



Insolvency

If your customer's go broke how do you avoid the domino affect?

Jim Babalis
Senior associate

 **gadens**
lawyers
melbourne



What is insolvency?

An insolvent company is one that is unable to pay all its debts when they fall due for payment. *Section 95A of the Corporations Act* is where we find the definition of insolvency.



What is insolvency?

The classic legal interpretive text of what constitutes insolvency is a statement by Barwick CJ in the case of *Sandell v Porter* (1996) 115 CLR 666, where he stated the following:

“The conclusion of insolvency ought to be clear from a consideration of the debtor’s financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It is the debtor’s inability, utilizing such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates that a company is insolvent”.



Director's duties

It is expected that Directors maintain an awareness of the financial position of their company that goes above and beyond a knowledge of the yearly financial statement of the company. This requirement is found in Section 588G of the Corporations Act.



Director's duties

The recent case of Centro is also relevant. In this decision, Justice Middleton of the Federal Court has stated the following with regard to the actions of company director's with regard to financial reporting:

1. Director's can not simply delegate responsibility in relation to financial transactions to external advisors (i.e. accountants) they need to have a significant degree of knowledge of the inner financial workings of their companies;
2. Director's are required to have a degree of financial literacy and if not, they must educate themselves with respect to basic accounting principles and practices;
3. Information overload can not be relied upon as a defence or excuse in mitigation.




Director's duties

In short, it is expected that adequate financial records are kept that explain the transactions of the company.



How do you recover your money when your customer's go broke?


Until recently the most common way for a company to recover goods or money from an insolvent or bankrupt client was for them to enter into contract clauses known as “retention of title”. In other words, in a situation where a company became insolvent, the aggrieved party had the right to seize relevant goods on the basis of failure of payment.



The advent of the Personal Property Security Register Scheme (PPSR)

Personal property is defined to include items such as livestock, machinery, cars, boats, trucks, gardening equipment, crops, seeds and very importantly intellectual property.

The great thing about the new register is that if you have institutional clients, you don't need to continuously register, once is enough.



The advent of the Personal Property Security Register Scheme (PPSR)

Also, by securing your interest the recent law changes deems your right of priority to be perfected as of the date of register. In other words, first in first served. . Previously, there were inconsistencies as to who got priority in the “waiting line” of secured and unsecured creditors.



How do you avoid the domino affect of insolvency?

1. Legalistic Approach

- Contract Law
- PPSR

2. Strategic

- Have a full understanding of your own corporate health check.
- Know your customer base very well.
- Know your customers' customers.
- Think local, well maybe you need to think global.
- Invest in the new economy.