

Insolvent Trading

Risks and benefits for liquidators, creditors and ASIC. What is a debt and when is it incurred for insolvent trading purposes?

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1. Introduction

It is an opportune time to revisit and review the law surrounding insolvent trading.

Last year saw some significant publicity concerning the insolvent trading provisions as John Elliott and directors of the Water Wheel companies were found to have breached the law.¹ The appeal case in those proceedings is being heard next week.

Early last year the Australian Securities & Investments Commission (**ASIC**) established a National Insolvency Co-ordination Unit to target directors involved with companies suspected of insolvent trading. According to ASIC:

Insolvent trading causes significant hardship to the business community, and imposes significant costs to the Australian economy through unpaid taxes, superannuation, and losses to legitimate business Directors and advisors must be held accountable for irresponsible corporate decision-making, and ASIC will ensure that directors of companies who fail to comply with the law are prosecuted.²

Federal funding of \$12.3 million over 4 years is being provided to ASIC for its National Insolvent Trading Program (**NITP**). ASIC's focus on insolvent trading and the NITP are considered further in section 18 of this paper.

ASIC's advice for the lawyers and accountants among us is also clear:

Proper accounting and legal advice can avoid many insolvencies, and ASIC urges accountants and lawyers to have a proactive role in advising their corporate clients.³

The insolvent trading provisions may again come under some high-profile consideration this year as the liquidators of One.Tel and HIH continue their deliberations on the actions they may take to recover monies for the benefit of creditors.

The liquidators of One.Tel are presently conducting at the Australian Federal Court an inquiry into the operations of the failed telecommunications company to consider among other possible actions insolvent trading. In July of this year proceedings brought by ASIC against 5 directors of One.Tel will be heard and the issue of solvency will certainly come to the fore.

In relation to HIH, it is not clear whether the liquidators will be pursuing actions for insolvent trading. Investigations in to the actions which are likely to be brought are continuing.

This paper outlines the law surrounding insolvent trading and seeks to highlight the risks and benefits for liquidators, creditors and ASIC. The central question of what is a debt and when is it incurred for insolvent trading purposes is also addressed.

¹ *Australian Securities & Investments Commission v Plymin & Others* [2003] VSC 123.

² *ASIC acts to prevent insolvent trading*, ASIC Media Release, 7 April 2003.

³ *ASIC acts to prevent insolvent trading*, ASIC Media Release, 7 April 2003.

2. Overview

One of the reasons for limited liability companies is to encourage entrepreneurial zeal rather than risk averse behaviour. When a company is insolvent it would appear that the consideration which outweighs entrepreneurial risk-taking is the protection of creditors. The fact that fear of personal liability may encourage directors to wind a company up rather than trying to salvage it by continuing to trade (which could in some cases ultimately benefit creditors and shareholders) is not considered to be relevant. The insolvent trading provisions are aimed more at ensuring that directors do not abuse the privilege of limited liability.

In order for the duty to prevent insolvent trading to be imposed, a number of elements of liability must be fulfilled under s588G of the *Corporations Act 2001* (Cth) (the **Act**):

- (a) the person must be a director at the time the relevant company incurred a debt;
- (b) the company must be insolvent at the time the debt is incurred, or become insolvent by incurring that debt;
- (c) at the time the debt was incurred there must have been reasonable grounds to suspect that the company was insolvent or may become so by incurring the debt; and
- (d) the director was aware that there were reasonable grounds to suspect insolvency, or a reasonable person would have been so aware.

3. To Which Companies Does Section 588G Apply?

The duty under section 588G(1)(b) to prevent a company incurring a debt arises only if the company is insolvent when the debt is incurred, becomes insolvent by incurring that debt, or by incurring debts at that time including that debt. This limits the operation of section 588G to companies who have failed financially or who are at least under the threat of such failure.

In contrast to the position under the old insolvent trading provisions (section 592 of the *Corporations Law*), the duty in section 588G is not limited to companies which have entered or which subsequently enter external administration. Whilst section 588G can apply to companies under external administration, it can also apply to companies which never enter it and to those which do not enter external administration but are subsequently restored to solvency.

