ARITA
AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION

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Directors' duties in uncertain financial times

March 2021

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The ongoing impact of the extraordinary events of 2020 is causing significant distress to companies. Indeed, for many companies, cash flow has slowed to a trickle or even stopped completely.

Regardless of the size or type of company, directors have specific duties and obligations in carrying out their role. In uncertain times, directors need to understand how their duties may change when faced with financial distress and who they can turn to for expert advice.

Directors' duties apply equally to volunteer directors of not-for-profit companies, to operators of small companies, as well as professional board members of listed entities – the key takeaway is be aware of your duties and seek timely advice from an expert.

Who do directors owe duties to?

Firstly, let's consider who the directors owe duties to.

Generally, directors owe duties to the company rather than to individual shareholders, employees or to other stakeholders. The obligation of company directors is to act in 'the best interests of the company as a whole'.

However, when the company is operating in a period of financial distress where its solvency is doubtful, the scope of the duties broadens to include an obligation to take into account the interests of creditors, and to refrain from taking actions which may be detrimental to creditors' interests.

In periods of financial uncertainty, it becomes more important for directors to understand the financial position of the company and assess whether it can pay all its debts as and when they become due and payable. If a company is unable to meet this obligation it is not solvent and likely to be insolvent.

This will mean that directors need to consider the impact of their decisions on creditors or potential creditors of the company when assessing whether a particular action is in the best interest of the company.

Consideration of creditors' position

There is not a single standard requirement for what steps need to be taken to consider creditors' interest in times of

financial distress or insolvency of the company. However, court decisions indicate that the law requires directors to:

- give increased and proper consideration to creditors
- not favour one group of creditors over another, and
- not act in a way which prejudices the interests of creditors.

Is the company insolvent?

Insolvency is defined as the point when you can't pay all your debts as and when they fall due. If your company is showing signs of financial distress, it's crucial to determine if it's insolvent.

Importantly, the legal definition of insolvency focuses on a **cash-flow test**. However, the company's balance sheet, available assets and the commercial realities play a part in considering what resources (including external sources of funding) may be available to a company to meet its debts when they are due.

Insolvency is characterised by an 'endemic shortage of working capital' which is distinct from temporary cash flow challenges. While it's likely that cash flow has been adversely impacted by the current economic challenges, it's important to take early steps to ensure that it doesn't result in a shortage of working capital which cannot be overcome, resulting in a formal insolvency appointment.

The determination of insolvency at a point in time can be a challenging assessment. It requires a careful and honest assessment of a company's financial position, taken as a whole. It needs to cover debts which are currently due and those which may fall due in the near future.

If a company is on the brink of insolvency the directors need to take action immediately for two reasons:

1. If they act quickly, they may be able to save the company or, at the very least, minimise the consequences.
2. If they continue to trade while it is insolvent, they could be breaking the law. Insolvent trading is a criminal offence which may impact their personal financial position.

If a director has concerns over the solvency of their company, they should act quickly to review the company's financial position and seek professional advice from a Registered Liquidator or a specialist insolvency lawyer. Most ARITA Professional Members[1] will not charge for an initial consultation.

Differences for SMEs, large companies & not-for-profits

From 1 January 2021, the law provides for different options of dealing with financial distress depending of the size of your company (regardless of whether it is for-profit or not-for-profit).

Safe Harbour protection is available to all companies and offers options outside of a formal insolvency appointment.

Small businesses may be able to access new Restructuring or Simplified Liquidation processes aimed at providing quick and cost effective options to eligible companies (see below).

Engaging a restructuring or insolvency professional doesn't need to be onerously expensive if the company is a not-for-profit. Indeed, the majority of insolvency and turnaround professionals work in small firms themselves.

In either case, while these options give directors protection from insolvent trading liability, directors' ordinary statutory and fiduciary duties continue to apply, including the duty to act in the best interests of the 'company' (again, this will correspond to the interests of creditors in times of doubtful solvency). On that basis, if directors are not confident an informal or formal restructuring will produce a better outcome for creditors, a winding up may be the only realistic alternative.

