a banned and disqualified persons register.

Employee entitlement proceedings

It is an offence for anyone, including a director, to enter into an agreement or transaction to avoid paying the company's employee entitlements. The maximum penalty is 1,000 penalty units or 10 years' imprisonment, or both.

If the company is in liquidation and the employees suffer damage or loss because a person entered into such an agreement or transaction, that person is liable to pay compensation for the loss suffered. This liability can arise even if the person has not been convicted of an offence for the contravention. A recovery action for compensation can be taken by the liquidator or, in certain circumstances, by an employee.

More information

- INFO 39 *Insolvency information for directors, employees, creditors and shareholders*
- RG 217 *Duty to prevent insolvent trading: Guide for directors*
- ARITA Code of Professional Practice

Related links

- Resigning or removing a company director

Important notice

Please note that this information sheet is a summary giving you basic information about a particular topic. It does not cover the whole of the relevant law regarding that topic, and it is not a substitute for professional advice. We encourage you to seek your own professional advice to find out how the applicable laws apply to you, as it is your responsibility to determine your obligations.

You should also note that because this information sheet avoids legal language wherever possible, it might include some generalisations about the application of the law. Some provisions of the law referred to have exceptions or important qualifications. In most cases, your particular circumstances must be taken into account when determining how the law applies to you.

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

This information sheet was updated in December 2024.