

Insolvency Warning Signs for Directors of Co-operatives

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Introduction

The aim of this paper is to focus on insolvency warnings for directors of co-operatives so that it could be possible for action to be taken by directors before it is too late. While the focus will not be on the liabilities imposed on directors and the defences available to them for insolvent trading, it is necessary to define insolvent trading and outline the responsibilities of directors.

The Statutory Duty and Requirements

The duty to prevent a co-operative from trading while insolvent, or to become insolvent as the result of a contract, is an important statutory duty.

Section 348 of the Co-operatives Act adopts Part 5.7B of the Corporations Act with respect to insolvent co-operatives. By adoption, s 588G of the Corporations Act imposes a liability on a director of a co-operative who allows the co-operative to incur a debt at a time when the co-operative is insolvent when, at the time the debt was incurred, there existed reasonable grounds for suspecting that the co-operative was, or may become, as a result of incurring the debt, insolvent. A director will be liable if, at the time, he or she was actually aware of the existence of reasonable grounds to suspect insolvency or a reasonable person in a similar position within a co-operative would have been so aware.

The provision applies only to directors, whereas the previous provision applied equally to directors and those who were involved in the management of a co-operative. This emphasis on directors was recommended by the Law Reform Commission and the aim is to make directors primarily responsible for debts incurred while insolvent. Essentially this is because insolvent trading causes significant hardship to the general business community and imposes significant costs on the Australian economy through unpaid taxes, superannuation and losses to legitimate business.

One of the main problems directors face is being able to identify when a co-operative is insolvent. The Corporations Act now contains s 95A which provides that a person (including a co-operative) is insolvent if they are not solvent. They are only solvent if they are able to pay all their debts as and when they become due and payable. Note that this applies to **all** debts rather than particular debts. The question of when this occurs will be a decision based on the facts.

Section 222 of the Co-operatives Act provides that, in the discharge of his or her powers and duties, officers (which includes directors) must exercise the degree of care and diligence that a reasonable person in a like position in a co-operative would exercise in the co-operative's circumstances. This includes taking steps to ensure that they are properly informed about the financial position of the co-operative and ensuring that the co-operative does not trade while insolvent. The courts have made it quite clear that, except in very limited circumstances, passive or sleeping directors are a thing of the past. That is, all directors need to take their responsibilities seriously.

When Does Insolvency Exist?

It is necessary to distinguish between temporary illiquidity and insurmountable illiquidity. As discussed in the case of *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation*

(2001) 39 ACSR 305, insolvency will be a question of fact from a consideration of the co-operative's financial position taken as a whole and due regard must be had to the commercial realities, the realisable assets of the co-operative and the nature of the trading. As Barwick CJ said (at 670 – 671) in *Sandell v Porter (1966) 115 CLR 666* “the conclusion of insolvency ought to be clear from a consideration of the debtor's financial positioning 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, utilising 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 insolvency. Whether that state of affairs has arrived is a question for the court.”

However, it is important to note that latitude by creditors in payment terms does not warrant a conclusion that the debts are not due at the time (see, for example, *Standard Chartered Bank of Australia Ltd v Antico (Nos 1 & 2) (1995) 38 NSWLR at 331*). If creditors do not actually press for payment this does not actually amount to forbearance on their part. In assessing insolvency, the courts act on the basis that the payment is due unless there is evidence of an agreement to extend the time for payment, there is a course of conduct giving rise to estoppel or industry conduct or practice extends the time for payment.

Insolvency is not usually determined by looking at the balance sheet of a co-operative and determining whether there is a surplus of assets over liabilities. Rather, the emphasis is on cash flow.

What Information Does a Director Need?

So, what information should a director request? Essentially, any information necessary to make decisions about the management and financial position/solvency of an organisation. It is worth noting the comments of Mandie J in the case of *ASIC v Plymin 175 FLR 124* (better known as the Water Wheel case) at 230:

“However, I specifically accept ASIC's contention that the reasonable person envisaged by s 588G(2)(b) would have obtained from management on a regular basis a list of debtors and creditors by age and amount (including off balance sheet finance), regular profit and loss and cash flow statements and reports on negotiations (if any) with creditors whose debts were outside trading terms and that the information thereby obtained would have made such a director aware of reasonable grounds for suspecting insolvency at the relevant times (to the extent that such a director was not already aware of such grounds).”