Although it is possible for section 588G to apply to companies in a form of external administration other than liquidation, such as a deed of company arrangement under Part 5.3A, in practice this will prove difficult. Due to the standing rights reserved for liquidators under the insolvent trading provisions, unless ASIC brought a claim or the Minister authorised it, a claim would only be brought against a director under these provisions after the commencement of winding up of the company. Accordingly, where it is intended to prosecute a director under section 588G creditors will often choose to place the company into liquidation.

Section 588G also applies to companies that enter external administration but which are subsequently restored to solvency. For example, a company that enters voluntary administration but enters into a deed of company arrangement under Part 5.3A may be restored to solvency. However, in the absence of any loss or damage sustained by the company or a creditor such proceedings would appear practically remote.

4. The Elements and Proof of Insolvency

4.1 What is Insolvency?

An issue which arises before there can be a consideration of the circumstances in which there may be grounds to suspect insolvency is the definition of insolvency itself. The definition of insolvency is central to the operation of the insolvent trading provisions. Liability is not triggered under the insolvent trading provisions unless the company was insolvent at the time the particular debt was incurred, or became insolvent by incurring that debt.

The Act defines a person which is not *solvent* as being insolvent (s95A(2)). The term person in this context includes a body corporate. The enquiry which should be made under the section to ascertain whether a company is insolvent is as follows: *Is the company able to pay all of its debts as and when they become due and payable?* To answer this question it may be necessary to consider the following:

- (a) cash reserves expected to be available at the time when debts become due;
- (b) adequacy of working capital/cash flow;
- (c) available (and reliable) sources of funding;
- (d) the company's ability to borrow;
- (e) times and dates for payment;
- (f) reliability of promises which have been made by creditors to pay; and
- (g) assets available for realisation and the value they will realise (and whether this would involve the company in a voidable transaction or preference).

Justice Emmett in *Quick v Stoland* (1998) 157 ALR 615 at 622 set out four factors which should be taken into account. They are as follows:

- (a) all of the company's debts as at the time in order to determine when those debts were due and payable;
- (b) all of the assets of the company as at the time in order to determine the extent to which those assets are liquid or are realisable within a time frame that would allow each of the debts to be paid as and when they become payable;
- (c) the company's business as at the time in order to determine its expected net cash flow from business by deducting from projected future sales the cash expenses which would be necessary to generate those sales; and
- (d) arrangements between the company and prospective lenders such as its bankers and shareholders in order to determine whether any shortfall in liquid and

realisable assets and cash flow could be made up by borrowings which would be repayable at a later time than the debts.

In the same case, Justice Finkelstein stated:

The inquiry whether there are reasonable grounds to expect the company will not be able to pay its debts when due is a factual one to be decided in the light of all the circumstances of the case. It is to be decided as a matter of commercial reality and thus requires a consideration of the company's financial condition in its entirety, including its activities, assets, liabilities, cash, money that it could procure by sale of assets or by way of loan and its ability to raise capital.

Clearly, the definition in section 95A suggests that in most instances a cash flow test is intended rather than a simple balance of assets over liabilities.

4.2 Rebuttable Presumptions of Insolvency

Two rebuttable presumptions of insolvency are contained in the Act. These are contained in section 588E. The presumptions operate in relation to civil recovery proceedings and are not applicable for the purposes of criminal prosecution.

The presumptions are appropriate because they can be rebutted and they apply to directors who should stay involved with the financial affairs of the company and thus have access to the means of rebuttal.

Accordingly, the statutory definition of insolvency contained in section 95A will only be relied upon where the statutory presumptions of insolvency in subsection 588E(3) and subsection 588E(4) are unable to be relied upon or are able to be rebutted.

(a) **Presumption as to Continuing Insolvency Upon Proof of Insolvency at a Specific Date**

Under section 588E(3) where it is proved that a company which is being wound up was insolvent at a particular time during the 12 months prior to the relation-back day (most often the date an application to wind up the company is filed or an administrator was appointed), it is presumed that the company was insolvent from that time until the relation-back day.

(b) **Presumption of Insolvency based on Insufficient Accounting Records**

Under section 588E(4) where it is proved that the company failed to keep proper accounting records which correctly explain and record its transactions and financial position, or has failed to keep them for 7 years after the completion of the transaction to which they relate, it is presumed that the company was insolvent during that period.

