

# Guidance for Directors of Arts and Cultural Companies

## PROTECTIONS FROM INSOLVENT TRADING

This factsheet has been commissioned by Arts Queensland and prepared by Board Matters to provide guidance to directors of arts and cultural companies about insolvency and the safe harbour provisions of the Corporations Act 2001 (Cth) (Corporations Act) including the COVID-19 related temporary measures.

### Corporations Act and insolvency

Directors are subject to a range of duties, one of which is the duty to prevent insolvent trading<sup>1</sup>.

Under normal circumstances, the duty to prevent insolvent trading is triggered:

- if a company is insolvent when a debt is incurred; or
- a company will become insolvent if a proposed debt is incurred; or
- a company will become insolvent by incurring debts including the proposed debt.

Directors breach this duty if, at the time a debt is incurred, there are reasonable grounds for suspecting a company is insolvent or is likely to become insolvent. A company is insolvent if it cannot pay its debts as and when they fall due. There is also a statutory presumption of insolvency if a company fails to keep proper financial records<sup>2</sup>.

Directors risk various penalties for insolvent trading including civil penalties, compensation proceedings (including proceedings against directors personally to recover company debts), criminal charges and disqualification from managing a corporation for a period of time.

In addition to the above, if a company is registered as a charity with the Australian Charities and Not-for-profits Commission (ACNC) it must not be allowed to trade whilst insolvent.<sup>3</sup>

### Signs of financial distress

Common signs of financial distress include:

- continuous losses;
- the company's liquidity ratio is less than 1:1 (which means for every dollar the company owes, it does not have a dollar to pay it);
- tax liabilities cannot be paid;
- alternative funding or finance options are withdrawn or cannot be accessed;
- payments to creditors extend well beyond normal trading terms; or
- the company is forced to negotiate special repayment arrangements with creditors.

<sup>1</sup> Section 588G of the Corporations Act

<sup>2</sup> Section 286 of the Corporations Act

<sup>3</sup> ACNC Governance Standard 5

## Steps directors should take when faced with company's financial distress

Directors who suspect a company is under financial distress should take the following steps:

- **Obtain accounting and legal advice:** Getting accounting and legal advice early increases the chances of a company pulling through a bad financial patch.
- **Conduct an insolvency review:** Insolvency practitioners or business turnaround specialists can review a company's financial position and provide more detailed options which could include refinancing, equity funding, restructuring debt, restructuring the company, or appointing an administrator.

## Defences against insolvent trading

In recognition of the fact that directors operate in an environment of uncertain commercial decision-making, several defences exist against allegations of insolvent trading. For instance the director may have a valid defence in any of the following situations:

- they had reasonable grounds to suspect the company would remain solvent if the company incurred a particular debt;
- they believed the company to be solvent based on information provided by a "competent and reliable person";
- they were not participating in the management of the company at the relevant time incurred due to illness or some other good reason; or
- all reasonable steps were taken to prevent the company from incurring the particular debt that rendered the company insolvent.

## How will the safe harbour provisions now work in a COVID-19 world?

The recent 2020 amendments to the safe harbour provisions provide a safety net to give directors some confidence that a company can continue to trade, pay creditors and retain staff during the COVID-19 crisis without the added pressure of having to place a company into administration if there is a chance the company is insolvent.

For six-months from 25 March 2020 (unless otherwise extended by the Federal Government), directors may not be held personally liable for insolvent trading<sup>4</sup> provided debt is incurred:

- during the ordinary course of the company's business; and
- during the six-month period from 25 March 2020, or a longer period prescribed by regulation; and
- before an administrator or liquidator is appointed during the temporary safe harbour application period.

The reforms do not specify what debt will be considered as being incurred in the "ordinary course of the company's business" because each situation will be different. However, it would appear reasonable to consider that a debt is incurred in the ordinary course of a company's business if it is necessary to ensure the company's continuation during the six-month period from 25 March 2020. For example, it could include debt incurred to pay employees during the COVID-19 crisis, or a loan to enable the company to move its business operations online.

Care should be taken to assess whether an incurred debt is necessary for the company to survive the COVID-19 crisis, which must be assessed on a case-by-case basis.

<sup>4</sup> the *Coronavirus Economic Response Package Omnibus Act 2020*, which received Royal Assent on 24 March 2020, inserted a new section 588GAAA into the Corporations Act granting temporary relief for potentially financially distressed companies

## How can directors access the protection offered by the current safe harbour provisions?

Directors wanting to rely on the current safe harbour provisions must demonstrate they meet the requirements including ensuring statutory payments are up to date.