Possible Indicators of Insolvency

ASIC has identified/published a list of key operational and financial practices which, in combination with other practices, indicate a company (co-operative) is at significant risk of insolvency. These include:

- Continuing loss making activity.
- Poor cash flow, or no cash flow forecasts.
- Disorganised internal accounting procedures.
- Incomplete financial records.
- Absence of budgets and corporate plans.
- Accumulating debt and excess of liabilities over assets.
- Default on loan or interest payments.
- Increased monitoring or involvement of the financier.
- Outstanding creditors of more than 90 days.
- Instalment arrangements entered into to repay creditors.

- Judgement debts received.
- Significant unpaid tax and superannuation liabilities.
- Difficulties in obtaining finance.
- Difficulties in realising current assets (e.g. stock and debtors).
- Loss of key personnel.

While this is not an exhaustive list, it is certainly a good starting point. One of the indicators not included, but observed by inspectors of the Registry, is the holding of drawn cheques – usually in a safe.

Other indicators include:

- Poor or questionable accounting practices.
- Management frailties.
- Economic pressures.
- Qualified audit reports and failure to address concerns raised in audit management letters.
- Letter from the regulator (not sent lightly).

Poor or questionable accounting practices include the overstatement of revenue (for example, sales forecasts for subsequent years brought into the current year) and understatement of costs by deferring to a subsequent year. They can also include the window dressing/manipulation of the balance sheet by, for example, optimistic valuation of assets.

Management frailties include management indecision or even paralysis, rapid management turnover, increasing time spent on cash flow and crisis management and the inability to articulate a recovery plan.

Economic pressures include the viability of the business model – is it realistic in the current business environment, particularly given market place pressures the co-operative may be under? Also, are budget/actual/amended budgets being produced to give an up to date indication of trends being experienced?

The board should bear in mind that trading conditions can change quickly and the debt situation can catch up quickly in these circumstances. For example, a turnover of \$12 million to \$15 million per annum could well produce \$1million of debts in a month. However, this principle applies just as much to smaller co-operatives as it does to larger ones. For example, the co-operative may have a substantial part of its business with one debtor which goes into liquidation.

Auditors only qualify audit reports as a last resort. Any qualifications in an audit report, or discussions with auditors about qualifications, are an important sign. Auditors quite often raise a number of management issues in an audit management letter and the board should ensure that these are reviewed and addressed.

The Registry sometimes has occasion to write to co-operatives about a number of matters, including the question of insolvency. This action is based on information available (for example losses/financial position disclosed in Annual Returns) and may be in conjunction with an inspection of the co-operative. The board should ensure that issues raised in this correspondence are addressed immediately.

A Case in Point – Water Wheel

It would be useful to review the application of these warning signs/indicators of insolvency in the framework of the Water Wheel case.

A summary of some of the background and signs of insolvency allegedly ignored by directors follows. It should be noted that this is a very brief summary. The judge's review of the facts covers 63 pages.

Water Wheel was incorporated in 1888 and was listed on the ASX in 1960. It was comprised of a pure Holding company and a trading subsidiary, Water Wheel Flour Mills Pty Ltd. The main business was the purchase and milling of wheat and paddy rice and the distribution of flour, rice and stockfeed products. It only entered the rice industry in 1997 when a rice mill was purchased and installed at Bridgewater for \$3 million.

In 1998 a rights issue and private placement raised \$5 million capital and this enabled the rebuilding of the stockfeed plant at a cost of \$4 million. Rice drying and storage facilities were purchased and located at Mitiamo. 1998 was the first full year of rice production.

In 1999 Water Wheel generated revenue of \$12.5 million from the flour business, \$9 million from the rice business and \$5.7 million from the stockfeed business.

