Indicators of Insolvency

Collecting debts from insolvent debtors and business re-structure/survival

Insolvency is the inability to pay all debts, as and when they become due and payable.

Some of the *indicators of insolvency* are externally known (i.e. known to third parties) and some are only internally known (only known to the Directors or owners of a business).

Early identification of insolvency or potential insolvency is important, as it can affect your strategy for:

1. Recovering debts from your debtors. If you are aware of facts which should lead you to suspect your debtor may be insolvent, your debt collection strategy should take into account the potential for your debtor to "collapse" and the very real risk of any payments made to you being "clawed back" by a liquidator or bankruptcy trustee (known as unfair preferences). In other words, you may have to *pay back* any payments you received.
2. Survival of your own business. Directors have duties to avoid trading whilst insolvent, and unless there are urgent operational or structural changes to a business when it is likely to become insolvent (or is already insolvent), the risk is that the business must cease.

If one or more of the indicators exist, seek advice.

The earlier the advice, the more potential options there may be to revive (turnaround) a business, or recover a debt from a potentially insolvent debtor.

The Indicators

The case of *ASIC v Plymin and Others* (2003) 46 ACSR 126 is commonly referred to on this topic, as it contains a non-exhaustive list of some indicators of insolvency at [386], being:

1. Continuing losses.
2. Liquidity ratios below 1.
3. Overdue Commonwealth and State taxes.
4. Poor relationship with present Bank, including inability to borrow further funds.
5. No access to alternative finance.
6. Inability to raise further equity capital.
7. Suppliers placing the company on COD, or otherwise demanding special payments before resuming supply.
8. Creditors unpaid outside trading terms.
9. Issuing of post-dated cheques.
10. Dishonoured cheques.

11. Special arrangements with selected creditors.

12. Solicitors' letters, summons[es], judgments or warrants issued against the company.

13. Payments to creditors of rounded sums which are not reconcilable to specific invoices.

14. Inability to produce timely and accurate financial information to display the company's trading performance and financial position, and make reliable forecasts.

One strategy for collecting debts from potentially insolvent debtors is to first better protect your position in light of impending insolvency (e.g. agreement in writing with alternate security), and then collect payments, rather than blindly accept payments which you may have to pay back.

Strategies for a potentially insolvent business re-structure include re-financing, asset or business sales, transfers, lease arrangements, and operational changes. All of these will be affected by your business' potential insolvency, such that extra obligations and duties apply to Directors in insolvency situations. Re-structures and even simple asset sales therefore need careful and proper planning and documentation, lest they fall foul of "phoenixing" or "disposal of assets with intent to defraud creditors" or "uncommercial transactions" (to name only a few).

Our Business Advisory and Insolvency and Asset Protection team, and Debt Collection team, are available for a no-obligation initial discussion about your debt collection or insolvency/re-structuring needs.

For further information contact Murfett Legal by telephone on +61 8 9388 3100, via our website at www.murfett.com.au or email one of the following directors:

Jason De Silva : jason.desilva@murfett.com.au

Kelly Parker : kelly.parker@murfett.com.au

Peter Broun : peter.broun@murfett.com.au