This presumption does not arise where the failure to maintain accounting records was minor or technical. It also does not arise where the accounting records have been removed, destroyed or concealed by a person other than the defendant director and the defendant director was not implicated in those activities.

4.3 Indicators of Insolvency

According to ASIC, the following are key operational and financial practices, which, in combination with other practices, indicate that a company is at significant risk of insolvency⁴:

- poor cash flow, or no cash flow forecasts;
- disorganised internal accounting procedures;
- incomplete financial records;
- absence of budgets and corporate plans;
- continued loss making activity;
- accumulating debt and excess liabilities over assets;
- default on loan or interest payments;
- increased monitoring and/or involvement of financier;
- outstanding creditors of more than 90 days;
- instalment arrangements entered into to repay trade creditors;
- judgement debts;
- significant unpaid tax and superannuation liabilities;
- difficulties in obtaining finance;
- difficulties in realising current assets (eg stock, debtors);
- loss of key management personnel.

5. To Whom Do the Duties Apply?

The law imposes a wide range of duties and responsibilities on directors and other officers. However, the law on “who can be considered a director” is far from settled.

The definition of “director” within section 9 of the Act has a wide ambit. Included within the definition are people:

- (a) who act in the position of a director, by whatever name called and whether or not validly appointed (***de facto director***); and
- (b) whose instructions or wishes the directors of the corporation are accustomed to act in accordance with (***shadow director***).

Persons acting in a professional capacity or business relationship are exempted from the operation of these provisions provided they are merely giving advice to the directors.

⁴ ASIC's National Insolvent Trading Program, ASIC Information Sheet available at www.asic.gov.au

5.1 De Facto Directors

Section 9 includes de facto directors within the definition of a “director”. A person may be a de facto director even if they are generally engaged in the affairs of the company, rather than performing specific functions.⁵ De facto directors are subject to the same duties and liabilities as directors properly appointed, including the duty to prevent insolvent trading.⁶

In the case of *Deputy Commissioner of Taxation v Austin* (1998) 16 ACLC 1555 the Court considered the concept of de facto directorships. Mr Austin and his wife were friends with another couple. The two wives ran a restaurant business. The company in question was a \$2 company incorporated to incur debts for the supply of goods and services for the restaurant and the wages of the employees. Mr Austin was appointed as a director of the company for 3 months to assist at a time when the families were experiencing personal problems. Mr Austin then sought to resign his directorship and his accountant prepared documents to this effect. These documents were never lodged with ASIC. Following his purported resignation, Mr Austin undertook numerous negotiations with the Deputy Commissioner of Taxation (**DCT**) for the payment of outstanding group tax and penalties, countersigned company cheques in favour of the DCT, issued stop notices to the company’s bank and negotiated with other creditors.

The Court decided that Mr Austin was a de facto director of the company. In such a small company it was likely that Mr Austin was exercising top management functions. Despite his purported resignation, Mr Austin had practical direction and effective control of the company.

5.2 Shadow Directors

Section 9 includes shadow directors within the definition of “director”. This seeks to situate the true source of decision-making within the corporation and to hold persons responsible for the consequences of their decisions (see *Australian Securities Commission v AS Nominees Ltd* (1995) 13 ACLC 1822). Shadow directors are also subject to the same duties and liabilities as directors properly appointed, including the duty to prevent insolvent trading.

Each element of the definition of a “shadow director” must be examined in order to determine the extent of those included within the definition.

(a) Person

Under section 221(3) only an individual can be a validly appointed as a director. Despite this, the extended definition of “director” in section 9 means that a corporation can be a “director” for the purposes of section 9 even though they cannot be “appointed” as such. This is supported by the line of cases which have found a holding company to be a director of its subsidiary.

(b) Instructions or Wishes

⁵ *Mistmorn Pty Ltd (in liq) v Yasseen* (1996) 14 ACLC 1387.

⁶ *Corporate Affairs Commission v Drysdale* (1978) 141 CLR 236.

