



FINANCIAL PLANNING

Insolvencies solve nothing

Australia's draconian insolvent trading laws encourage small companies to throw in the towel, laments Victorian liquidator **Gess Rambaldi**

OFTEN considered among the harshest regimes, Australian insolvent trading laws are fast-tracking the demise of many ailing companies, offering directors little or no incentive to seek better outcomes for insolvent companies other than to throw in the towel and appoint a liquidator or administrator.

Australian Securities and Investment Commission figures show the number of companies going under increased by 38 per cent in January, compared with the same period last year. The ASIC statistics show a 154 per cent increase in the number of receivers and managers being appointed by secured creditors between November 2007 and October 2008.

Victorian businesses have been hit the hardest, with receiver and manager appointments skyrocketing by 2600 per cent during the 12 months from November 2007 to November 2008.

The present dire financial situation serves to demonstrate that our insolvency laws are woefully inadequate in meeting the needs of Australian directors, creditors and financially distressed businesses, with small to medium-sized enterprises particularly affected by the failings of these laws.

The primary purpose of insolvency trading laws is to promote good corporate behaviour among company directors.

Good corporate behaviour occurs when directors are encouraged to make reasonable commercial decisions that take into account the interests of the company and its creditors, with creditors' interests taking precedence in times of financial distress.

Promotion of good corporate behaviour involves positive and negative sanctions. However, Australian insolvent trading laws provide nothing but negative sanctions in the form of a threat of personal liability to directors if they breach the provisions.

As a liquidator, I recently closed the doors of a logistics company turning over \$8 million a year after the company director sought to escape personal liability for insolvent trading. The company became insolvent as a result of an important client leaving the business.

Before liquidation, a new client twice the size of its largest existing client was contracted to come on board in three months, providing the company with good margins. In the meantime, the company could not get the finance to bridge the three-month gap and the directors, despite the existence of a legally binding contract, were not prepared to take the risk as the law would not protect them if something were to go wrong.

On my appointment all clients left the business, making it unsaleable. Creditors suffered losses in the millions of dollars because the director, understandably, did not want to breach insolvent trading laws by continuing to trade and become personally liable for debts that would be incurred in the event the company was placed into liquidation.

(Under British and Canadian legislation he would have been protected and could have had the opportunity to double the company's income in a six-month period, allowing creditors to be paid in full and liquidation to be avoided.)

Despite the detrimental influence to the value of a business that often occurs on the formal appointment of a liquidator or administrator (and, therefore, to its creditors), responsible directors of insolvent companies are not provided with any incentive to engage in continued trading, even if such trading would reasonably result in a better result for the company and its creditors.

The line argued is that the threat of personal liability will deter directors from breaching the insolvent trading provisions. Another defence of present laws is that they encourage directors to be aware of their company's finances, allow creditors to take control and to determine a company's future, and allow creditors to improve their position by suing directors for recovery.

The reality for directors of small business is that, paradoxically, the insolvent trading laws result in businesses being prematurely closed or continued to be traded even though they may be hopelessly insolvent.

Unlike directors of large corporations, directors of small to medium enterprises have

limited access to internal and external experts and professionals, and are shown comparatively little interest in their businesses by the company's bankers who normally hold by way of security, directors' personal guarantees and pledges over directors' real property and personal assets including their family home.

The reality for directors of these organisations is that when insolvency arrives, it often does so quickly and without warning. The only relief provided by Australian insolvent trading laws is for them to appoint an external administrator in the form of a voluntary liquidator or voluntary administrator.

To make matters worse, small to medium enterprises have their personal and financial wealth tied up with the success of the business, so it is little wonder that many directors are faced with the option of appointing an external administrator or continuing to trade in the hope they pull through and avoid liquidation or administration.

If they choose to continue trading businesses, even though the company may be hopelessly insolvent, they will face personal liability for debts incurred that remain unpaid in a liquidation.

The economic downturn presents an opportunity to urgently review and amend Australia's insolvent trading legislation.

We need to introduce positive sanctions to encourage reasonable and responsible commercial decision-making to help prevent avoidable liquidations while protecting the interests of company directors and their creditors, and if the company is insolvent, it is primarily the interests of the creditors that must be protected.

Otherwise, these directors will give up prematurely in the hope that they can avoid liquidation or, worse, continue to trade because they have nothing to lose.

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Detrimental: Gess Rambaldi urges new legislation to help prevent avoidable liquidations