

Considerations for Directors When a Company Is in Financial Difficulty



This quick guide summarises the duties that directors of companies incorporated in Australia are subject to, and how those duties change when a company is insolvent or at risk of being insolvent.

It also gives an overview of the personal risk to directors when a company is in financial difficulty.

This note is intended as an overview and should not be relied on as legal advice. Should you require legal advice in relation to your specific circumstances, please contact the Restructuring & Insolvency team member whose contact details are at the end of this note.



Directors' Duties When Solvent

Directors are obliged to discharge a number of duties and obligations under the Corporations Act, the common law and the company's constitution: In particular, directors are duty bound to:

- Act in good faith and in the best interests of the company
- Exercise their powers for proper purposes
- Act with reasonable care and diligence
- Avoid conflicts of interest
- Use company information and their position for proper purposes and not to gain a personal advantage, any advantage for someone else or cause detriment to the company

Financial Distress

Directors' Duties When Insolvent, or at Risk of Being Insolvent

- Generally, the statutory, common law and constitution-based duties of directors remain the same during solvent and potentially insolvent periods, but directors are obliged to pay specific regard to, and safeguard against, various risks.
- In particular, directors have a positive duty to prevent insolvent trading. Directors cannot continue a company's trade-in-business when there are reasonable grounds for suspecting that the company is insolvent or would become insolvent as a result of ongoing trading and incurring of debts.
- During times of financial distress and potential insolvency, directors must consider the interests of company creditors and, in particular, their priority and secured creditors whose interests in, and recourse to, the company may be significantly impacted by decisions taken by directors to continue trading, embark upon a restructuring or appoint external administrators.
- Directors must also ensure that all statutory and regulatory reporting obligations are being met and accurate, and timely records are being kept in respect of any restructuring under safe harbour protections.

It is important for directors to understand their directors' duties, as well as how their actions and the decisions the board makes when the company is in financial distress, could expose them to personal liability, criminal sanction and risk.

Below is an overview of the potential claims and potential exposure for directors if the company is insolvent or at risk of insolvency.

Insolvent Trading

Directors may be liable for failing to prevent a company from trading while insolvent. Insolvent trading primarily concerns the incurring of debts in circumstances where there are reasonable grounds for suspecting that a company is insolvent or would become insolvent by incurring a debt. Importantly, a debt may be incurred by various actions, including declaring or paying a dividend or making a capital reduction (and not simply by incurring a liability in the course of trading).

Criminal Liability

Directors may be liable to criminal prosecution if they are found to have:

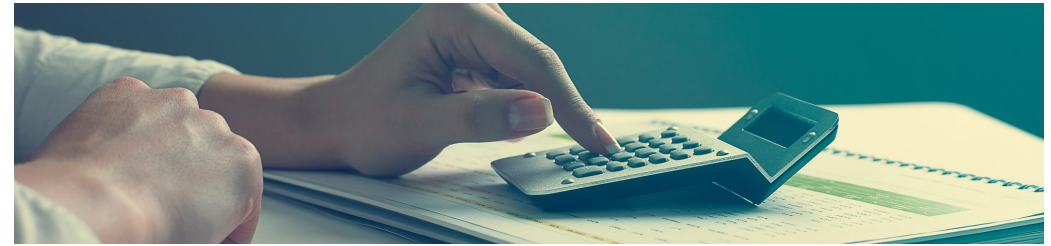
- Intentionally, recklessly or dishonestly contravened their duties
- Dishonestly failed to comply with financial reporting or auditing obligations
- Knowingly or recklessly provided false or defective disclosures to the market

Directors may be liable to criminal prosecution by the Australian Securities and Investment Commission, other regulators and the director of public prosecutions under the Corporations Act and related legislation. Penalties range from disqualification orders to substantial pecuniary penalties and significant terms of imprisonment.

Civil Liability

If directors breach any of their duties, they may also find themselves liable to civil liability actions brought by:

- The companies they serve
- Shareholder actions under statutory derivative action provisions of the Corporations Act
- Third parties for misleading and deceptive, anticompetitive or wrongful conduct
- Creditors and external administrators



Voiding Directors and Officers Insurance

Directors may be insured against liabilities they may incur as a director under a directors and officers (D&O) policy. However, if any wrongful conduct is established against a director, subject to the nature of their conduct, D&O insurers may seek to avoid cover. Although D&O policies all have their own policy terms, conduct involving wilful or dishonest breaches of duty will risk policies being rendered void.

Tax Liability

If a company commits a tax offence, the directors involved in the management of the company may be deemed to have committed the same offence. A director may be able to defend a claim on the basis that he or she did not aid, abet, counsel or procure, and was not knowingly concerned in, the commission of the offence. In addition, directors may become personally liable for unpaid pay-as-you-go, superannuation, and goods and service tax not remitted to the Commission of Taxation.



Practical Tips to Mitigate Liability

- Keep an accurate and up-to-date record of a company's changing statutory, regulatory, common law and constitutional obligations, including, but not limited to, financial auditing, reporting, taxation, occupational health and workplace safety, environmental, anti-money laundering and counterterrorism financing, and general trading obligations, and its discharge of the same.
- Keep an accurate and robust register of directors' interests, particularly in relation to sectors in which the company trades and where its directors have other direct or indirect commercial or financial interests. Manage potential conflicts proactively and on an ongoing basis.
- Maintain a large enough board to ensure that conflicts of interests and the trading interests of the company can be appropriately managed.
- Accurately account for and document the basis for key strategic, trading, financial and operational decisions.
- Engage appropriate external advisers, including potential safe harbour advisers, at an early stage of financial distress to ensure the prospects of a successful turnaround are maintained.
- Engage all key stakeholders, particularly key priority and secured creditors, in the face of financial distress to ensure a degree of support and financial flexibility.

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See our [Summary of European Government Financial Support Guide](#) to find out what financial support European governments are offering to help support businesses.

For further information and to receive updates relating to the legal impact of COVID-19 please sign up to our [COVID-19 Resource Hub](#).

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