LAW PATH

Avoiding the wall

Insolvency can be dodged with planning but there are actions to be taken even when it looms

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Transport companies need to get smart to survive. There is no room for sloppiness. Stress factors in the industry include low barriers to entry, significant financing costs, locked-in contracts, poor strategy and poor financial controls.

Australian Securities and Investments Commission (ASIC) data and anecdotal cases back up these factors as causes of insolvency in the transport industry.

So, the message for transport and logistics managers is to avoid focusing too much on the legal test for insolvency, instead focus on warning signs that will show long before insolvency becomes a risk.

Smart transport companies must set themselves up right, avoid toxic clients and staff, carefully identify their margins and seek early advice on business support if they are to avoid insolvency.

WHAT TRANSPORT COMPANIES NEED TO AVOID

In this strange new Covid-19 world, the transport industry is going to play a vital role. In a country as large as Australia, trucking goods from town-to-town will always be an essential industry. Unfortunately, the transport industry as a whole has a relatively high level of business failure.

There is a certain archetype that insolvency lawyers often bump into at the head of a trucking company — hard-working blokes in their 40s and 50s, tired, frustrated, and in desperate need of a holiday. They have poured their heart and soul into what is, in reality, a low-margin business.

They have worked their backside off to keep others in paid employment, but often have very little to show for it themselves.

Let's examine why transport is such a tough gig: significant costs (including award wage levels and debt repayment), combined with intensive competition and poor management practices, can quickly get transport companies in hot water.

While some get ahead through dumb luck, for the rest, it is essential to act smarter, be more selective with tenders and follow a conservative growth model.

In this piece we look at:

- the nature of the transport industry in Australia
- the consequences of the standard operating model
- the legal test for insolvency versus the 'practical' test
- four steps that transport companies should take to avoid insolvency and eventual liquidation: Set yourself up for success, sack toxic clients and employees, work out your margins, and dodge the terminators at the door.

STRESS FACTORS

There are several different factors which together put a lot of financial pressure on trucking companies.

The transport industry has low barriers to entry. There is nothing stopping someone with the right licenses getting into the business. This, in turn, means significant competitive pressure.

High capital investment in vehicles is generally supported by debt – financiers offer relatively easy trucking finance.

Significant use of long-term contracts means that truckers are vulnerable to substantial cost fluctuation (e.g., fuel and tyres). If they do use a short-term contract they are also in a bind as they can't rely on and plan around those contracts;

Poor strategy and financial controls are also apparent. On start-up, the head of a trucking company tends to focus on just getting up and moving goods as quickly as possible. They don't want to faff about with legal and financial structures and carefully planning a growth strategy. But as we shall see, this comes with significant risk.

CONSEQUENCES OF THE OPERATING MODEL

For a while now, the transport industry has been identified as at relatively high risk of external administration (this covers liquidation and voluntary administration processes). For the past few years, the Australian Securities and Investments Commission (ASIC) has released *Insolvency Statistics: External*

Administrators' Reports identifying 'Transport, postal and warehousing' as the fifth-highest area in Australia for insolvencies. In the year ended June 30, 2019, this industry constituted around five per cent of insolvencies.

The ASIC reporting provides some interesting statistics on the significant causes of failure in businesses under external administration. Most significant was 'poor strategic management', which was a cause of failure in 48.5 per cent of all transport insolvencies. Other notable areas of failure were:

- poor financial controls
- failure to keep financial records
- inadequate cashflow.

Also notable were a relatively high number of criminal offences by officers as well as civil-law breaches for insolvent trading.

We can look to some high-profile trucking liquidation cases to drill down these causes in greater detail. In the Tim Fisher Transport (TFT) and Redstar Transport liquidation cases, the real pain point was identified as an ambitious growth strategy. In the case of TFT, areas identified included:

- unprofitable long-term contracts where rates remain unchanged for five years or more
- a flawed job-costing model where tenders did not reflect genuine costs
- high financing costs incurred through a rapid expansion of the fleet.

These factors led to a significant cash strain which was the eventual cause of insolvency.