“Instructions and wishes” can be distinguished from “advice”. Whereas “advice” is merely an opinion and is not ordered as a course of action a party is required or compelled to follow “directions or instructions”.

In this sense, “instructions and wishes” involve no element of choice on the part of those being instructed and suggests the absence of available alternatives.

A single instruction or wish is unlikely to satisfy section 9 as its requirements suggests “instructions or wishes”, the plural suggesting a number of acts. In addition, a single act is unlikely to result in the directors becoming “accustomed to act” upon it, although it is arguable that a single instruction or wish of fundamental importance that results in an action repeatedly being taken by the corporation may fulfil this requirement.

It is unclear whether the instructions or wishes must be given to the board of directors as a whole or merely to a particular board member. This may be a crucial issue in determining whether the directors are accustomed to act in accordance with the instructions or wishes. Arguably, section 9 implicitly requires the instructions or wishes to be given to the board as a whole. However, it is arguable that if a person gives instructions or wishes to a dominant managing director or nominee director, and the board is accustomed to act in accordance with their instructions, then from a policy perspective the person is effectively contributing a vital element of decision-making in the corporation’s affairs. In this way they should arguably be subject to the same duties and liabilities as directors.

(c) Directors of the body

Whether or not all of the board members, or merely a majority of board members, must be accustomed to act in accordance with a person’s instructions or wishes is far from clear.

Although there has been some commentary supporting the need for *all* directors to be accustomed the case of *Re Lo-Line Electric Motors Ltd* [1988] BCLC 698 suggested that “the board” must act in accordance with the instructions. This implies the requirement of a simply majority of directors to be so accustomed.

The decision in *Kuwait Asia Bank v National Mutual* [1990] 3 All ER 404 indicated that a minority of directors accustomed to act in accordance with a person’s instructions or wishes will be insufficient to form a shadow directorship.

Since decisions made by the board are made by a majority of directors, the preferable position would be to simply require a majority of directors to be accustomed to act in accordance with the person’s instructions or wishes. To require *all* board members to be so accustomed may provide a considerable loophole in the law.

(d) Accustomed to Act

This element is intended to cover those persons with effective control of a corporation, making decisions that the directors of the corporation simply follow without independent thought, analysis or discretion. It suggests some sort of

ongoing control or interference in internal affairs. As stated by Millet J in *Re Hydrodam (Corby) Ltd*:

What is needed is . . . a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the direction of others. ([1994] 2 BCLC 180 at 183)

For a director to be “accustomed” to act in accordance with a person’s instructions or wishes, it is not necessary for the director to follow *every* direction or instruction received. The term “accustomed” suggests that the director must generally accept the instructions of the person. In other words it is arguable that the director must customarily accept and act upon the person’s instructions or wishes without independent analysis.

(e) Professional Capacity or Business Relationship Exemption

The definition of director is designed to encompass all those who have a decision-making role within the corporation. It is not intended to cover those who merely offer advice or suggestions on particular issues. For this reason, section 9 provides that a person will not fall within the definition of “director” merely because the directors or members of the board are accustomed to act on *advice* given by that person in their professional capacity or as a result of a business relationship with the directors, members of the board, or the body. Accordingly, an exemption is provided to *advisers*.

It is conceivable that advice given in a professional capacity or business relationship may in fact lead to instructions or wishes. The danger in this possible overlap between professional or business advice on the one hand and instructions and wishes on the other bears great relevance to financial institutions with insolvent corporate clients, holding companies with insolvent subsidiaries, and “company doctors” or accountants or lawyers with insolvency expertise.

5.3 Risks for Company Doctors, Banks and Other Financial Institutions Participating in Informal Work-Outs

There have been no cases where a financial institution has been held to be a shadow director to date. However, in times of economic difficulty, financial institutions will be keen to become actively involved in the internal affairs of its corporate clients facing insolvency. If the degree of this involvement is to the extent that the financial institution is making decisions for the corporate client, the risk is run that the financial institution will be considered a shadow director. Banks and other financial institutions exercising management discretion in important strategic issues may be caught by the definition of “director”. Although no financial institutions have been held de facto or shadow directors within Australia to date, in the absence of an “arm’s length” relationship, it is possible that such a relationship will be found by the courts.

