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Who Really Owns the Business? Or More Importantly, Who is Liable?

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By Schon G Condon RFD

Thankyou to all those who took the time to write in and pass on compliments for our last issue. It's always pleasing to receive these responses as they genuinely indicate that our efforts are appreciated and absorbed.

On a recent advisory matter we were introduced to we arrived at the business premises and after being given the general look around picked up one of the business cards off the counter which proudly announced *'"Blah, Blah, Blah" proudly owned and operated by Mr X and Mrs X'*. It was clear not just by the warm reception and passionate air to their approach, but also by the very wording of their card that they were very proud of their business.

We then sat down with the owners to discuss the parameters of our assignment when I queried that when I had arrived I had the understanding from their external accountant that the business was actually operated under a corporate structure. This they confirmed was correct and that in essence it was the husband's business in which the wife did have some degree of involvement.

The entire presentation, short of an invoice, showed no ready or distinctive denunciation of the fact that the business was in fact a corporate entity. It was acknowledged that the necessary stationery, invoices etc, did actually contain the relevant and legally required information. However, as we drew to their attention the potential legal door had been opened. In the event that a claim is made the potential claimant will seek to use any piece of evidence they can to make a claim against any and all possible parties, and in particular both husband and wife where they can because they can generally rely on the fact that one or both of them will be asset holders.

We often address the issue of structuring so as to ensure that the appropriate assets are exposed to appropriate threats, but all this planning can be suddenly brought undone by the silliest little mistake. Some will say that because there is an appropriate structure in place such claims can easily be defeated, and I'm not to say that that is not true, however it can be costly. The safest way to avoid a legal claim being successful against you is by not putting yourself in the position that someone can make the claim in the first place.

In pursuing these situations the claimant is seeking to place you in a position where there is a definitive cost involved to extricate yourself, thus at least a partial settlement can be achieved on the basis that "its going to cost you X to fight this so why not offer us Y and we'll drop the action against you." Had they not been in the position to start then you would not be in the position of thinking about settling.

All the efforts in the world to properly structure your affairs can be very quickly brought undone by one lapse of application or one failure to maintain procedural necessities. It is far better to plan for and around difficulties than have to bear the costs associated with confronting them. Early advice and action is just about always cheaper than the costs of dealing with things at the last minute.

Remember planning is one half, positive and consistent action is the other. We are always happy to assist in such cases as we desire to avert calamity rather than confront it, but where necessary we will!

I do trust you benefit from the remainder of the articles in this newsletter. Please, enjoy the read.

Inside this issue:

Insolvent Trading Action and the Defences Available

By Bruce Huynh

Pursuant to Section 588G of the Corporations Act 2001 ("the Act"), Director's have a duty to prevent insolvent trading by the Company. If the Director incurs a debt without reasonable prospect for being able to repay the debt, the Director can become liable to compensate the Company/Creditors for those further debts.

It is noted that an Insolvent Trading Action can only be taken once the Company has been placed into Liquidation, and the action can be commenced by the Liquidator, or a Creditor.

There are a number of factors which need to be established before any insolvent trading action is taken against the Director. These factors include:-

- Whether the debt was incurred at a time when the Company was insolvent or caused it to be insolvent
- The Director knew, or a reasonable person in his/her position should have suspected the Company was insolvent and failed to prevent the Company from incurring further debts,
- Who were the Directors at the time, and are there any Shadow Directors or other Consultants/Advisers who may also be liable to be held accountable.
- The commerciality of taking any action against the Director or persons involved.
- Time limits

The above points will be briefly described below:-

Timing

The Director will only be held to be liable for those debts which were incurred post the determination of insolvency. Debts incurred prior to this time which remain unpaid at the commencement of the Liquidation will not be awarded by the Court.

Section 588G(1A) of the Act sets out the transactions which could lead to claims in insolvent trading.

Director knew or should have suspected the Company was insolvent

The Liquidator will need to establish this before any further action can be pursued. The Liquidator is required to examine whether the Director had taken reasonable steps to prevent the Company from incurring debt which could not be paid when they fell due.

