Are You Concerned About a Company's Solvency?

It is a company's ability, utilising cash resources they have or can obtain to meet debts as and when they fall due, that indicates a company's solvency.

Solvency is not to be determined by the application of a rigid rule, but rather is a factual question to be determined in the light of all the circumstances.

Definition of solvency

The Corporations Act 2001 provides that a company is insolvent if it cannot pay its debts as and when they become due and payable.

When is solvency assessed

Solvency must be considered at the time the relevant debt is incurred rather than when the debt becomes due for payment.

The immediate future must be considered when examining the company's ability to pay its debts. Exactly how far into the future this assessment extends is reliant on individual circumstances and to the extent future liabilities are known. Therefore, reliable and well considered cash flow forecasts are critical to this assessment.

What are the responsibilities of directors to ensure a company remains solvent?

Directors have a duty to prevent insolvent trading, that is, incurring debts whilst they have reasonable grounds to suspect a company is insolvent.

Directors must take reasonable steps to prevent debt from being incurred:

- A debt will typically be incurred when a company enters into a contract, such as the purchase of goods. A debt can be incurred by a company even if there is no formal contract in place, where work is carried out on the basis that it will generate a right to be paid.
- A debt includes a liability even if it is contingent. This is on the basis that the liability, in the event the contingency arises, is unavoidable and quantifiable. Typical examples include a guarantee or a contract under which an amount is required to be paid upon the satisfaction of a condition or the occurrence of some event. In each case, the debt is incurred when the contract is entered into, not when the condition is satisfied or a demand is made under the guarantee. For example, break costs under a lease agreement or termination entitlements under a contract of employment.

Directors must also have reasonable grounds to expect the Company is solvent:

- Directors may rely on a reasonably held belief that the company can pay its debts as and when they fall due.
- The definition of insolvency is different from which formerly applied and it is no longer described as an inability to pay "from our moneys". Therefore, directors may reply on a reasonably held belief that if external financial support is available they remain solvent.
- If a company has a reasonable expectation that it will be able to generate sufficient cash flow to repay its creditors, refinance its debt facilities, raise further debt against assets or gain access to funding from shareholders, it will satisfy reasonable grounds test.

Director liability

If a director is found by a Court to have breached their duty to prevent insolvent trading, civil liabilities will apply to the director personally. This removes the protection of limited liability and holds the director liable for the debts of the company incurred whilst insolvent.

The loss or damage in question will normally be the quantum of the relevant unpaid debts incurred whilst insolvent, less what creditors were likely to receive in the liquidation of the company.

Tips for advisors, CEOs and CFOs if they suspect a solvency concern

- Place yourself in the directors shoes
- Seek independent external legal and financial advice and quickly
- Manage stakeholder communications....communication is key
- Document steps taken
- Ensure all statutory lodgments have been completed
- Ensure financials are up to date together with cash flow forecasts
- Enter into negotiations with creditors early and obtain forbearances in writing
- If assets need to be realised or businesses need to be sold, ensure a proper process is undertaken which will optimise chances of success and be realistic in price expectations

What if you have a concern about the solvency of one of your creditors?

- Limit credit or place creditor on cash on delivery
- Do your own monitoring and investigations
- Collect your stock and/or equipment
- Be vigilant in receivable collection
- Ensure any security interests are properly registered on the PPSA register and that terms of trade properly reflect the granting of a security interest and that this is has been executed and acknowledged by the creditor

If you have a PMSI security interest, that is, retention of title or asset financing arrangement, the security interest needs to registered on the PPSA Register prior to the delivery of goods.

How can FTI Consulting assist?

FTI Consulting can work alongside companies' advisors and management to:

- Advise directors, secured and unsecured creditors of options;
- Review businesses and determine strategies for recovery;
- Drive restructure initiatives, turnarounds and workouts;
- Manage stakeholder communications;
- Assist in business transformation, operational improvement or interim management solutions; and
- Protect and preserve assets through "formal" insolvency

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