To manage the financial disruption caused by the COVID-19 crisis, directors should take the following steps:

- **Know and understand the company's financial position:** Directors should be properly informing themselves of the company's bottom line and regularly monitoring it. The degree of regularity will depend on the particular circumstances and directors should also insist that they are kept abreast of all changes to the company's financial position.
- **Seek professional or expert advice:** Directors cannot blindly follow expert advice as a means of absolving themselves from personal liability for insolvent trading, but seeking advice shows steps were being taken to understand a company's financial position. The expert must be given sufficient information to provide an informed opinion.
- **Act quickly:** Directors must act quickly when a suspicion arises that a company could be, or is, trading while insolvent. Directors will be unable to rely on the safe harbour provisions if they fail to act within a reasonable timeframe. "Reasonable" may mean different things to different people. For a financially distressed company, it would not be unusual to keep a very close eye on money coming in and out of the company – so this may mean a fortnightly, weekly or even daily consideration of whether the company is solvent or not. Undertaking a cash flow analysis and tracking against that document would be a good start for directors to evaluate financial performance on a more informed basis.
- **Keep proper records:** Proper records must be kept documenting decisions and financial transactions including steps taken by directors to inform themselves of the company's financial position and any expert advice relied upon in making decisions.
- **Act honestly:** Honesty is the best policy always, but directors will not be able to rely on the current safe harbour provisions if they act dishonestly in failing to prevent a company from insolvent trading.
- **Implement a financial survival strategy:** A financial survival strategy should improve a company's financial position and could include an organisational restructure or debt restructure.
- **Appoint an administrator or liquidator if necessary:** If the action being taken under the current safe harbour provisions or pursuant to a financial survival strategy are not improving the company's financial position then directors should consider appointing an administrator or liquidator as soon as possible, to limit the risk of personal liability for company debts.

## Remember: the other directors' duties still apply

The current safe harbour provisions are only temporary and are intended to enhance the existing safe harbour provisions found in the Corporations Act, not replace them. The reforms are not a "free pass". Directors must continue to carefully monitor the company's financial position and assess the implications of incurring further debt.

Importantly, the relief provided by the safe harbour reforms do not extend to the other statutory and common law directors' duties. Directors are still bound by their duty, for example, to act in the best interests of the company and to act in good faith. Directors must continue to consider, for example, the interests of creditors when approaching insolvency, whether incurring further liabilities is reasonable and whether this course of action aligns with the obligation of care and diligence.

## Director duties (a quick refresher!)

The legal (or fiduciary) duties of directors can be boiled down to a small handful of ‘general’ duties of directors which apply to every decision and action of each director. These duties are designed to assure the integrity of every decision that a board takes, by requiring that decisions are fully informed and are not undermined by conflicting interests of directors. The duties fall in to two categories, which are:

- the **duties of care and diligence** requiring that directors use care and diligence in their actions as directors, meaning that they:
  - become familiar with the business and financial management of the company;
  - ask for further information where it is required;
  - read board papers in advance of meetings;
  - attend meetings;
  - have robust discussions at meetings ensuring that they demand the appropriate information to enable them to make each decision on a fully informed basis; and
- the **duties of good faith**—requiring that directors act in good faith, exercising their extensive powers in the interests of the company, and not in the interests of any other person (including themselves), which duties include specific prohibitions on misuse of information gained as a director, misuse of position of director, and avoiding conflicts of interest.

## Other types of organisations

The information above only applies to Corporation Act companies. Different rules apply to the following entity types:

- **Incorporated associations and insolvency**

The insolvency provisions of the Corporations Act do not apply to arts and cultural bodies incorporated under the *Associations Incorporations Act 1981 (Qld)*.<sup>5</sup>

Ultimately the legal duties of members of incorporated associations demand, amongst other things, the exercise of a high level of care, skill and diligence. In order to demonstrate that they meet this high standard of care, skill and diligence, it is preferable for board members of incorporated associations to regard themselves as being bound by the same insolvent trading provisions as organisations falling under the Corporations Act.

It should be noted that the members of incorporated association boards are still subject to a range of legal duties based on common law and legislation applicable to charities in Australia, where they are registered with the ACNC. All ACNC charities must abide by the Governance Standards – one of which is a provision which requires charities to not operate while insolvent.<sup>6</sup>

- **Statutory Bodies and insolvency**

Five arts and cultural organisations are incorporated under their own specific Act of Queensland Parliament and the Corporations Act provisions do not apply to these organisations.

## Further resources

On 23 March 2020, the Australian Securities and Investment Commission (ASIC) announced it was recalibrating its regulatory priorities in light of COVID-19. Further information about ASIC’s current regulatory priorities can be found here:

<https://asic.gov.au/about-asic/news-centre/articles/covid-19-information/>

Australian Government Department of Health alerts can be found here:

<https://www.health.gov.au/news/health-alerts/novel-coronavirus-2019-ncov-health-alert>

Australian Institute of Company Directors COVID-19 Resource Hub can be found here:

<https://aicd.companydirectors.com.au/resources/covid-19>

ACNC Charity Operations and COVID-19 resources can be found here:

<https://www.acnc.gov.au/node/5781959>

Institute of Community Directors Australia response to COVID-19 can be found here: <https://communitydirectors.com.au/save-our-sector>

Please note this document is intended to be a helpful broad guide only and should not be read or interpreted as an exhaustive list of factors which will need to be considered by directors in the context of the COVID-19 crisis nor as a supplement for legal advice.

<sup>5</sup> Robson & Ors vs. Commissioner for Taxation [2015] QSC 76

<sup>6</sup> ACNC Governance Standard 5