



ASIC

Australian Securities & Investments Commission

REPORT 210

Response to submissions on CP 124 Duty to prevent insolvent trading: Guide for directors

July 2010

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 124 *Duty to prevent insolvent trading: Guide for directors* (CP 124) and details our responses.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

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

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 217 *Duty to prevent insolvent trading: Guide for directors* (RG 217).

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A Overview/Consultation process

- 1 The *Corporations Act 2001* (Corporations Act) imposes on directors a positive duty to prevent insolvent trading: see s588G.
- 2 In Consultation Paper 124 *Duty to prevent insolvent trading: Guide for directors* (CP 124), we consulted on a draft regulatory guide for directors to help them understand and comply with their duty to prevent insolvent trading.
- 3 CP 124 set out:
 - (a) the relevant legal background to the director's duty to prevent insolvent trading;
 - (b) the following four principles, which we consider directors should follow when endeavouring to meet their obligation to prevent insolvent trading:
 - (i) directors must remain informed about the company's financial affairs, and regularly assess the company's solvency;
 - (ii) directors should investigate financial difficulties immediately they identify concerns about the company's financial viability;
 - (iii) directors should seek appropriate professional advice to help address the company's financial difficulties; and
 - (iv) directors should consider and act appropriately on the advice received, in a timely manner; and
 - (c) some of the factors we will take into account in assessing whether directors have contravened the Corporations Act by allowing a company to trade while insolvent, in light of the key principles set out above.
- 4 This report highlights the key issues that arose out of the submissions we received on CP 124 and our responses to those issues.
- 5 This report is not meant to be a comprehensive summary of all responses received. It is not meant to be a detailed report on every question from CP 124. We have limited this report to the key issues.

Responses to consultation

- 6 We received 19 responses to CP 124 from a variety of sources, including relevant professional industry bodies, lawyers, academics and insolvency practitioners. The list of non-confidential respondents is set out in the Appendix and copies of their submissions are on the ASIC website at www.asic.gov.au/cp under CP 124. We are grateful to respondents for taking the time to send us their comments.

- 7 Respondents were generally supportive of us providing guidance to directors to help them understand and comply with their duty to prevent insolvent trading and generally agreed with the nature and scope of our proposed guidance. Many submissions offered useful suggestions about how our proposed guidance could be improved.
- 8 The main issues raised by the respondents related to:
- (a) making it clear that the courts ultimately decide whether a director has breached their duty, and that parties other than ASIC (i.e. liquidators and creditors) may bring claims against directors for insolvent trading (see Section B);
 - (b) stating that the law on insolvent trading involves complex legal and accounting issues, and that our regulatory guide is intended to provide general guidance only (see Section C);
 - (c) expanding the scope of our proposed guidance to include more detailed information about the law relating to insolvent trading, the consequences of a director breaching their duty to prevent insolvent trading, and factors to consider when assessing solvency (see Section D);
 - (d) distinguishing between the role of directors in large companies and directors of small-to-medium companies and how those roles may affect the key principles outlined in our guidance, including reliance on advice from the company's employees and from external professional advisers (see Section E);
 - (e) providing further guidance on the type of external advice that should be obtained (see Section E); and
 - (f) a perceived risk that the proposed guidance on our approach to insolvent trading may be used by a director to establish a defence to a claim for insolvent trading, and some other more general comments about our proposed guidance (see Section F).
- 9 We have refined our draft regulatory guide in CP 124 to take into account the feedback in the submissions we received. Our final guidance is in *Regulatory Guide 217 Duty to prevent insolvent trading: Guide for directors* (RG 217).

B Role of the courts, liquidators and creditors

Key points

A number of respondents suggested that we clarify:

- the role of liquidators and creditors in bringing proceedings against a director to recover compensation for loss resulting from insolvent trading; and
- it is the courts that ultimately determine whether a director has breached their duty to prevent the company from incurring debts when insolvent.

Role of liquidators and creditors

- 10 CP 124 stated that nothing in our proposed guidance affected the legal right of a liquidator or creditor of a company (with the liquidator's or court's consent) to bring proceedings against a director to recover compensation for loss resulting from insolvent trading. A number of respondents commented that our guidance should place greater emphasis on the fact that ASIC is only one party that may bring proceedings against a director for failing to prevent the company from incurring debts when insolvent.

