

Incorporated Associations and Insolvency

Introduction

The laws against insolvent trading or incurring debts whilst insolvent apply as much to non-profit organisations as they do to for profit organisations. For companies these laws are contained in the *Corporations Act 2001* (Cth); and for incorporated associations the laws can be found in the Associations Incorporation Acts (**Associations Acts**) of each Australian State and Territory. For example, section 38 of the *Associations Incorporation Act 1984* (NSW) makes it an offence for an association to incur debts if there are reasonable grounds to expect that the association will not be able to pay them. Mirror legislation exists in all Australian states and territories. Unlike the *Corporations Act 2001* (Cth), which states when a company is taken to be unable to pay its debts¹ and is, therefore, insolvent, the Associations Acts do not provide a definition of the meaning “unable to pay all its debts”.²

The phrase “unable to pay all its debts” appears on its face to be an uncomplicated, straightforward statement about the state of the financial affairs of the incorporated association; it is, however, an unformulated, nebulous phrase that requires a significant degree of interpretation and substantial proof prior to it being applied. Further, the importance of this phrase cannot be underestimated as an incorporated association may be wound up under the Associations Acts if it is established that it is unable to pay all its debts.³

In order to establish when an incorporated association is deemed to be insolvent, we can seek guidance from both the *Corporations Act* and the case law setting out the Courts’ considerations and determinations of when a company is deemed to be insolvent.

Indicia of Insolvency

Recent case law has provided a “shopping list” of the matters to be considered when determining whether a company is insolvent.

In *Lewis v Doran* (2004) 208 ALR 385 and *Australian Securities and Investments Commission v Plymin (No 1)* 46 ACSR 126, the following matters were found to be evidence of a company’s insolvency:⁴

- continuing losses;
- liquidity ratios below 1;
- overdue taxes;
- poor relationship with banks/lenders;
- no access to alternative finance;
- history of dishonoured cheques;

¹ *Corporations Act 2001* (Cth), s585.

² Fenwick C and Magner G, “Some difficulties in winding up an incorporated association”, *Insolvency Law Bulletin* Vol 7 No 10, June/July 2007.

³ For example, see *Associations Incorporation Act 1984* (NSW), Part 8.

⁴ Hirst, M, “Ground control to Major Tom: Part 3”, *Insolvency Law Bulletin*, Vol 8 No 6, February 2008.

- COD delivery of goods;
- special arrangements with creditors;
- issuing post-dated cheques;
- demands, summonses, judgments or warrants issued against a company; and
- an inability to produce accurate and timely financial information.

Temporal Gap

For many incorporated associations, “insolvency” may occur due to it being “technically” without the capacity to pay its debts for a short period of time prior to receiving an injection of capital in the form of a grant, for example.

In *Sandell v Porter* [1966] 115 CLR 666, the Court held that insolvency is determined by considering all of the circumstances of the debtors’ financial position. It is the financial position in its entirety that must be considered and insolvency should not be drawn simply from evidence of a temporary lack of liquidity.⁵

The Court confirmed this position in *Lewis v Doran* when referring to the enactment of s 95A of the *Corporations Act*. The Court said:⁶

... s 95A is unequivocally and emphatically clear that insolvency is, first and last, a question of fact “to be ascertained from a consideration of the company’s financial position taken as a whole. In considering the company’s financial position as a whole, the Court must have regard to commercial realities. Commercial realities will be relevant in considering what resources are available to the company to meet its liabilities as they fall due, whether resources other than cash are realisable by sale or borrowing upon security, and when such realisations are achievable.” *Southern Cross Interiors Pty Ltd (in liq) v DCT* (2001) 53 NSWLR 213 at 224.

It goes too far to say that insolvency exists merely because there is an insufficiency of funds at a particular point in time. This circumstance may exist merely due to a temporary lack of liquidity, whereas insolvency is confirmed if the insufficiency represents an “endemic shortage of working capital”.⁷

Realisation of Assets

It is not only capital that is considered in determining whether an incorporated association is able to meet its debts as and when they fall due. Moneys that can be secured by realising assets by sale or mortgage or pledge within a reasonably short period of time will also discharge an incorporated association’s liabilities in order to show solvency.⁸ The assets of an incorporated association should be examined to determine how realisable they are and whether they are sufficient to cover the level of debt incurred.⁹

⁵ *Sandell v Porter* [1966] 115 CLR 666, 670 per Barwick CJ.

⁶ *Lewis v Doran* (2004) 208 ALR 385, 408.

⁷ *Hymix Concrete Pty Ltd v Garrity* (1977) 2 ACLR 559.

⁸ *Lane Rowin Pty Ltd v Perovich* [2007] FMCA 1429.

⁹ Fenwick C and Magner G, op cit.

Statutory Demands

An important difference in determining whether a company is insolvent and whether an incorporated association is insolvent relates to statutory demands. Failure to respond to a statutory demand triggers deemed insolvency and the subsequent winding up of a company. However, if an incorporated association fails to respond to a statutory-like demand insolvency is not automatically triggered. Instead, the failure forms part of the evidence that a creditor may produce to support a conclusion that an incorporated association is insolvent.¹⁰

Conclusion

The situation for incorporated associations can be likened to that of companies involved in building and construction, where cash flow relies upon the payment of progress payments. Proof of failure to pay one debt is not evidence of insolvency.¹¹ If a company or an incorporated association is able to show that it has capital coming into it which can be regarded as “immediately realisable or obtainable”¹² and not in the indeterminate future, then, coupled with a consideration of the nature of its assets and the nature of its business, it is likely that a conclusion of insolvency will be prevented.¹³

¹⁰ Ibid.

¹¹ Ibid.

¹² *Hymix Concrete Pty Ltd v Garrity* (1977) 2 ACLR 559.

¹³ *Rees v Bank of New South Wales* (1964) 111 CLR 210, 229.