Further to the above, the Court will consider whether a reasonable person in the Directors position should have suspected the insolvency of the Company.

Directors, Shadow Directors and Consultant/Adviser

If it can be proven that a person has acted as a Shadow Director, this person can be held to be just as accountable as a party who is listed with ASIC as being the Director.

Commerciality of taking action against the Director or persons involved

Once it is established that the Director or relevant persons involved did engage in insolvent trading action, the Liquidator will have to establish whether it is commercial to pursue.

The Liquidator will need to examine whether the Director and other parties have sufficient resources to meet any amounts awarded against them by the Court.

Timing

Pursuant to Section 588M of the Act, the Liquidator has a time limit of six (6) years from the date of Liquidation to take action in relation to insolvent trading.

As we know every case has two sides, and in this case Section 588H of the Act makes available certain defences for Directors. Some of the defences available to a Director in defending an insolvent trading action are as follows:-

- The Director had reasonable grounds to believe or suspect that the Company was solvent at the time
- The director had reasonable grounds to expect the company would remain solvent if it incurred the debt and other debts at the time the debt or debts were incurred
- From the information available to the Director, the Director or a reasonable person would have concluded the Company was solvent at the time
- The Director took positive action to stop the Company from incurring further debt
- If the Director can prove he/she had reasonable grounds not to partake in the management of the Company (e.g. illness, death in the family, mentally unstable or sound)
- The Director can reply on the advice of professionals who have advised them. However the Director must establish he/she had reasonable grounds to believe that:-
  - (a) the person who advise them was competent and reliable
  - (b) the person knew and was fulfilling their role and responsibility
  - (c) with the information provided they believe the company was solvent at the time and would remain solvent if the debt was incurred.
- The Director took reasonable steps to prevent the company from incurring further debt. To establish this, the Director needs to prove:-
  - (a) the Director took action to consider or appoint an administrator to the company;
  - (b) provide a date when the appointment took place;
  - (c) the resolution to appoint an administrator; and
  - (d) any other information which would establish that the Director was taking steps to prevent further debt.

The onus is on the Director to prove that they had reasonable grounds to believe the Company was solvent and they did in fact believe the

Company was solvent. To prove that the Director did believe the Company was solvent at the time, evidence needs to be produced to show the Director made enquires into the matter and advice was sought from an adviser or consultant.

The reliance on information produced by a professional adviser or consultant is a major stepping stone in establishing that the Director did in fact believe in the solvency of the company before incurring debt, which led to insolvency.

In seeking to commence an insolvent trading action, a Liquidator will need to assess whether he/she can prove to the Court that the company was insolvent, the Directors allowed the company to continue to trade and that further debts were incurred which ultimately were not repaid. As taking such an action can prove to be a costly exercise, the Liquidator will also need to consider if the Director has funds or assets to warrant taking the action in the first instance.

If there are no resources available to the Director to satisfy any judgement for insolvent trading, then there is little point in taking an insolvent trading action, if no recoveries will be made from same.

Common Indicators of Potential Insolvency

By Padmini Saheb

The Consultation Paper 124 issued by ASIC in November 2009 outlines proposals to help Directors understand and comply with their duty to prevent Insolvent Trading. Section C of the Consultation Paper provides guidance on how ASIC will assess whether a Director has breached his/her duty to prevent Insolvent Trading. This Section also demonstrates the importance of a Company maintaining proper Books and Records, and the need for the Directors to actively monitor the solvency of the Company. The common indicators of potential insolvency that ASIC will look for in assessing whether insolvency existed at a particular time include the following:-

- the company has a history of continuing trading losses;
- the company is experiencing cash-flow difficulties;
- the company is experiencing difficulties selling its stock, 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 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 , Payroll Tax, Goods and Services Tax);
- cheques are being returned dishonoured;
- legal action is threatened or 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;
- the company's financier has appointed an investigative accountant to advise the financier about its funding exposure to the company;
- 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;

ASIC suggests, and so do we, that in the event that a company is displaying the above indicators that professional advice should be sought at the earliest instance. At Condon Associates we have the necessary skill set to assess this matter for you.