Clarification of the court's role

- 11 A number of respondents commented that our guidance should clarify that the court ultimately determines whether a director has breached their duty and, in making its decision, the court may have regard to factors other than those identified in the draft regulatory guide.
- 12 One submission commented that a decision by ASIC not to commence proceedings against a director could be made for a number of reasons and did not necessarily mean that a director has not breached their duty to prevent insolvent trading.
- 13 One submission stated that we could 'usefully explain that the courts may expect that directors be aware of and apply the principles stated in the regulatory guide in any action brought by liquidators or ASIC', and another stated that we should inform directors that adherence to the principles is likely to be taken into consideration by the courts.

ASIC's response

Sections A and C of RG 217 clarify that:

- a liquidator or creditor of a company (with the consent of the company's liquidator or the court) may bring a claim against a director to recover compensation for loss resulting from insolvent trading;
- a liquidator or creditor may consider factors other than those which we will take into account when determining whether a director has breached their duty to prevent insolvent trading;
- a liquidator or creditor may bring a claim whether or not we have conducted an investigation or brought proceedings against the director for insolvent trading; and
- a court may have regard to some or all of the key principles in Section B of RG 217 when determining whether a director has breached their duty to prevent insolvent trading.

We have not included the suggested comments regarding whether the courts may expect that directors be aware of and apply the principles stated in RG 217. While RG 217 reflects the current law, we do not think that it is appropriate in a regulatory guide to speculate on what the courts may have regard to in assessing liability for insolvent trading where there is no established legal precedent.

C Nature of the guidance provided

Key points

A number of respondents suggested that the draft regulatory guide be amended to clearly state that the law on insolvent trading involves complex legal and accounting issues, and is intended to provide general guidance only.

General guidance only

- 14 A number of respondents commented that we should clearly state that the guidance provided is of a general nature only, and that directors must consider their specific circumstances at all times.

The need for professional advice

- 15 One submission commented that we should state that, for example, it will not always be necessary for directors to seek external advice, and that whether or not it is necessary will depend upon the skills and experience of the board members and company officers. Another submission commented that we should state that the law around insolvent trading involves complex legal and accounting issues, and that directors should seek professional advice (including legal and/or accounting advice) at the earliest signs of financial difficulty.

ASIC's response

In Section A of RG 217 (in the 'Key points' part of the 'Overview' section), we state that the law on insolvent trading involves complex legal and accounting issues, and that directors should ensure that they understand their legal obligations and, if necessary, obtain appropriate advice.

In the 'Scope of this guide' part of the 'Overview' section, we state that RG 217 is intended to provide general guidance to directors and that the law on insolvent trading is complex and depends upon the facts in each case, and that directors should ensure that they understand their legal obligations and, if necessary, obtain appropriate advice. We have added a similar statement under the heading 'When is a company insolvent?'.

D Expanding the scope of our guidance

Key points

Generally, respondents were satisfied that the nature and scope of the director's duty to prevent insolvent trading was adequately summarised in the draft regulatory guide.

A number of respondents suggested that we:

- clarify the consequences of non-compliance with s588G;
- clarify the definition of insolvency and provide further explanation about what a debt is, how debts are incurred and when debts are due for payment; and
- expand the relevant legal background to include various further matters.

Consequences of breach of duty

- 16 A number of respondents suggested that we set out in more detail the consequences of a director breaching their duty to prevent insolvent trading, provide a dollar value for the civil and criminal penalties for contravention, and clarify what defences are available to directors to a civil claim for insolvent trading. It was suggested that this include inserting a statement that the 'business judgment rule' is not a defence to a breach of s588G, and stating that courts have used the discretionary power in s1317S and 1318 of the Corporations Act to relieve a director from liability for insolvent trading in certain circumstances.

