

Fact sheet: Financial problems or insolvency

Overview

This fact sheet provides information for Victorian incorporated associations and companies limited by guarantee that are facing financial difficulties or are concerned about becoming insolvent.

Not-for-profit community organisations may face financial difficulties for a number of reasons, and it may be external forces such as economic trends that cause strain on an organisation's financial position. Whatever the cause, all organisations and their Committee members need to be aware of the possibility and consequences of insolvency. Acting on early warning signs is important!

Note: The information contained in this fact sheet is intended as a guide only, and is not legal advice. If you do have a legal problem you should talk to a lawyer before making a decision about what to do. The information in this fact sheet is written for people resident in, or affected by, the laws that apply in Victoria, Australia and is current at 1 March 2010.

Who can this fact sheet assist?

There are different structures under which not-for-profit community organisations can be formed. This fact sheet only relates to:

- ▶ Victorian incorporated associations (governed by the *Associations Incorporation Act 1981* (Vic)); and
- ▶ Companies limited by guarantee (governed by the *Corporations Act 2001* (Cth)).

The wording used to describe the governing body of an organisation will differ according to the structure under which your organisation operates and your rules or constitution. (Some examples are - Board of Directors, Committee of Management, Council, Trustees, etc).

To keep it simple, this fact sheet refers to all governing bodies as 'Committees' and all members of governing bodies as 'Committee members', unless it is necessary to distinguish between incorporated associations and companies.

This fact sheet is divided into the following sections:

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Some common terms

Some times the language used can be technical. Here are a few of the most common terms:

- ▶ **ATO:** the Australian Taxation Office:
- ▶ **cash flow:** cash receipts minus cash payments over a given period of time; the movement of cash in and out of an organisation over a given period of time:
- ▶ **CAV:** Consumer Affairs Victoria:
- ▶ **creditor:** a person, company or other organisation that your organisation owes money to (for example, the paid staff are creditors if they are owed wages, the landlord is a creditor if he or she is owed rent):
- ▶ **debtor:** the opposite of a creditor, namely, a person, company or other another organisation that owes money to your organisation (for example, someone your organisation's agreed to provide services to for a fee):
- ▶ **liquidator, receiver, administrator:** people with specialist accounting training who are appointed to investigate and deal with a range of financial issues faced by an organisation. Each has different obligations and priorities - sometimes they will be acting for a creditor and sometimes they will be appointed by the Committee or even a court to wind up the organisation: and
- ▶ **winding up:** bringing the organisation to an end or closure, either because of financial problems or because the members agreed, perhaps because the project or mission of the organisation has finished.

Now we consider the main issue for this fact sheet, what does 'insolvency' mean and how to protect against it.

What is insolvency?

Deciding if an organisation is insolvent can be a complex process. It is sometimes difficult to determine the solvency of an organisation simply by looking at its financial records / accounts. A range of factors (not just one) will be relevant.

The law provides that an organisation is 'insolvent' when it is unable to pay all its debts when they fall due. The test is basically a 'cash flow' test. To apply this test you ask, 'does the organisation have access to enough ready cash (including deposits and loans) and expected future income, to meet its current and expected future expenses'?

It is this cash flow test that is applied rather than asking whether or not the organisation's assets exceed its liabilities.

The ability to collect money owed to the organisation, to raise funds and sell an organisation's assets (for a reasonable market value in a timely manner), are relevant considerations as to whether an organisation is 'unable to pay its debts when they fall due'.

As insolvency does not arise just because the organisation does not, at a particular point in time, have enough money, the organisation's financial position as a whole must be considered. Any combination of the following factors can indicate that an organisation is near insolvency or is actually insolvent. None of these factors is decisive, but they should act as a warning to Committee members that they may need to consider taking steps to protect against insolvency:

- ▶ continuing losses over successive financial reporting periods;
- ▶ overdue tax debts, for example 'pay-as-you-go' (PAYG) instalments, GST, superannuation guarantee contributions;
- ▶ increasing levels of bad or doubtful debts, the collapse of a significant creditor or withdrawal of a major source of funding;
- ▶ inability to borrow funds or get loan approvals;
- ▶ cheques issued by the organisation being returned dishonoured;
- ▶ cheques are being issued post-dated (that is, dated after the date on which it is actually written) or are not being sent;
- ▶ delays in paying suppliers resulting in stricter credit terms or suppliers insisting on "cash on delivery";
- ▶ legal proceedings being initiated or threatened by creditors, including the ATO, or judgments being entered against the organisation; and / or
- ▶ repeated failure to produce timely and accurate information on the organisation's financial position.

If your organisation is experiencing any of the above factors, you may need to take action to prevent insolvency or, in a worst case, to prevent the organisation from continuing to operate while insolvent.