The Rice Marketing Board regulated the NSW rice industry and, in turn, vested power to process and market the NSW crop, where most of Australia's rice is grown, in Ricegrowers' Co-operative Limited. Because of a resulting lack of supply, Water Wheel's rice mill operated at only 40% of capacity. There was an expectation on the part of Water Wheel that the rice industry would be deregulated and that the company would be in a position to use its slack capacity.

Because of falling margins and a high fixed cost structure, Water Wheel incurred a loss of \$900,000 for the year ended 3 December, 1998. The auditor expressed concern over internal control and financial reporting systems. The audit management letter covered 28 pages.

Management claimed that there were sales of \$1.2 million which had not been invoiced. This was not able to be proved by either the auditor or Deloitte, who were brought in for such a task.

In March 1999, there were board discussions about the tightening of liquidity, creditor litigation and the difficulty being experienced paying debts when they were due. Cheques were being held in drawers. Deloitte reported that gross margins had suffered a significant deterioration and an analysis of operating expenditure for the six months ended 3 December, 1998 revealed that expenses had increased by \$1.2 million in the period. There was also no expectation that deregulation of the rice industry would happen any time soon. Even though the board had asked for a series of financial statements at a board meeting in October, 1998, these were still not being produced.

In April, 1999, an off balance sheet funder refused further finance. Trade creditors of \$1 million were now between 90 and 100 days outstanding. There was a shortfall of \$2 million in liquidity. There was also a report to the board saying that a further \$5.7 million in working capital was needed. Such a large requirement would be hard to fund when total turnover is \$27 million. There were further trading losses and superannuation payments were three months behind. Water Wheel applied to the ANZ Bank for further finance. At 148, Mandie J said: "Apparently, the ANZ Bank required further information from Water Wheel, but it ultimately did not agree to Water Wheel's request for additional finance."

A director and the financial controller, who had sought his own legal advice and warned the board at a meeting about the matter of insolvent trading, resigned in April, 1999. The financial controller had only commenced in February, 1999.

In July, 1999, the ANZ Bank expressed concern about the financial position of the company. At 158, Mandie J said: “On 19 July, 1999, the ANZ Bank wrote to Water Wheel noting the recent agreement of PWC to undertake a review of Water Wheel’s financial results and business operations. The letter noted that the bank had serious concerns in relation to a number of matters including significant trading losses, inadequacies of the existing accounting systems/controls, and unreliable financial data, the lack of a financial controller, breached covenants and other events of default, a material adverse change in Water Wheel’s financial position and the safety of the bank’s exposure. The letter went on to say that, under the circumstances, ongoing provision of banking facilities would be subject to the board providing the bank with an action plan by 30 July, an external valuation of Water Wheel’s assets (and) an ongoing monitoring role for PWC (pending a return to profitable trading).”

One director stated that it was at about this time that the board seriously decided to sell both the flour business and the stockfeed business.

Another director resigned from the board on 28 July, 1999 – no reasons given.

In August the ANZ Bank refused requests for funding, placed the facilities on demand and required a separate designated wages account be set up. The Bank was not, at that stage, demanding repayment. The half year loss was reported as \$2.135 million and the auditors informed the board that, for the half year, the loss was effectively being funded by the trade creditors.

In September, 1999 a post-dated cheque arrangement was reached with a major supplier and a letter arrived from ASIC expressing concerns about the company’s solvency.

On 14 September, 1999 there was a meeting with the ANZ Bank which required that any proceeds from sale of assets be used to reduce the facilities rather than fund additional working capital requirements. The proposed sale of assets did not proceed. The Bank also informed the company that it had decided to end its relationship with Water Wheel and, while no demand had been made, facilities were payable on demand.

In October, 1999 suppliers required cash with orders, a second letter about insolvency arrived from ASIC and the subsidiary, the operating company, was evicted from its offices.

Finally, on 18 February, 2000, the board determined to appoint an Administrator. While the appointment of an administrator can be a recognised defence in appropriate circumstances under s 588H, in this case the action was taken far too late.