Schon with Louise Markus at the Macquarie Business Network.

Annulment of a Bankruptcy

By Maggie Lau

In the administration of a small number of Bankruptcies, the Trustee's investigations may reveal realisable assets which, if realised, would enable a full payment to Creditors. Alternatively, the Bankrupt may receive monies from a third party. Whatever the cause is, if the Trustee is satisfied that all the Bankrupt's debts have been paid in full, the Bankruptcy is annulled by force of Section 153A of the Bankruptcy Act.

In such circumstances, not only do all Creditors receive 100 cents in the dollar on their admitted claims, Section 153A(1a) says that Creditors whose debts normally bear interest are entitled to interest up to and including the date when the cheque is drawn and sent out to that Creditor. Some Creditors' receive a larger amount than the claim they have proved due to interest being accrued after the commencement of the Bankruptcy.

For Creditors whose debts have interest components and have obtained Judgement from the Court, their debts accrue simple interest at the rate which applies to the jurisdiction of the Court. For example, the rate that applies to Judgements obtained from the NSW Local Courts from 6 March 2009 is 9%. For Creditors whose debts have interest components but they do not have Judgement, the debt bears interest at its usual rate as if the Bankruptcy never occurred. For example, if it is a debt on a credit card account, the rate that applies would be the usual commercial rate that applied before the Bankruptcy.

A Bankruptcy is not annulled unless all Creditors debts have been paid, including the interest to Creditors who normally earn interest on their debt, the costs of the Trustee for administering the Bankruptcy, and any statutory charges owed to the Insolvency and Trustee Service Australia.

An interesting scenario can arise when dealing with the ATO and seeking to effect the annulment of a Bankruptcy.

As discussed above, the Bankrupt's debts must be paid in full for an Annulment pursuant to Section 153A to occur. In a recent publication of the Personal Insolvency Regulator, Mr Tomiczek of ITSA provided some insight in dealing with the claim of the ATO in seeking to effect an annulment. According to the Bankruptcy Act, the "Bankrupt's debt" means all debts that have been proved in the Bankruptcy. The onus is on the Creditor to prove their debt in the estate. The onus is on the ATO to prove their debt in a Bankruptcy.

An obligation for Income Tax is imposed on a person who derives assessable income within the meaning of the Income Tax Assessment Act 1936 at the time such income is derived. However, due to the nature of self-assessment in the Australian taxation system, the ATO would not know the amount owed by the taxpayers until they file their Income Tax Returns or Business Activity Statements ("BAS's").

In other words, the ATO does not crystallise the taxpayer's liability for Income Tax until the Assessment is made, and it will not lodge a claim in the Bankruptcy until such time. In fact, it is not uncommon that the ATO advises the Trustee that it has no claim as the Bankrupt has not lodged his or her Income Tax Returns or BAS's.

As Trustees should not unnecessarily delay the administration of an Estate, it is not necessary or appropriate for Trustees to proactively pursue the Bankrupt to ensure that he or she brings their tax affairs up to date. If the Bankrupt does not bring his or her affairs up to date, the Trustee should proceed to continue with effecting the annulment of the Estate as soon as practicable.

In the event that the Trustee distributes the funds without regard to any claim that the ATO may have as the ATO did not lodge a proof of debt, and the Bankrupt brings their tax affairs up to date post the annulment of the Bankruptcy, and it is subsequently revealed that the ATO in fact has a claim against the Estate as at the date of Bankruptcy, the claim of the ATO, unlike other claims in the Bankruptcy, has not been paid despite the annulment.

Provided that the ATO did not previously prove in the Bankruptcy, the debt to the ATO has not been released by virtue of the Bankruptcy, nor the annulment there of. Accordingly, the ATO will be entitled to pursue the debt post the annulment of the Bankruptcy.

Farewell

With a degree of sadness we have farewelled Maureen Scott into new opportunities, most likely with a consulting venture of her own.

Maureen was the foundation person in our Business Development area and we are extremely appreciative of the efforts that Maureen put in over the time she has been with us.

We wish Maureen well for the future and trust that we will be able to refill the void that exists.

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