



Insolvency Guidelines

The purpose of this Guideline is to provide legal practitioners with a starting point for identifying warning signs of insolvency in their practice, how to avoid or manage it and how it can impact upon their ability to practise law.

The general principles apply to legal practices of a sole practitioner, partnership or an incorporated legal practice. A reference in these guidelines to a “practice” is applicable to all such forms of practice, except where indicated otherwise.

What is Insolvency?

1. An individual, partnership or company is likely to be insolvent if they cannot pay their debts and other liabilities on time from their own resources or from realisable assets or financial facilities they have.
2. Section 95A of the *Corporations Act 2001* (Cth) states the following:
 - (1) *A person is solvent if, and only if, the person is able to pay all the person’s debts, as and when they become due and payable.*
 - (2) *A person who is not solvent is insolvent.*

What are the warning signs?

3. If you suspect your practice is in financial difficulty you should seek specialised accounting advice or legal advice from an insolvency lawyer as early as possible. Early professional advice can avoid further financial distress.
4. Some of the warning signs of insolvency for a practice, as identified by ASIC in Information Sheet 42, can be summarised as follows:
 - Ongoing losses
 - Poor cash flow
 - Absence of a business plan
 - Incomplete financial records or disorganised internal accounting procedures
 - Lack of cash-flow forecasts and other budgets

- Increasing debt (beyond the value of realisable value of assets i.e. realisable WIP and debtors)
 - Problems realising WIP or collecting debts
 - Unrecoverable loans to associated parties
 - Creditors unpaid outside usual terms
 - Solicitors' letters, demands, summonses, judgements, warrants or ATO garnishee notices issued against your practice
 - Suppliers placing your practice on cash-on-delivery terms
 - Not paying rent for your premises, putting at risk a possible distraint for rent which will deny you access to your premises and place you at risk of breaching your professional obligations
 - Issuing post-dated cheques or dishonouring cheques
 - Making special arrangements with selected creditors
 - Payments to creditors of rounded sums that are not reconcilable to specific invoices
 - Overdraft limit reached or defaults on loan or interest payments
 - Not paying off credit card charges and interest or relying on credit cards to meet unpaid debts
 - Problems obtaining finance
 - Change of bank, lender or increased monitoring/involvement by financier
 - Inability to raise funds from shareholders
 - Overdue taxes and superannuation liabilities
 - Partnership or Board disputes, director resignations or loss of management personnel
 - Increased level of complaints or queries raised by clients or suppliers
 - An expectation that the 'next' big client/settlement will save the practice
5. Additional warning signs to those set out in paragraph 4, as identified in ASIC's Regulatory Guide 217, are as follows:
- A history of continuing trading losses
 - Cash flow difficulties
 - Difficulty in realising inventory or WIP and collecting debts

- Not paying Commonwealth and state taxes when due (e.g. pay-as-you-go instalments are outstanding, goods and services tax (GST) is payable, or superannuation guarantee contributions are payable).
- Legal action is being threatened or has commenced against the company, or judgments are entered, in relation to outstanding debts.
- You are unable to produce accurate financial information on a timely basis that demonstrates the practice's trading performance and financial position or that can be used to prepare reliable financial forecasts
- There are resignations, citing concerns about the financial position of the practice or its ability to produce accurate financial information
- The practice has defaulted, or is likely to default, on its agreements with its financiers
- Employees, or the practice's bookkeeper, accountant or financial controller, have raised concerns about the practice's ability to meet, and continue to meet, its financial obligations, including dealing with creditors and making excuses or requesting time to pay
- It is not certain that there are assets that can be sold in a relatively short period of time to provide funds to help meet debts owed, without affecting the practice's ongoing ability to continue to trade profitably

How to avoid?

6. In order to avoid insolvent trading, ASIC's Regulatory Guide 217 outlines the following 4 key principles, which apply to all forms of practice; whether an incorporated practice, a partnership of individuals or an individual sole practitioner:

(1) Principals must remain informed

- (2) All principals of the practice must actively monitor, and keep themselves informed about the financial position and ensure that the practice maintains proper financial records and prepares relevant financial information. All principals must make all reasonable enquiries to enable them to always understand the practice's financial position. One or more principals are never excused or relieved from actively monitoring the financial position of the practice and its affairs.