ASIC's response

Section A of RG 217:

- sets out in more detail the consequences of a director breaching their duty to prevent insolvent trading, including stating the monetary amount of civil and criminal penalties which may apply; and
- clarifies the defences available to directors, including noting that the business judgment rule does not apply to a breach of s588G, and noting the court's power to relieve a director from liability for breaching their duty (either wholly or in part) under s1317S and 1318 of the Corporations Act.

Defining insolvency and debt

- 17 One respondent suggested that the law on insolvent trading could be expanded to refer to the application of insolvent trading laws to holding companies and directors of trustee companies.
- 18 Differing views were expressed about our guidance regarding when a company is insolvent. Although some respondents indicated that the guidance was adequate (one stating that providing more detailed guidance may be misleading), a number of respondents suggested that we:
- (a) provide a specific reference to the definition of ‘insolvency’ in s95A of the Corporations Act, and provide guidance about what a debt is, when it is incurred and when it becomes due for payment;
 - (b) clarify what the ‘cash flow’ test is and make a specific reference to the ‘balance sheet’ test of insolvency;
 - (c) provide guidance about the extent to which further funding (debt or equity) can be taken into account, what form of funding is appropriate, how directors should deal with creditors and how far into the future a director must look when assessing solvency;
 - (d) explain the difference between ‘solvency’ and ‘going concern’;
 - (e) refer to the statutory obligation of a company to keep financial records and the rebuttable presumption of insolvency for failure to comply with this obligation;
 - (f) provide further guidance on what actions a director should take if it is determined that the company is insolvent; and
 - (g) include an explanation of s588FB (uncommercial transactions) and s588FE (voidable transactions) to give guidance as to what matters a director should consider before entering into transactions that are at risk of constituting uncommercial or voidable transactions.
- 19 It was also suggested that:
- (a) Table 2 in the draft regulatory guide be amended to make it clear that the factors listed may be an indicia of insolvency, but will not necessarily lead to the conclusion that the company is insolvent (two submissions commented upon the indicia listed); and
 - (b) ‘books and records’ be described in a consistent manner.
- 20 A number of respondents noted that assessing solvency involves a consideration of complex legal and accounting issues and it was suggested that the guidance could be enhanced by including more examples.

ASIC's response

Our final guidance in RG 217:

- refers to the definition of insolvency in s95A of the Corporations Act;
- clarifies the 'cash flow' and 'balance sheet' tests for insolvency;
- refers to the presumption of insolvency where a company does not maintain proper financial records, and defines 'financial records' as a key term (rather than using 'books and records'); and
- clarifies in the appendix that where one or more of the potential indicators of insolvency in Table 2 are identified, a director should investigate the financial position of the company and consider obtaining appropriate advice about the financial position of the company and the courses of action available to the director.

It is beyond the scope of RG 217 to provide further detail on what a debt is, when it is incurred, when it becomes due for payment, and the extent to which further funding can be taken into account, what form of funding is appropriate and how far into the future a director must look when assessing solvency.

We have also determined that there are sufficient examples of when a company may be insolvent in RG 217.

In coming to these conclusions, we have been mindful of the fact that each of these issues is highly fact-specific, so that further guidance is unlikely to be helpful for directors in considering how they should act if their company is in financial difficulty.

Similarly, we have considered whether to provide further guidance about what steps a director should take if the company is insolvent, but have determined that it is not practicable to do so given that this will also depend upon the company's particular factual circumstances. These are issues about which directors should obtain advice and should then carefully consider the advice and, if appropriate, act on the advice.

We have also determined that an explanation of uncommercial transactions and voidable transactions, and the application of insolvent trading laws to holding companies and directors of trustee companies, is beyond the scope of RG 217. We also consider that RG 217 gives sufficient guidance on what directors should do to prevent the company from incurring debts if it is insolvent.

E Role of directors and obtaining advice

Key points

A number of respondents commented that the involvement of directors in the day-to-day activities of the company will be different for directors of small-to-medium enterprises and large publicly listed companies, and that the draft regulatory guide did not sufficiently acknowledge this distinction in setting out the four key principles that we consider directors should take into account to comply with their duty to prevent insolvent trading.