Safe harbour protection for restructuring outside of a formal appointment

'Safe harbour' protection gives directors the opportunity to restructure their business outside of a formal insolvency appointment, with protection for directors from insolvent trading offences should the restructuring be unsuccessful, and the company end up in liquidation.

Directors remain in control of the company throughout this process and the restructuring adviser works for the company and assists the directors.

There are important steps directors must take to protect themselves under safe harbour as well as giving the company the best chance to recover:

1. **Financial records in order**

   Directors can't claim the protection of a safe harbour unless the company's books and records are in order. This is vital because unless directors know where the company's money is coming from and going to, there cannot be a plan to restructure the business. It's also vital to understand where the company's debts may be and how much is really owed, including tax debts, and this is important in understanding if the business is actually viable.

   The company must have also complied with its obligation to pay its employees (including their superannuation) and

its tax reporting obligations.

2. **Get expert help**

   The law requires that directors get advice from an appropriately qualified adviser. The sooner expert advice is sought, the more options there are likely to be. While the law does not prescribe who this adviser should be, an ARITA Professional Member[1] will be qualified to provide the needed advice.

3. **Directors must properly inform themselves of their company's financial position**

   Once directors have got their company's financial records up to date and have taken advice from a qualified adviser, they must make a decision about where to from here. The law says directors have to decide if the proposed restructuring plan is 'reasonably likely to lead to a better outcome for the company and the company's creditors than if it had entered into voluntary administration or liquidation'. And that's why the advice from a properly qualified professional is vital.

4. **Develop & implement a restructuring plan for the company**

   The law – and common sense – says directors must have a properly documented restructuring plan for their company. It's important that it's documented, not just for them to be able to check off that they are following the plan, but also if the turnaround doesn't work, to ensure they can avail themselves of the safe harbour protections.

   A restructuring plan doesn't need to be long or complex. As long as it has clear and appropriate steps to getting the company back to financial health and, importantly, as long as the directors follow the plan.

SME Restructuring & Simplified Liquidation

A small business restructure allows eligible companies to compromise their debts with their creditors' agreement and maximise their chances of trading profitably in the future. It also allows for business owners to remain in control of their business during the restructuring period. Directors are assisted through the restructuring process by a restructuring practitioner (who must be a registered liquidator). This is a formal insolvency process and different to the informal restructuring possible under Safe Harbour.

Where a restructure is not feasible, a simplified liquidation process may be available to eligible companies in a creditors' voluntary liquidation. The simplified process is intended to be more cost effective due to reduced investigation, reporting and distribution requirements, however much of the process remains the same. While directors may propose that simplified liquidation process be followed, it is up to the liquidator to decide whether to adopt the process and creditors get to consider if they support the adoption of a simplified process.

To be eligible for Restructuring or Simplified Liquidation a company must:

- Owe less than $1 million to its creditors (excluding employee entitlement for Restructuring, where all outstanding employee entitlements need to be paid prior to a plan being offered to creditors)
- Not have previously done a Restructuring or used Simplified Liquidation in the past 7 years
- Lodge all outstanding documentation and returns with the ATO.

More information on Restructuring and Simplified Liquidation is available in ARITA's fact sheets for directors

- Small business restructuring[2]
- Simplified Liquidation[3]

Where to from here?

There are good options to help companies and directors through financial distress. But expert advice is key – an ARITA Professional Member can be part of the solution.

For your company's financial health, don't rely on dodgy advisers who may offer their service through Google advertising. Often their only qualification is that they've been broke before.

Disclaimer:

This material is not intended to constitute legal, business or other professional advice but is for information only. It is not intended as a substitute for advice from a qualified professional.

Document links

1. https://www.arita.com.au/member
2. https://www.arita.com.au/ARITA/Insolvency_help/Insolvency_explained/Insolvency_and_company_directors.aspx
3. https://www.arita.com.au/ARITA/Insolvency_help/The_liquidation_process.aspx

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