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AUSTRALIAN RESTRUCTURING INSOLVENCY & TURNAROUND ASSOCIATION
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Directors' duties in uncertain financial times

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The impact of the last bushfire season and now COVID-19 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.

The Government has recently introduced temporary changes to the operation of insolvent trading laws as a result of the COVID-19 pandemic. However, this does not remove all risks from directors during the current period of financial distress.

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, in certain circumstances, 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 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 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. Ordinarily, 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. However, temporary relief from the trading while insolvent laws has recently been implemented (see below).

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.

Temporary relief for financially distressed businesses

On 23 March 2020, the Government passed laws to assist businesses with the impact of the current economic conditions, including temporary relief for directors from personal liability for trading while insolvent.

Directors have been given 6 months relief from their duty to prevent insolvent trading. This is to give companies confidence to trade through the current crisis, with the aim of returning to viability once it has passed.

The relief only relates to debts incurred in the ordinary course of business i.e. debts that are necessary to facilitate the continuation of the business during the 6-month period, including new borrowings. It does not remove the requirement to repay the debts. There are specific exclusions for dishonest and fraudulent activities.

It's important to understand that this is a temporary measure to relieve the pressure directors may feel to make quick decisions to enter a formal insolvency appointment in the current uncertain environment. It does not impact the underlying financial position or long-term viability of the business.

Despite the relief offered, directors need to determine if the business is suffering from temporary liquidity challenges or a shortage of working capital that can't be overcome, and consider their longer-term options.

It's a good idea to use this grace period to seek expert advice from an ARITA Professional Member[1]. This can be done remotely, and most members will not charge for an initial consultation.

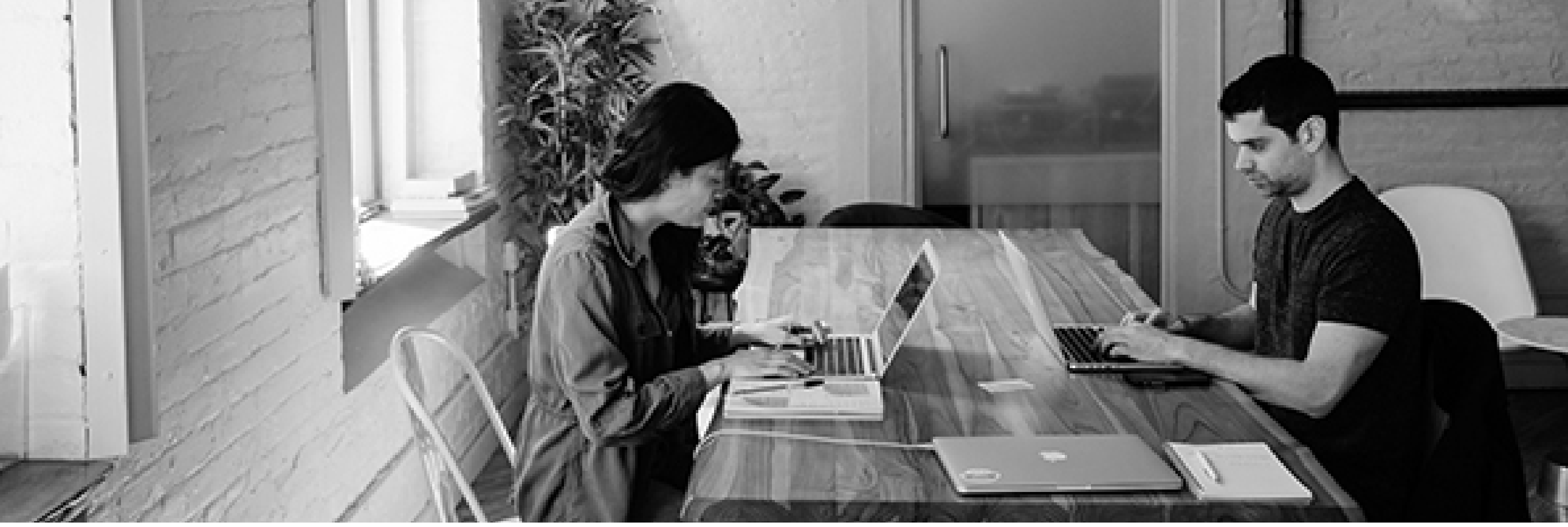
NB: Federal and State Governments continue to update relief and assistance measures and you should refer to Government websites for up-to-date information.

Safe harbour protection for restructuring

'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.

Safe harbour is separate from the protections offered by the Government's recently announced temporary relief. It can offer protection beyond the 6-month period covered by the temporary relief.

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.

   Compliance with tax reporting obligations is also necessary to ensure the company has access to any Government cash flow assistance which may be available[2], noting that the 'Cash flow assistance for business' payment is tied to the ongoing lodgement of activity statements.

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.

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

The law does not distinguish the treatment of financial distress between different sizes of companies or even if they are a not-for-profit.

In a practical sense, the main difference is the size of the response to distress. 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.

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.ato.gov.au/Individuals/Dealing-with-disasters/In-detail/Specific-disasters/COVID-19/

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