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TEST FOR INSOLVENCY

Insolvency, as defined by Section 95A of the *Corporations Act 2001 (Cth)*, occurs when a business or an individual is unable to meet their debts as they become due and payable. As determined by the courts, there are two tests for insolvency:

- the cashflow test. This assesses the ability of a company to pay its debts (or sell its assets fast enough to pay its debts) as they become due and payable
- the balance sheet test. This assesses the solvency of a company in reference to the total external liabilities against the total value of company assets. If liabilities exceed assets, the company is insolvent.

We have already discussed the way in which the cost of transport assets, overly ambitious growth strategies and poor job costing can lead to cash shortages which breach the cashflow test. However, there is a risk in focusing too much on the legal tests when thinking about transport business failure.

The legal tests are all "lagging tests" rather than leading indicators. They really only tell us there is a problem after it has already happened. The real leading indicators are qualitative. We need to look at the following:

- personal issues affecting proprietors. Is depression or drug and alcohol addiction a factor?
- management issues relating to a lack of controls and records, meaning that managers lack up-to-date financial information
- client concentration. Companies that overly rely on a single client are highly vulnerable
- 'overtrading'. Some trucking businesses take on too many jobs and are then required to quickly invest in capacity which is too costly. This relates back to the issue identified

> *Transport companies need better accounting systems to determine where cash is going.*

earlier that transport companies do not always cost jobs robustly.

If a transport company wants to avoid some of the problems we have listed so far, we suggest taking the four broad steps outlined below.

STEP 1: Set yourself up for success

Even more than in the construction industry, transport companies need better accounting systems to determine where cash is going.

Accounting has been developed for over a thousand years – your spreadsheet isn't going to beat up-to-date accounts showing your creditors list and profit and loss.

Something that might help here is to outsource internal bookkeeping overseas – it can be difficult to get good bookkeepers in regional areas.

Others might include:

- optimal company structuring – consider how to best handle sizable capital investments. Expect a recession and set up a corporate structure that separates trading risk and title to key assets such as unencumbered trucks
- financing costs – take care before using high-interest financing as cashflow might not be enough to make the payments
- Support. Don't do it alone – look to team up with another person to grow the business. Ask yourself, don't you want to have holidays in your 40s and 50s?
- Arrange for money to be put into superannuation – even if you go bankrupt, it is still protected. This is the best vehicle for asset protection purposes.

STEP 2: Sack people and clients

Deals with toxic clients that are unprofitable and demanding need to be terminated. Margins are too thin for this kind of waste.

Toxic and unproductive employees should be let go. It's a slow process, but minimum staff contributions should be identified – what is the minimum job before termination that you need to ensure is met?

Employees that don't make the grade need to be performance-managed out of the company.

STEP 3: Work out your margin on jobs

Working out your minimum pricing for jobs is essential. Taking on no-profit jobs for volume is a giveaway and will wreck a business on thin margins.

Look at options for workplace flexibility – is it possible to reduce driver headcount during lean times? For example, during the coronavirus disaster, Qantas relied on a right under the *Fair Work Act* to 'stand down' employees without pay to save the company.

Proprietors need to step back from the frontline. You should spend more time talking to customers and managing staff, and less time driving.

Once you have worked out your margin, be selective with taking on clients – choose profit over growth every day.

Differentiate yourself from the competition – tell people regularly and loudly what you do better and why.

STEP 4: Avoid the liquidators at the door

If it appears as though insolvency might be approaching, transport companies need to consider alternatives to liquidation.

Voluntary administration may be essential if the business is chronically insolvent, but the research shows that a positive outcome is very unlikely.

An alternative to a voluntary administration is to seek pre-insolvency advice and look at the possibility of restructuring. Companies might consider whether 'safe harbour' provisions of the *Corporations Act 2001* could be used to legitimately restructure a struggling business.

This allows them to legally trade while they are insolvent if it could result in a better outcome than a fire-sale liquidation.

TAKEAWAYS

The transport industry is particularly susceptible to insolvency risk due to poor planning, poor controls and poor cost accounting which ultimately lead to cashflow issues.

Transport companies need to take a range of steps to mitigate that insolvency risk: Set themselves up right, ditch the toxic people, cost jobs properly and take steps early before liquidation becomes a real risk. **A**