Due to the complex nature of this issue and the possible serious consequences for the organisation and its Committee members, we suggest that you should, in the first place, speak with the organisation's accountant and / or discuss the concerns with the organisation's auditor (if any).

If there is any doubt about how to overcome or improve the problems in a timely way, it may be necessary to get a qualified accountant with insolvency experience to undertake an assessment of the overall financial position of the organisation to determine whether there is a risk of insolvency. Having an independent and experienced person to do this can often really help your organisation work out what is not working, how things can be improved and what (if any) other action needs to be taken - it can be a very wise use of your organisation's funds.

Tip: Legal proceedings threatened or initiated by creditors, including the ATO, must never be ignored, as they can result in a court placing the organisation in the hands of a liquidator. Speak to a lawyer urgently. If in doubt, you can telephone PilchConnect.

How can a Committee protect against insolvency?

The main thing a Committee can do to protect against insolvency or the consequences of insolvency, is to prevent an organisation from incurring debts when there are reasonable grounds to suspect it will be unable to repay them.

This means Committee members must insist that they are kept up-to-date on the financial circumstances of the organisation (ie. its liabilities and cash flow) at all times. This knowledge will enable a Committee member to take steps to protect the organisation against insolvency, and in that way act in the organisation's best interests. Those steps may include identifying problem areas and reducing expenses / liabilities or increasing income and cash flow, or at least ensuring that the problem does not get any worse.

Does the Committee have a duty to prevent insolvent trading?

Yes. To understand why, we have set out the law in relation to incorporated associations and companies limited by guarantee separately.

Tip: If you are not sure what your organisation's legal structure is (or even if it is incorporated), then you can check for free on-line by entering your organisation's name or ABN at the [Australian Business Register website](#) search and check the 'entity type'. If your organisation does not appear on this register, then you can double check if it is a Victorian incorporated association by searching on the [CAV website](#). If your organisation does not appear on either of these registers, then it is likely to be unincorporated, see Related resources at the end of this document.

Incorporated associations

For incorporated associations, the *Associations Incorporation Act* does not expressly prohibit Committee members from allowing an association to trade while it is insolvent. However, Committee members are often regarded as having similar duties as directors of companies under the *Corporations Act*, and it is generally accepted at law that the duty to prevent insolvent trading applies to Committee members as well as to directors. It is also best practice for Committee members to comply with these duties and the Victorian government is likely to change the *Associations Incorporation Act* to expressly include this duty as has been done in some other States. The three basic directors' duties are:

- ▶ A duty of good faith and loyalty to the organisation. There are several aspects to this duty of good faith and loyalty:
 - ▶ you must act in good faith in the best interests of your organisation, even if this is not in your own best interests;
 - ▶ you must act for a proper purpose, and never take advantage of your position as an office bearer or information you have gained in the role for personal advantage; and

- ▶ you must avoid conflicts of interest between your own personal interests and the interests of the organisation;
- ▶ A duty to exercise reasonable care and skill in carrying out the role of a Committee member; and
- ▶ A duty to prevent insolvent trading by the association, which includes the duty not to incur a debt that will cause the association to become insolvent.

Further information on the duties on Committee members of incorporated associations can be found on our page on 'People involved in an incorporated association' (see [Related resources](#) section at the end of this document).

Tip: Ignorance is no excuse, and the duty applies to all Committee members (not just the Treasurer). You must not simply turn a 'blind eye' to the financial status of the organisation, or leave the problem to other Committee members.

Companies limited by guarantee

For companies limited by guarantee, directors are required by the *Corporations Act* to comply with the duties listed above. This includes the duty to prevent insolvent trading which is expressly stated in the *Corporations Act*.

For further information on the duties on directors of companies limited by guarantee, see our page on 'People involved in a company limited by guarantee' (see [Related resources](#) at the end of this document).

What are the consequences of breaching duties?

Incorporated associations

The *Associations Incorporation Act* states that, as a general principle, the members of an association (including Committee members and the Public Officer) will not be personally liable for the debts of an association, or for the expenses involved with the winding up.

However, the situation in relation to breaching these (director-like) duties, such as insolvent trading is different. A Committee member may be personally liable for the debts of an association where they have failed to meet the duty to act in the association's best interests and prevent insolvent trading.

If a liquidator is appointed to an association, it is possible for the liquidator to consider a claim against any or all of the Committee members alleging breach of their duties. However, there would need to be clear evidence of a breach, such as an obvious failure to act in the association's best interests.

Further information on the duties of Committee members of an incorporated association can be found on our page on 'People involved in an incorporated association' (see [Related resources](#) at the end of this document).

Companies limited by guarantee

Directors of companies limited by guarantee may be personally liable for debts of the company where they have knowingly allowed the company to trade and incur debts while it is insolvent.

