

DIRECTORS DUTIES, INSOLVENT TRADING AND YOU

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Introduction

The outbreak of COVID-19 is having an overwhelming impact on individuals, businesses and communities. The purpose of this Fact Sheet is to provide an overview of Director's Duties and Insolvent Trading provisions in the Corporations Act 2001 (the Act) and the implications this may have for CPA Australia members in their role as an adviser to clients in financial distress, despite the relief offered through the Coronavirus Economic Support Package (the Package).

This Fact Sheet should be read in conjunction with our other CPA Australia issues Fact Sheets '[The meaning of insolvency](#)' and '[Options for clients in Financial Distress](#)'.

Directors Duties

During the current COVID-19 pandemic, CPA Australia members may see an increase in indicators of insolvency from their clients and/or their clients' associated entities. It is important to keep in mind that the relief provided by the Package does not mitigate the role of the director/officer to make decisions in the best interests of the company.

Sections 180-184 of the Act details what duties a Director and/or Officer of a company has in relation to the entity. In particular, the Act imposes both civil and criminal duties on an Officer to:

- Take care and diligence in the decisions made on behalf of an entity.
- Act in good faith and for proper purpose of the entity.
- Not use their position to gain advantage for themselves or cause detriment to the entity.
- Use information to gain advantage for themselves or cause detriment to the entity.

Further obligations imposed on Officers of a company are set out the Act and include:

- Maintain proper books and records of an entity (sections 286 and 344).
- Prevent the entity from trading whilst insolvent (section 588G).
- Avoid creditor defeating dispositions (section 588FDB) (see **Phoenix Activity** below).

Whilst Directors and Officers are making decisions in the current economic climate due to the COVID-19 pandemic, they may rationalise that these decisions were made with the best interests of the company. However, these decisions must take note of those further obligations imposed under the Act as the relief for these obligations through the Package is limited to Insolvent Trading only (see next section) and do not extend to Phoenix Activity (below).

Insolvent Trading

Simply put, a Director has a duty to prevent a company from incurring a debt, if he/she believes that the company is insolvent or likely to become insolvent as a result of incurring that debt. This is relevant even if the Director, or a reasonable person in a like position suspects that the company may be insolvent. Should a company enter liquidation, the Director (or reasonable person in a like position) may be held personally liable

for the debts of the company from the date the liquidator deems the company is insolvent to the date the company entered liquidation.

The Package has effectively given company directors a moratorium period to 31 December 2020 from insolvent trading as they navigate their way around the current trading conditions imposed by State and Federal Governments. This protection is seemingly only afforded if the company in financial distress is placed into a form of external administration prior to 31 December 2020.

Phoenix Activity

CPA Australia members may have seen terms used by both the Australian Securities and Investments Commission (ASIC) and the Australian Taxation Office surrounding the definitions of legal and illegal phoenix activity.

ASIC defines illegal phoenix activity where a new company is created to continue the business of an existing company that has been deliberately liquidated to avoid paying outstanding debts, including taxes, creditors and employee entitlements. The effect is that the new company continues to trade while the creditors remain unpaid in the initial company.

ASIC further describes a legal phoenix as a responsibly managed company, whose director has complied with their legal obligations and acted in the best interests of the company and its creditors, may have transferred the assets for market value without any detriment to creditors.

The term 'Phoenix Activity' is presently not defined by the Act. The Act however has recently (18 February 2020) implemented amendments which deal with 'Creditor Defeating Dispositions'. These transactions are a creation of a right or other interest in a company's property in favour of another entity where:

- The consideration payable to the company for the disposition was the lesser of either market value or than the best price that would reasonably be obtainable for the property as at the time of the disposition.
- There is no agreement for such a disposition.
- The disposition of the property had the effect of preventing the property from becoming available in a wind up of the company or hindered or significantly delayed that property becoming available to the company's creditors in the wind up of a company.

If a company fails to keep adequate books and records in relation to the transaction, it is deemed that the disposition was not for market value.

There are both civil and criminal penalties associated with:

- Company officers that fail to prevent the company from making creditor defeating dispositions; and
- 'Other persons' that facilitate a company making a creditor defeating disposition.

Whilst defences are available for the above mentioned such as that:

- The person acted in good faith;
- The assets were purchased for market value.
- No notice of the company's insolvency.

These defences will not be available if the company entered external administration (e.g. Voluntary Administration, Liquidation) within 12 months of the transaction. It is also unnecessary to prove insolvency.

Risks to CPA Australia members in their role

As CPA Australia members would be aware, the role of the external accountant has evolved over the years. Accountants are now Trusted Advisors to their clients. However, with this responsibility also comes an increased risk to members depending on the advice given to clients. CPA Australia members may fit the definition under the Act as an 'Officer' or 'Other Person' pertaining to a creditor defeating disposition. Members need to maintain their

separation from clients' company operations to ensure that they are not exposed to the dangers of insolvent trading or creditor defeating dispositions which can give rise to both civil and criminal penalties. Members may risk exposing their Professional Indemnity Insurance in any such proceeding.

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=d20580707dbe4fb6b68d1d0615801c74>