“Company doctors” or accountants or lawyers with insolvency expertise often undertake a review of a corporation’s financial affairs and operations to aid the recovery of failing businesses at the request of creditors. Company doctors also run the risk of becoming a shadow director if they assume effective decision-making power and control of the

corporation's affairs when assisting the financial recovery. An example of this overlap between advice on the one hand and directions and instructions on the other is provided by *Re Tasbian (No.3)* [1992] BCC 358. Briefly, in this case a chartered accountant was appointed to an ailing retail business (*Tasbian*) by a finance company (*Castle*). As *Tasbian* had never traded at a profit, the accountant was appointed to get the company "on track" and producing a profit, which he was ultimately unable to achieve. However, during his appointment, the accountant had taken over effective control of *Tasbian* as he had required all *Tasbian* cheques to be countersigned by himself, had bargained with external entities on *Tasbian*'s behalf, negotiated an informal moratorium with *Tasbian*'s trade creditors and so on. In this way, he was not merely providing advice but was exercising decision-making powers and control on behalf of *Tasbian* and was thus a de facto director of *Tasbian*. In addition, the accountant had acted beyond his professional expertise by engaging in nefarious conduct through a tax avoidance scheme designed for *Tasbian*. This unprofessional conduct indicated that he was not covered by the "professional" advice exemption. As a result, the accountant was held to be a "director" of *Tasbian* and subject to disqualification and other sanctions.

Clearly, the distinction between advice and instructions and wishes is important to maintain to receive protection under section 9. The wide definition of "director" may threaten those involved in "workouts" or other forms of financial management.

5.4 Holding Companies as Shadow Directors

In addition to the insolvent trading provisions imposing liability on holding companies for the debts of their insolvent subsidiaries, holding companies with subsidiaries face the possibility of being found to be a shadow director of their subsidiaries. This possibility will be of particular concern to holding companies with subsidiaries in financial difficulty. Once again, in times of economic difficulty a holding company is likely to exercise management discretion and general decision-making powers in relation to the affairs of its subsidiary. If the board of the subsidiary simply accepts these decisions without independent analysis, the holding company is likely to be a shadow director within the terms of section 9.

This particular area will be given further consideration in a later presentation within the 2004 Corporate Insolvency & Restructuring Forums.

6. What is a Debt and When is One Incurred?

To bring an action for insolvent trading, it must be shown that a company has in fact incurred a debt. It is also necessary to determine the exact time when this debt was incurred.

The time of incurring the debt is important because it is at this time that the state of mind of the director must be assessed. The director's belief about the company's ability to pay its debts as and when they fall due is determined at the time of incurring the particular debt. If at the time the debt was incurred there were reasonable grounds to suspect that the company would not be able to pay its debts as and when they fell due, the director would be liable under the insolvent trading provisions.

There is no definition of “debt” within the Act. There is no “quick and fast” rule of what constitutes a debt as its meaning varies according to the type of transaction in question. Generally, a company incurs a debt when by its choice, it does or omits to do something which, as a matter of substance and commercial reality, renders it liable for a debt for which it otherwise would not have been liable.⁷

“Debt” has been interpreted to bear its ordinary technical meaning as something recoverable by an action for debt and thus must be ascertained or capable of being ascertained.⁸ Therefore, a “debt” signifies an obligation for the payment of money or money’s worth. Many authorities suggest that the obligation must be for an ascertained liquidated sum.⁹

The terms “incurs” and “debt” are words of flexible meaning. Their meaning changes in accordance with the context in which they are used. The words “incurs” and “debts” are not words of precise and inflexible denotation. Where they appear they are to be applied in a practical and commonsense fashion, consistent with the context and with the statutory purposes.¹⁰

The statutory purpose of the definition of “debt” is to encourage directors to focus on the overall management of their company’s financial affairs. In this sense, the central focus of the definition is to achieve an appropriate level of vigilance by directors for the overall financial affairs of their company. For this reason, what constitutes a “debt” has broad economic and social policy implications. Clearly, the meaning of “debt” in any situation requires a flexible consideration from the point of view of commercial reality.