(3) Principals should investigate financial difficulties

Where there are reasonable grounds to suspect that the practice is in financial difficulty or a risk that it is insolvent or will become insolvent, the principals must immediately investigate and assess the practice's financial position, its ability to meet its obligations and carefully consider whether the practice can afford to incur any further liabilities.

(4) Principals should obtain advice

As soon as there is suspicion that the practice is in financial difficulty, the practice should

consider obtaining advice from suitably qualified individuals within the practice (i.e. internal accountant), as well as professional advice from an appropriately experienced insolvency accountant or insolvency lawyer or other professional who has the relevant competence and expertise.

(5) Principals should act in a timely manner

Once the advice has been obtained, the principals need to consider that advice in light of the practice's financial position and take appropriate action in a timely manner.

How to rectify?

7. If your practice is insolvent and you are advised that the practice cannot be restructured and should not continue to operate, you should immediately cease trading and not allow it to incur any further liabilities. You should immediately notify the Law Society's Ethics and Practice Unit.
8. You should consider on advice, whether you can rectify the insolvency by refinancing, promptly restructuring the practice or obtaining equity funding to recapitalise the practice.
9. If none of those options are viable, you may need to consider appointing a voluntary administrator or liquidator (for an incorporated legal practice). For a sole practitioner or partnership, you may need to consider appointing a trustee in bankruptcy who may be a specialised insolvency practitioner who has experience in bankruptcy and/or acting as a controlling trustee, or seek the Society's assistance for the appointment of a Manager to your practice pursuant to section 45 of the *Legal Practitioners Act 1981* (SA).
10. If your practice is not insolvent but you are experiencing warning signs of insolvency, you should immediately investigate and fully inform yourself of the practice's financial position and take advice (internally and/or externally) in terms of remedying the financial distress, which may involve a financial restructure of your practice.
11. If you have an incorporated legal practice which is likely to become insolvent, you should seek professional legal advice to determine what specific action can be taken to protect your position as a director so you can provide yourself with the best opportunity of availing yourself of the specific defences to insolvent trading that may apply to you and the "safe harbour" provisions in the *Corporations Act 2001* (Cth) in the event that your practice is wound up and a liquidator is appointed. If you are unable to avail yourself of these defences, you may face substantial civil and criminal penalties referred to at paragraph 16 below.
12. If you were or are the director of an incorporated legal practice or a corporate entity entitled to engage in legal practice in a foreign country during the winding up for the benefit of creditors you must not without the authority of the Supreme Court practice the profession of the law and must make application to the Supreme Court, pursuant

to section 49 of the Legal Practitioners Act 1981, for authority to be able to continue to practice. Such application must be served on both the Law Society and the Legal Profession Conduct Commissioner. If authority is granted, it may be subject to conditions.

13. If you are a sole trader or in a partnership of individuals and believe the practice is likely to become insolvent, you should immediately take professional advice to minimise your exposure to civil and possibly criminal liabilities. Incorporated Legal Practices
14. The *Corporations Act 2001* (Cth) imposes *general* duties on company directors including:
 - (a) The duty to exercise your powers and duties with the care and diligence that a reasonable person would have which includes taking steps to ensure you are properly informed about the financial position of the company and ensuring the company doesn't trade if it's insolvent;
 - (b) The duty to exercise your powers and duties in good faith, in the best interests of the company and its creditors and for a proper purpose;
 - (c) The duty not to improperly use your position to gain an advantage for yourself or someone else, or to cause detriment to the company; and
 - (d) The duty not to improperly use information obtained through your position to gain an advantage for yourself or someone else, or to cause detriment to the company.
15. In addition to the above general directors' duties, there is also a duty not to trade while insolvent. Therefore, before incurring a new liability, a director must consider whether there are reasonable grounds to suspect that the company is insolvent or will become insolvent as a result of incurring the new liability.
16. A director must also take all reasonable steps to ensure that the company keeps adequate financial records to correctly record and explain transactions and the company's financial position and performance.
17. There are civil and criminal penalties for insolvent trading including fines up to \$220,000.00, imprisonment for up to 5 years, compensation proceedings for amounts lost by creditors which can result in the personal bankruptcy of directors and disqualification from continuing as a director or managing a company.
18. Pursuant to section 50(3) of the *Legal Practitioners Act 1981* (SA), the receiver, administrator or liquidator appointed on behalf of an incorporated legal practice may carry on the incorporated legal practice for up to 12 months or a longer period of time as allowed by the Supreme Court.

