

# Insolvency Update

## as part of the recent law changes for incorporated associations



### Introduction

Previously, Queensland courts held that the committee members of an incorporated association could not be held liable for insolvent trading under the provisions of the *Corporation Act 2001 (Cth)* (the **Corporations Act**) which apply to the winding up of a company. However, as part of a raft of legislative changes designed to improve the internal governance of incorporated associations, committee members and other executive officers will soon be liable for penalties under the *Associations Incorporation Act 1981* (the **Act**) if their association is found to have engaged in trading while insolvent.

The specific duty to prevent insolvent trading – which applies to a committee member and any person who took part in the management of an association at the time a relevant debt was incurred – will commence upon proclamation by the Queensland government, which is expected to be on **22 June 2022**. It is therefore important that committee members and other management personnel understand what constitutes insolvent trading and the scope of their duty to prevent it.

### What constitutes insolvent trading?

The concept of 'insolvency' is defined by reference to the test for whether or not a *person* is 'solvent'. This test is defined in section 95A of the Corporations Act as follows:

- A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.
- A person who is not solvent is insolvent.

The courts will look at a range of various factors to determine whether an organisation was, at the time it incurred a relevant debt, able to pay all its debts as and when they became due and payable. Some of the more common 'indicators of insolvency' used by the courts to assist them in making this determination are as follows:

- continuing losses;
- liquidity ratios below 1<sup>\*</sup>;
- overdue Commonwealth and State taxes;
- a poor relationship with a present bank, including an inability to borrow further funds;
- no access to alternative finance;
- an inability to raise further equity capital;
- suppliers placing the organisation on 'COD' (cash on delivery) terms, or otherwise demanding special payments before resuming supply;
- creditors remaining unpaid outside their trading terms;
- special arrangements being made with selected creditors;
- solicitors' letters, summonses, judgments, or warrants being issued against the organisation;
- payments to creditors of rounded sums which are not reconcilable to specific invoices; and
- an inability to produce timely and accurate financial information to display the organisation's trading performance and financial position and make reliable forecasts.

\*A liquidity ratio is calculated by dividing the association's current assets by its current liabilities. If this ratio is a number less than 1, this is a sign that the association's current assets may not be sufficient to meet its debts as and when they fall due.

It is worth noting that when considering the solvency of an organisation, the courts take into account the organisation's financial position *as a whole* rather than considering any single factor in isolation. Therefore, committee members and other management personnel should be aware of each of these indicators in order to recognise any early signs of insolvency within their association and understand when it may be necessary to take remedial action.

## The scope of a committee member's duty

Under the new provisions of the Act, if a person was a committee member (or took part in the management of an incorporated association) at the time a particular debt was incurred and, at the time the debt was incurred, there were reasonable grounds to expect that the association was insolvent (or would become insolvent by incurring that debt), then that person will have committed an offence.

In order to satisfy their duty to prevent insolvent trading, committee members must ensure the club ceases trading and not incur any further debts when they might reasonably expect that their association is insolvent.

It should be noted that the only defences available to a person accused of allowing their association to trade while insolvent are as follows:

- that the person can prove the debt was incurred without their authority or consent;
- that the person can prove they did not take part in the management of the association when the debt was incurred (because of illness or some other good reason); or
- that the person had reasonable grounds to expect that the association was solvent when the debt was incurred and would remain solvent.

For the purpose of deciding whether a person had reasonable grounds to expect that the association was solvent and would remain so, if the person relied on information given to them by an employee, professional advisor, sub-committee or another officer acting within the scope of that person's competence or authority, then such reliance will be considered to be reasonable if it was made in good faith and after an independent assessment was made by the person.

Committee members and other officers of an incorporated association should not simply rely on the defences available to them under the Act – instead they should always be careful to take reasonable steps to identify the cause of any financial difficulties that may lead to the insolvency of their association and put in place measures to address them before it is too late.

## What does this mean for committee members?

The new provisions relating to insolvent trading are designed to protect creditors and give them greater confidence when dealing with incorporated associations. Soon, committee members will be answerable for the financial decisions made by the committee at a time when a reasonable person would have known, or ought to have known, that the incorporated association was insolvent.

In order to make informed decisions about whether the association can responsibly enter into new transactions and liabilities, a committee member should understand the association's current financial position. Racing Queensland would therefore recommend that all reporting at committee meetings contains neatly summarised information regarding the association's financial position.

Further, it will not be an excuse for a committee member to leave their understanding of the association's financial position solely to information or advice given by the Treasurer or another committee member without having first independently assessed the accuracy of the information or advice they have received. When reviewing financial statements or advice, committee members must apply their own mind to the information and satisfy themselves that it is consistent with their own understanding.

Whilst these new provisions may seem daunting, committee members should take comfort in the fact that action being taken against committee members is highly unusual and is generally reserved for the most serious of cases.

Usually, the committee member's duty will be satisfied if the committee member complies with his or her common law duty to act with reasonable care, skill and diligence. However, given the heightened risks surrounding insolvent trading, committee members should ensure they:

- have a well-informed opinion of the association's financial capacity and solvency position at all times; and
- remain abreast of their options if they believe the association may be facing serious financial difficulties, obtaining independent legal and/or financial advice at an early stage where required.