At a fundamental level, the company must commit a positive act to bring a debt into existence. In this sense a debt can only be incurred by a positive, voluntary act that signifies the company’s willingness and intention to be bound. Its ordinary use implies that it is an obligation actually incurred.¹¹

6.1 General Checklist – Has a Debt Been Incurred?

The following general checklist may assist in determining whether or not a debt has been incurred:

- Is the transaction for an ascertained sum of money?
- Has the company committed a positive act to bring the "debt" into existence?
- Does this positive act indicate the company's intention to be bound by the act or transaction?
- Does the company have a choice to do (or omit to do) the act?
- Is it the act (or omission) that renders the company liable for the debt?

⁷ *Standard Chartered Bank v Antico* (1995) 131 ALR1.

⁸ *Ogden’s Ltd v Weinberg* (1906) 95 LT 567 per Lord Davey. See also *Hussein v Good* (1990) 8 ACLC 390.

⁹ *3M Australia Pty Ltd v Watt* (1984) 9 ACLR 203. See also *Jelin v Johnson* (1987) 5 ACLC 463.

¹⁰ *Hawkins v Bank of China* (1992) 10 ACLC 588.

¹¹ *Hawkins v Bank of China*.

- Would the company have been liable for the debt in any event?

We now consider a number of forms of debt and outline when they are incurred for the purposes of insolvent trading considerations.

6.2 Dividends and Share Capital

Section 588G(1A) incorporates a table which clearly sets out when debts of this nature are incurred.

Action of company	When debt is incurred
Paying a dividend	When the dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared.
Making a reduction of share capital to which Division 1 of Part 2J.1 applies (other than a reduction that consists only of the cancellation of a share or shares for no consideration).	When the reduction takes effect.
Buying back shares (even if the consideration is not a sum certain in money).	When the buy-back agreement is entered into.
Redeeming redeemable preference shares that are redeemable at its option.	When the company exercises the option.
Issuing redeemable preference shares that are redeemable otherwise than at its option.	When the shares are issued.
Financially assisting a person to acquire shares (or units of shares) in itself or a holding company.	When the agreement to provide the assistance is entered into or, if there is no agreement, when the assistance is provided.

The table also deals with uncommercial transactions.

6.3 Uncommercial Transactions

A company incurs a debt for the purposes of the insolvent trading provisions when it enters into an “uncommercial transaction” (as defined under the voidable transaction provisions). Broadly speaking, an uncommercial transaction is one that a reasonable person in the company’s circumstances would not have entered into having regard to the benefits and detriments to the company of entering into the transaction and respective benefits to other parties to the transaction. The liability of directors for insolvent trading therefore extends to circumstances where the company has not actually incurred a debt at the relevant time but entered into an “uncommercial transaction”.

6.4 Leases

In *Russell Halpern Nominees Pty Ltd v Martin* ((1986) 4 ACLC 393), which was decided under the old section 556, the Court emphasised that a positive act must be committed in order to bring a debt into existence.

A lease represents a continuing or serial obligation. The only act that satisfies the “positive act” requirement in the context of a lease is the initial entering into of the contract of lease. Therefore, a company incurs a debt when they first enter into a contract of lease. The company does not incur a debt each and every time rent becomes payable under the lease because there is no positive act on the part of the company on these occasions. According to Burt CJ it would be unacceptable to decide otherwise:

To hold otherwise would be to say that if a company when in all respects financially sound were to enter into a lease for a term of years and at some time thereafter and for reasons which could not be anticipated it were to fall on bad times and be unable to pay its debts, the directors would thereafter and on every rent day within the remainder of the term be guilty of an offence for the reason that on the rent day the company incurs a debt.

Where there is a periodic tenancy or a holding over after expiry of a term, it has been suggested that it is the failure of the tenant company to take steps to terminate the lease at the end of each period which would incur the debt for rent.¹²

6.5 Workers’ Compensation Insurance and Other Features of Contracts of Employment

The company usually pays workers’ compensation insurance at the time of entering into the contract of employment with an employee. This initial contract of employment could be seen as a positive act by the company. In *State Government Insurance Corporation v Pollock* (1993) 11 ACLC 839 Seaman J held that a premium for workers’ compensation insurance is a debt, incurred at the time the insurance contract is entered into.

