Directors' liabilities when things go wrong

In most cases, where a company has been responsibly managed, the debts of the company will remain with the company.

However, there are some circumstances where directors who breach the law can become personally liable for the company's debts and/or be the subject of other regulatory action against them.

- A company is a separate legal entity
- You may be personally liable as a director
- Consequences of failing to perform your duties as a director

A company is a separate legal entity

As far as the law is concerned, a company has a distinct legal existence that is separate from that of its owners, managers, operators, employees and agents.

A company has its own property, its own rights and its own obligations. A company's money and other assets belong to the company and must be used for the company's purposes.

A company also has the powers of an individual, including the power to:

- own and dispose of property and other assets
- enter into contracts
- sue and be sued.

Personal liability as a director

Once a company is registered, its separate legal status, property, rights and liabilities continue until ASIC deregisters the company. Your obligations as a director may continue even after the company has ceased trading and has been deregistered. Under certain circumstances, you may be personally liable as a director for the company's debts and other losses.

The members of a 'limited' company are not liable (in their capacity as shareholders) for the company's debts. As shareholders, their only obligation is to pay the company any amount unpaid on their shares if they are called upon to do so. However, members who are also directors may become personally liable under certain circumstances.

The key areas of potential **personal liability** for you as a director are:

- debts incurred when the company becomes insolvent
- company losses caused by a breach of directors' duties

- if you act as a guarantor or provide security over personal assets
- debts incurred by the company acting as trustee
- illegal phoenix activity
- other regulatory action that might be taken against you.

Debts incurred when the company becomes insolvent

You may be liable for debts incurred by the company at a time when the company itself is unable to pay those debts, as and when they fall due. This is because one of the fundamental duties of a director of any company is to ensure that the company does not trade while it is insolvent.

A company is insolvent if it cannot pay its debts when they become due. Common signs of insolvency include:

- low operating profits or cash flow from the business
- problems paying trade suppliers and other creditors on time
- trade suppliers refusing to extend your business further credit
- problems with meeting loan repayments on time or difficulty keeping within overdraft limits
- legal action taken, or threatened, by trade suppliers or other creditors over money owed to them.

To determine if a company is trading while insolvent, directors will need to assess:

- the cash flow of the company – You need to determine whether your company's anticipated current and future cash flow will be sufficient to enable it to pay current and future debts as and well they fall due
- the financial position of the company in terms of the assets and debts it has as a whole – Can the company liquidate (e.g. sell) sufficient assets to pay debts as and when the fall due?

If you allow the company to trade while insolvent, you may be acting illegally and be in breach of civil and criminal provisions of the *Corporations Act 2001*.

Read our information on your duties as a director when your company is in financial difficulty and what steps you can take to deal with insolvency if you think your company might be heading toward financial stress.

There are serious consequences of failing to perform your duties as a director.

Company losses caused by breach of directors' duties

Another way you can become personally liable as a director is where, as a result of you having breached your duties, you have caused the company to suffer some loss.

Under these circumstances you may have acted illegally, be in breach of civil or criminal provisions of the *Corporations Act 2001* and you may have to compensate the company for the loss.

It is important to remember that a director's obligations may continue even after the company has ceased trading and has been deregistered.

There are serious consequences of failing to perform your duties as a director.

Guarantor or security over personal assets

As a matter of commercial practice, a bank, trade creditor or anyone else providing finance or credit to a company may ask you for:

- a personal guarantee of the company's liabilities
- some form of security over your house or personal assets to secure the performance by the company of its obligations.

You may, for example, be asked by a bank to give a mortgage over your house to secure the company's repayment of a loan. If the company does not repay the loan as agreed with the bank, you may lose your house.

Where personal guarantees are provided by you, you may become personally liable for the repayment of company loans or debts.

Debts incurred by companies acting as trustees

If your company is acting as a trustee, in some circumstances you may become personally responsible for liabilities incurred by the company. For example, if the trustee company breaches the terms of the trust.

There are serious consequences of failing to perform your duties as a director.

Illegal phoenix activity

Illegal phoenix activity involves the intentional transfer of assets from an indebted company to a new company to avoid paying creditors, tax or employee entitlements.

The directors leave the debts with the old company, often placing that company into administration or liquidation, leaving no assets to pay creditors. Meanwhile, a new company, often operated by the same directors and in the same industry as the old company, continues the business under a new structure. By engaging in this illegal practice, the directors avoid paying debts that are owed to creditors, employees and statutory bodies (e.g. the Australian Taxation Office (ATO)).

Illegal phoenix activity is a serious crime and may result in company officers (directors and secretaries) being imprisoned. This practice severely disadvantages creditors and gives these business operators an unfair competitive business advantage.

While illegal phoenix activity can take many forms, the key characteristics are that:

- the company fails and is unable to pay its debts
- the company acts in a manner that intentionally denies unsecured creditors equal access to the company's assets to meet and pay debts
- soon after the failure of the initial company (usually within 12 months), a new company commences that may use some or all of the assets of the former business and is controlled by parties related to either the management or directors of the previous company.

Directors who engage in illegal phoenix activity may be acting in breach of civil and criminal provisions of the *Corporations Act 2001* (including the more general directors' duties under the Act, outlined at Directors' key responsibilities.

There are serious consequences of failing to perform your duties as a director.

Other regulatory action against directors

While you have numerous duties under the *Corporations Act 2001*, which is administered by ASIC, you may also be liable for breaches of other laws administered by other agencies.

For instance, you may be held personally liable for certain outstanding tax obligations of the company under the ATO's Director Penalty Regime, particularly in circumstances where the company has employees. As a director, you have a legal responsibility to ensure your company meets its Pay As You Go (PAYG) withholding and Superannuation Guarantee Charge (SGC) obligations.

If the company does not meet these obligations, you may become personally liable for a penalty equal to these amounts.

Consequences of failing to perform your duties as a director

If you fail to perform your duties as a director, you may:

- be guilty of a criminal offence with a penalty of up to a maximum of $200,000, or imprisonment for up to five years, or both
- have contravened a civil penalty provision (and the court may order you to pay to the Commonwealth up to $200,000)
- be personally liable to compensate the company or others for any loss or damage they suffer
- be prohibited from managing a company.

Was this information useful?

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