Personal Insolvency

19. Upon becoming bankrupt, the majority of the bankrupt's assets vest in the trustee. Debtors and WIP of a legal practice are assets that would vest in a trustee in bankruptcy. The trustee has the right to take control of and sell some of the bankrupt's

assets. In order to enable the trustee to effectively perform his/her role in the bankruptcy, the bankrupt must make full and continuing disclosure of his/her financial position.

- (a) The *Bankruptcy Act 1966* (Cth) imposes obligations and responsibilities on bankrupt individuals including, but not limited to the following: Notifying your trustee when your circumstances change such as your name, address, income, employment, purchasing or acquiring new assets, receiving an inheritance, tax refund, gift or any other asset, where you have forgotten to include debts or assets in your bankruptcy application etc.
 - (b) Requesting permission from your trustee to travel overseas, irrespective of the reason for the travel.
 - (c) Disclose your bankruptcy when applying for credit over a set amount or where you trade under a business name that doesn't include your name.
 - (d) Provide information to your trustee regarding your finances.
 - (e) Lodge your Statement of Affairs within 14 days of a notification of bankruptcy where you have been made bankrupt by a creditor.
20. The duration of a bankruptcy is normally three years and one day. However, if a bankrupt breaches any of his/her obligations and responsibilities, the trustee can extend the period of the bankruptcy. A bankrupt practitioner should therefore inform themselves of all their obligations and responsibilities to ensure compliance with same.
21. Pursuant to section 50(2) of the *Legal Practitioners Act 1981* (SA), the trustee in bankruptcy may carry on the bankrupt practitioner's legal practice for up to 12 months or a longer period of time as allowed by the Supreme Court.

Show Cause

22. Experiencing a Show Cause event - Part 3 Division 2B of the *Legal Practitioners Act 1981* (SA) relates to Show Cause Events. Section 5 of the *Legal Practitioners Act 1981* (SA) provides a detailed definition of what constitutes a show cause event for the purposes of Part 3 Division 2B which includes becoming bankrupt, being served with notice of a creditor's petition, and being convicted of a serious offence or a tax offence.
23. Where a practitioner experiences a personal bankruptcy, this part of the *Legal Practitioners Act 1981* (SA) will apply. The practitioner is not automatically suspended from practice on the happening of the bankruptcy but will need to prove to the Supreme Court that he/she is a fit and proper person to practise the profession of the law despite the bankruptcy.
24. In such cases the holder of the practicing certificate must, pursuant to section 20 AH of the *Legal Practitioners Act 1981*, provide notice of the Show Cause event to the Supreme Court within 7 days after happening of the event, and file a written

statement explaining the event within 28 days after the happening of the event.

25. In the event where an applicant for a practicing certificate experiences a show cause event the applicant must pursuant to section 20AG provide to the Supreme Court, as part of the application, a statement setting out particulars of the show cause event, explaining why, despite the show cause event, the applicant considers himself/herself, fit and proper to hold a practicing certificate.
26. If the Supreme Court considers, on application by the Attorney, the Society or the Commissioner that it is in the public interest to suspend a practicing certificate, it can be suspended pursuant to section 20AJ of the *Legal Practitioners Act 1981* (SA).
27. Where the practitioner's practicing certificate is suspended, he/she can make written representations to the Court, about the suspension. The Supreme Court may revoke the suspension at any time.
28. For further information about Show Cause Events, please see the article by Rosalind Burke, Director of Ethics & Practice, in the [April 2018 edition](#) of the Bulletin:

Unsatisfactory Professional Conduct or Professional Misconduct

29. Pursuant to section 70 of the *Legal Practitioners Act 1981* (SA), the conduct of a legal practitioner as or in becoming an insolvent under administration or conduct of a legal practitioner in becoming disqualified from managing or being involved in the management of any corporation under the *Corporations Act 2001* (Cth), is capable of constituting unsatisfactory professional conduct or professional misconduct.
30. Therefore, where a practitioner becomes insolvent, either personally or in the capacity of a legal practitioner director of an incorporated legal practice, the practitioner may be investigated by the Legal Professional Conduct Commissioner.