Following this line of reasoning, it is likely that salaries, wages and other incidents of the employment contract are debts incurred by the company at the time of entering into the initial contract of employment rather than on each and every pay day. Other incidents of the contract of employment may include liability for redundancy or retrenchment payment and obligations in relation to long service leave and holiday pay.

6.6 Interest and Financing

The key case which determined whether or not an agreement to pay interest constitutes a debt is *John Graham Reprographics Pty Ltd v Steffens* (1987) 5ACLC 904. In this case, Connolly J regarded the situation before him as resembling that in the *Russell Halpern* case and following the reasoning in that case. Thus, interest incurred under an agreement to pay interest is a debt incurred at the time of entering into the initial contract. In this way, failure to pay interest does not, of itself, constitute the incurrence of an independent debt.

The position is somewhat different in relation to bill financing. In contrast to the decision in *John Graham Reprographics*, the case of *Standard Chartered Bank v Antico* has decided that interest on a principal debt may be considered an independent “debt” in relation to bill

¹² *Standard Chartered Bank v Antico*.

financing. According to Hodgson J, where a loan is for a fixed term the borrower incurs interest for the term of the loan as a debt:

- (i) when the loan agreement was entered into, when early repayment of the principal is not a realistic option for the borrower; or
- (ii) from day-to-day, when early repayment is a realistic option for the borrower.

However, where the loan is not for a fixed term, or the fixed term has expired, the borrower incurs interest as a debt:

- (i) when the loan was entered into, when repayment is not a real option for the borrower; or
- (ii) from day to day, when repayment is a real option for the borrower.

Where re-financing occurs, and the borrower enters into a new agreement to pay interest on a loan that is due or overdue for repayment, the borrower incurs interest as a debt:

- (i) when the new loan agreement is entered into; or
- (ii) when the original loan agreement was entered into, when the borrower is unable to repay the existing loan and the new loan agreement is in substance merely an extension of time for repayment of the principal.

This clearly establishes that re-financing does amount to incurring a debt under the insolvent trading provisions where there is an entry into a new agreement that is not a mere extension of the existing finance facility. In order for a new independent debt to be created as a result of re-financing, the new loan agreement must be different in substance from the existing loan agreement.

In general terms, the more of an option repayment is, the stronger is the case for saying that the debt for interest is incurred by entering into the new agreement. Similarly, the more different the new agreement is from the original agreement, the stronger is the case for saying that the liability for interest under the new agreement is not the same liability as it would otherwise have been.¹³

It is not clear when repayment will be a “real option” for the borrower, but the court is likely to look at the financial affairs of the company and the assets and funds available to it to repay the loan. What is clear is that at the time of re-financing, directors must turn their mind to the financial position of the company and examine its ability to repay the interest in the principal.

6.7 Guarantees and Other Contingent Liabilities

Guarantees and other contingent liabilities are considered “debts” for the purposes of the insolvent trading provisions. In the case of a guarantee, whilst the liability of a guarantor arises at the time of entry into the contract, the primary debt does not arise until the primary

¹³ *Standard Chartered Bank v Antico*.

debtor defaults. However, the Court has held that a debt is incurred at the time of entry into the guarantee.¹⁴

6.8 GST

There is little authority dealing with the goods and services tax in an insolvent trading context.

However in practice, GST is a debt which is incurred at the time of sale of a good or service.

According to the reasoning and decision in *Commissioner of Taxation (WA) v Pollock* (1993) 11 ACLC 16, a debt is "that which is owed or due' anything which one person is under an obligation to pay or render to another". On this basis, GST is a debt for insolvent trading purposes.

Similarly, in the case of *Powell v Fryer*¹⁵ held that sales tax was a debt for the purposes of the insolvent trading provisions.

6.9 Payroll Tax

When a company employs an employee, the employer becomes liable to pay payroll tax under the *Payroll Tax Assessment Act 1941* (Cth). Payroll tax becomes owing when it is ascertainable, and this is usually the end of each month. The Court has held that payroll tax only becomes a "debt" upon the expiry of the month in which it was incurred but remains a contingent liability until that time.¹⁶

It should also be noted that a company's liability to remit PAYE deductions deducted from employee's salaries is a debt and is incurred when the deduction was made.