Mandie J, at 213 – 214 states:

“Humphris, an accountant called as an expert on behalf of Elliot, agreed that a checklist of matters put to him as being indicators of insolvency, was a fairly extensive list, albeit in general terms, and brought to mind very common features in insolvency situations. The list may be paraphrased as follows:

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 [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), judgements 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.

The evidence shows that most of these indicators were present in the case of Water Wheel, many of them well before September, 1999.”

Mandie J found that Water Wheel was insolvent on 14 September, 1999, the date of the meeting with the ANZ Bank.

ASIC had brought civil proceedings against three directors for alleged insolvent trading. The decision, subject to appeal, was:

This was an insolvency of monumental proportions with far-reaching consequences. The facts demonstrated some pretty obvious dereliction of duty and ignorance of ‘in your face’ signs of insolvency. It is no surprise that substantial penalties followed.

	Harrison (Chairman)	Plymin (MD)	Elliott (Non-exec)
Prohibited from managing a company	7 years	10 years	4 years
Pay compensation to creditors	\$300,000	\$1.4 mill.	\$1.4 mill.
Penalty order	\$0	\$25,000	\$15,000
Contribution to ASIC's costs (est. \$2m.)	nil	80%	80%

What Can We Learn?

- Don't stick your head in the sand and hope that it will all go away. Something will just not turn up without positive action. Be pro-active. Ignorance is no defence.
- Is management competent and reliable? The defence of reliance on another person in s 558H(3) depends on the board first and continuously being satisfied that those persons employed to manage are competent and reliable.
- Do you have reasonable grounds to believe that management are providing sufficient and adequate information about insolvency?
- What is the on-going trading profit and loss, based on regularly prepared financial statements?
- For larger co-operatives, are forecast profit and loss statements and balance sheets being prepared on a regular basis?
- What are the commercial realities of current operations? Does the business plan need adjustment? A week can be a long time in business.
- Is the cash flow and budget information provided sufficient? Are significant variances being analysed? Is the budget being adjusted as necessary?
- What is the status of debtors and creditors, particularly with respect to collectability and aging? Are outstanding debtors being systematically pursued? What is the status of any negotiations with creditors?
- What is the ability to pay creditors and manage the on-going cash commitments?
- What is the ability to raise extra cash, either through asset sales or further borrowing/equity facilities? What is the ability to pledge assets for further finance?
- Seek accounting and legal advice before it is too late. The sooner action is taken, the more chance of a wider range of recovery options.
- Bring the matter to a head by advising the chairman and other board members and the auditor (and possibly the Registry).
- Resign if considered necessary, making sure that the board, auditor and the Registry are aware of the reasons.
- Consider appointing an administrator.
- Consider your exposure to personal liability. The bottom line is your personal liability. On the broader front, however, the flow on effect to others connected with the co-operative can be devastating.

The Final Message

- Be aware of your personal exposure.
- Be careful, diligent and ask questions.
- Don't just rely on management but make your own judgement of whether the co-operative can pay its debts as and when they fall due.
- Take action sooner rather than later.

Internal Control and Cash Payments

One of the issues of serious concern to the Registry, as evidenced by numerous reviews undertaken, is loose control by some co-operatives of cash payments.

It may not always be possible to have the necessary separation of duties relating to the ordering, receipting and payment of goods and services, particularly in small co-operatives. However, there are a few simple procedures which should be carried out.

Payment should only be made after sighting of appropriate documentation (for example, invoices and purchase orders where possible) and the document should be marked paid and the method of payment identified immediately on signing of the cheque or on completion of the electronic funds transfer.

No payments should be made directly from income. All income should be receipted and banked.

There should be no signing of blank cheques. While two signatures may be required on a cheque, never assume that the bank will not pay a cheque with only one signature.

A list of all payments made since the last board meeting should be presented for covering approval at the next board meeting. It may be useful for the board to sight the co-operative's bank statements at the same time, remembering at the same time that the bank statement balance has to be adjusted for drawn cheques not yet presented.