Role of directors

- 21 A number of respondents commented that the role and activities undertaken by a director may differ depending on the size and complexity of the company's business and affairs. In particular, the level of direct involvement in the day-to-day activities of the company and the steps taken by a director to keep themselves informed about the financial position of the company and its affairs will be different for directors of small-to-medium enterprises and large publicly listed companies.
- 22 Some respondents also noted that, depending on the skills and experience of management and the directors, it may not always be necessary to engage external assistance to obtain appropriate advice.

ASIC's response

Many submissions contained very useful comments about how we may improve our guidance on this issue. Because this issue affects each of the four key principles outlined in our guidance, rather than amending each section we have clarified the scope of RG 217 to note that:

- the steps a director needs to take to comply with their duty to prevent insolvent trading will depend on all of the circumstances of the company, including the size and complexity of the business, and the skills and experience of the company's management and staff;
- to the extent that they are not directly involved in overseeing the company's financial position and rely on advice from management and external parties, the director must ensure that:
 - the people they rely on have the necessary knowledge, skill and experience to undertake their functions;
 - systems are in place and operating effectively to provide sufficient information to enable the director to keep themselves informed about the company's affairs and that

enable the director to assess the appropriateness of the advice they receive; and

—they make appropriate inquiries to remain informed about the financial position and affairs of the company.

Minor changes were made in other parts of our guidance where it was considered necessary to reflect this issue.

Obtaining advice

- 23 Some submissions suggested that further guidance should be provided regarding when a director should seek advice and who to seek it from, particularly in relation to the required skills and experience of the professional adviser engaged.

ASIC's response

When a director should seek advice, what type of advice should be sought, and what skills and experience the professional adviser should hold, depend upon the facts and circumstances of each case. It is therefore not possible or appropriate for RG 217 to be prescriptive about these matters. These are matters that directors must determine based upon the particular circumstances of their company and the nature of the advice that is required.

F General comments

Key points

Respondents were generally very supportive of the draft regulatory guide. Other more general comments included:

- some respondents were concerned that the guidance would provide a 'checklist' for directors to avoid an insolvent trading claim;
- one respondent commented that if the intent of the regulatory guide is to provide 'guidance', the use of the word 'must' should be changed; and
- one respondent suggested that the obligations of experts be clarified.

Risk of a 'checklist' to avoid liability

- 24 Some respondents expressed concern that the guidance provided may be used by some directors as a 'step-by-step' guide to establish a defence to a claim for insolvent trading.

ASIC's response

We are of the view that RG 217 is not so prescriptive as to be capable of being used in the manner suggested. The majority of submissions stated that the draft regulatory guide was helpful in assisting directors to understand and comply with their duty to prevent insolvent trading. Our guidance provides information about how ASIC will assess the existing law on insolvent trading and makes it clear that the courts ultimately determine whether a director has breached their duty.

Use of the word 'must'

- 25 One respondent commented that the use of the word 'must' to state what a director is required to do is not guidance and should be changed.

ASIC's response

We have used the word 'must' when we are reflecting legal requirements. When we are providing guidance to assist a director to understand and comply with their duty to prevent insolvent trading, we have used the term 'should'.

Obligations of experts

- 26 One respondent suggested that our guidance clarify what obligations experts have to companies and directors when providing advice, and what recourse liquidators have against professional advisers who fail to properly advise directors.

ASIC's response

We consider that it is beyond the scope of RG 217 to canvass the law on negligent advice.

Appendix: List of non-confidential respondents

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- Graeme Boorer
 - Stephen Maitland
 - Mr Jeffrey Fitzpatrick, Dr Vivienne Brand and Dr Christopher Symes
 - Australian Institute of Company Directors
 - Chartered Secretaries Australia
 - The Institute of Chartered Accountants in Australia
 - Australasian Compliance Institute
 - Housing Industry Association Ltd
 - Australian Bankers' Association
 - Insolvency Practitioners Association of Australia
 - PricewaterhouseCoopers
 - Alicia Hill
 - The Westpac Group
 - Shine Wong
 - Law Council of Australia
 - National Institute of Accountants
 - Group of 100 Inc
 - Australian Institute of Credit Management
 - Peter Keenan
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