There are significant civil (and in some cases criminal) penalties that can apply to directors that fail to meet the expected standard of care, and directors should always ensure that they:

- ▶ act honestly and diligently and in compliance with the company's constitution,
- ▶ act in the best interests of the company;
- ▶ never use their position for personal advantage (or for the benefit of a friend or associate);
- ▶ always disclose conflicts of interests; and
- ▶ not allow the company to trade while insolvent.

Further information on the duties of a director of a company limited by guarantee can be found on our page on 'People involved in a company limited by guarantee' (see [Related resources](#) at the end of this document).

What can we do if our organisation is facing insolvency?

If you are concerned that your organisation is nearing insolvency, we recommend that you speak with the organisation's accountant and auditor (if any). In light of that, it may also be important to organise for a qualified accountant with insolvency experience to look at the overall financial position of the organisation.

The following measures are options for an organisation nearing insolvency:

- ▶ negotiate a payment plan with the ATO if there are outstanding tax or superannuation guarantee contribution debts;
- ▶ negotiate a payment plan with creditors including banks;
- ▶ call in any outstanding debts or fees owed to the organisation;
- ▶ seek financial assistance from members;
- ▶ seek financial assistance from the community;
- ▶ review options for cost cutting, including reducing employee costs;
- ▶ approach banks or other lenders for a loan (providing the organisation will in the future have income sufficient to make repayments as and when they fall due); and / or
- ▶ investigate alternative sources of income, such as fee-for-service income.

Sometimes a public fundraising drive is a good option. Community organisations can often rely on the broader community to provide support in times of need, and it may be an option to initiate a funding drive

amongst members and external supporters of the organisation. However, you should not rely on this approach as a means of fixing your financial issues. The causes of the problems should be identified and fixed well before they become a significant problem.

Our web portal has a page dedicated to fundraising (see [Related resources](#) at the end of this document), which provides further guidance on the steps needed to consider before your organisation undertakes a public fundraising campaign. It may be necessary for your organisation to register as a fundraiser with CAV.

However, if you suspect that your organisation is facing insolvency or already insolvent and none of the options above is likely to produce a quick turnaround in the organisation's fortunes, more drastic action may be required in the interests of the organisation, its creditors and members. Again, an independent qualified accountant with insolvency experience who has looked at the financial position of the organisation will be best placed to advise you on your options, which may include appointing a liquidator or other external insolvency administrator.

Importantly, acting early and getting good advice can often prevent insolvency.

How can you find a qualified accountant, auditor or accountant with insolvency experience?

To find a qualified accountant, auditor or accountant with insolvency experience, there are three peak bodies for accounting professionals and one specifically for insolvency practitioners: [CPA Australia](#), [The Institute of Chartered Accountants](#), [National Institute of Accountants or Insolvency Practitioners Association](#).

Make sure you ask for a recommendation of a person or firm that has experience in dealing with not-for-profit groups and also ask for a guide as to the fees that are likely to be charged, (if your organisation is small / volunteer run you can try to negotiate with the particular practitioner for a reduced fee).

How can you find a qualified lawyer with insolvency experience?

For lawyers who have experience in insolvency law matters (eg. if a creditor has issued legal proceedings against your organisation), you search for a lawyer through the Law Institute Victoria's (LIV) [Legal Referral Service](#).

All law firms included in the legal referral service provide a 30 minute enquiry interview free of charge. If you request the solicitor to undertake any legal work on your behalf (eg. reading contracts, writing letters etc) the solicitor's normal fees will apply. Please be sure to discuss these costs before any work is undertaken. The Legal Referral telephone service operates 9am to 5pm Monday to Friday. Please call 03 9607 9550. Online access is available 24 hours a day via the LIV website.

How can PilchConnect Help?

If you are involved in a Victorian not-for-profit community organisation, and your organisation has a legal issue, PilchConnect may be able to provide assistance, via its telephone advice service or legal referral service (see [Related resources](#) at the end of this document).

Related resources

Related PilchConnect fact sheets

Fact Sheet: Duties of committee members in Victorian incorporated associations

Fact Sheet: Duties of directors in a company limited by guarantee

Related legislation

Associations Incorporation Act 1981 (Vic)

Associations Incorporation Regulations 1998 (Vic)

Corporations Act 2001 (Cth)

Related links

For online legal information resources for Victorian community organisations about:

- ▶ fundraising see www.pilch.org.au/financial/
- ▶ the people involved in an incorporated association see www.pilch.org.au/positionsia
- ▶ the people involved in a company limited by guarantee see www.pilch.org.au/positionsclg
- ▶ unincorporated associations and the incorporation decision see www.pilch.org.au/incorporation
- ▶ how PilchConnect can help see telephone advice service www.pilch.org.au/TAS and legal assistance www.pilch.org.au/pcguidelines