Tips for Good Practice

31. Do not ignore your obligations, especially your tax obligations to make sure that all personal tax, company tax, group tax and superannuation is paid up to date. If you are struggling, in particular to meet your tax and/or super obligations, it is best to make contact with the ATO directly or through your professional adviser as you may be able to negotiate a mutually acceptable payment plan to keep you on track to clear the arrears, while they are still manageable.
32. It is important to be aware of your financial obligations and have good practices in place to ensure you are complying with same. If you are not compliant with your financial obligations as a director, partner or sole trader, you may be subject to investigation for unsatisfactory professional conduct or professional misconduct, which, if found guilty, may affect your ability to continue to practise.
33. Prior to the establishment of a partnership, company, trust or any other structure or venture, practitioners should seek professional legal and accounting/financial advice to determine the best structure, the necessary documents and agreements required

before trading commences, the capital available to support the structure once trading commences, and to comprehensively understand the entirety of the practitioner's obligations under the proposed structure.

34. Foundation documents for an incorporated legal practice or partnership, such as a shareholders or unit-holders agreement or a partnership agreement, are vital. Practitioners who are the directors of an incorporated legal practice should have a written constitution as well as a written shareholder agreement. All loans to the practice should be documented and, in some circumstances, secured. Practitioners practising in a partnership should have a written partnership agreement which incorporates the applicable statutory liability, that being joint and several liability.
35. Sole traders must fully inform themselves as to their exposure to liability and take advice as to how they may be able to reduce their personal liability for the affairs of their law practice.
36. The constitution and shareholder agreement of an incorporated legal practice should include the various statutory obligations, including the obligation to have at least one legal practitioner director.
37. Where a practitioner is a director/partner of or has a personal interest in a business outside of the law practice, this should be disclosed to the principals of the law practice and advice should be sought, as this may present additional risk for the remaining directors/partners of the law practice.
38. Directors and Officers Insurance should be considered for tax liabilities, insolvent trading and other statutory liabilities not covered by other insurance policies with respect to an incorporated legal practice.
39. Practitioners who are directors of incorporated legal practices owe fiduciary duties to the clients and employees of the law practice as well as to the non-practitioner directors and shareholders and thus should fully inform themselves and keep all fellow directors and shareholders informed. The obligations are onerous and much more onerous than the duties owed by a non-practitioner directors or shareholders of an incorporated legal practice.
40. Legal practitioner directors can be jointly liable for any corporate offences with regards to the ATO, ACCC, ASIC and WHS obligations and liabilities and thus should fully inform themselves of these potential liabilities and take proper professional advice on how best to avoid or mitigate risk in these areas including managing risk with insurance referred to in paragraph 35 above.

Support

41. The Society understands that financial pressure can cause significant stress and concern for practitioners. There are support services available through Law Care, the Professional Advice Service and the Young Lawyers Support Group. If you need support or legal advice with respect to your financial affairs, you have the option to

contact our member support services co-ordinator, Annie MacRae, on 8229 0263 or by email at annie.macrae@lawsociety.sa.asn.au.

42. The [Australian Financial Security Authority](#) (AFSA) can also provide support, with more information available with respect to bankruptcy and formal creditor arrangements on their website.:

Resources

1. [ASIC's Regulatory Guide 217 – Duty to prevent insolvent trading: Guide for directors Updated August 2020](#)
2. [ASIC's Information Sheet 42 – Insolvency: A guide for directors Updated May 2023.](#)
3. ASIC's Regulatory Resources on Insolvency.
4. AFSA Publication - [Personal insolvency information booklet for debtors](#)
5. The Legal Services Commission's Law Handbook Online contains a [chapter on Bankruptcy](#)
6. For further information - <https://worrells.net.au/resources/guides-and-reports>

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