6.10 Penalties

It is not clear whether a penalty is debt for the purpose of the insolvent trading provisions.

Under the approach of Hodgson J in *Standard Chartered Bank v Antico* a penalty would not be a debt as there is no positive act to bring it into existence. However the approach of Prior J in *Powell v Fryer* suggests that the Courts may consider penalties for the failure to pay taxes or other obligations imposed by law as a "debt".

6.11 Judgment Debt

A debt requires an ascertained or liquidated sum. In *Jelin Pty Ltd v Johnson* (1987) 5 ACLC 483 the Court held that damages could not be a debt because there was no ascertained sum at the time the action arose. In addition, there is no act on the part of a company that can be considered as the requisite positive act.

¹⁴ *Hawkins v Bank of China*.

¹⁵ Unreported, Sup Ct, SA, Prior J, 14 April 2000.

¹⁶ *Commissioner of State Taxation (WA) v Pollock*.

6.12 Supply of Goods

There is no hard and fast rule that a company incurs the debt for goods sold and delivered at the time when the goods are delivered to the company, and not at any earlier time.¹⁷

The terms of trade, the nature of the goods, and their marketability will be considered.

The act or omission may be the order itself or the acceptance of delivery of the goods, depending on the facts of the case. If the goods are readily saleable by the vendor, it is more likely that the debt is incurred by the acceptance of delivery. On the other hand, if the goods are not readily saleable to another purchaser, it is more likely that the debt is incurred at the time of placing the order for the goods.¹⁸

7. Failure to Prevent the Company Incurring a Debt – Reasonable Grounds to Suspect and Awareness

For liability under section 588 to arise it must be proved that:

- (a) there were reasonable grounds for suspecting that the company was insolvent or would become insolvent (588G(1)(c)); and
- (b) either that:
 - (iii) the director was aware at the time that there were such grounds (588G(2)(a)); or
 - (iv) a reasonable person in a like position in a company in the company's position would have been so aware (588G(2)(b)).

This element of liability raises two main issues:

- (a) the degree of apprehension or anticipation of insolvency which will go to make up a suspicion of insolvency; and
- (b) the standard imposed for there to be reasonable grounds for that suspicion.

7.1 Suspicion

Section 588G's predecessors, section 592 and section 556, required that a director have reasonable grounds to *expect* insolvency which contrasts with the present requirement that a director have reasonable grounds to *suspect* insolvency. Some guidance as to the new standard of "suspicion" can be gleaned from the authorities concerned with the previous legislation. Foster J in *3M Australia Pty Limited v Kemish* (1986) 4 ACLC 185, one of the authorities dealing with the previous legislation, in exploring what was meant to *expect* said:

The word "expect" must be accorded due significance. The passages already cited established that "expectation...goes beyond a mere hope or possibility". Of course, "expecting" is very different from "suspecting" ... It is, in effect, synonymous with "predicting"

¹⁷ *Leigh-Mardon Pty Ltd v Wawn* (1995) 17 ACSR 741.

¹⁸ *Leigh-Mardon v Wawn*.

to suspect that something will happen. It requires a lower degree of apprehension or anticipation than is associated with an expectation that the same thing will happen.

In *Commonwealth Bank of Australia v Friedrich & Ors* (1991) 9 ACLC 946 there is a clear statement by Tadgell J that “evidence of a director’s mere suspicion will not afford evidence of his expectation”.

Evidence of a mere suspicion would now be enough to establish liability. Apart from being a lower level of apprehension than an expectation what exactly does a suspicion require? Justice Kitto in *Queensland Bacon Pty Limited v Rees* (1966) 115 CLR at 303 described a suspicion as:

More than a mere idle wondering whether [something] exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to a slight opinion, but without sufficient evidence.

This is one of the important differences between the present insolvency provisions and those they replaced. It was brought about as the result of a recommendation made by the Harmer Report. The lowering the degree of apprehension or awareness of the reasonable grounds on which insolvency could be based was aimed at widening the range of the insolvent trading provisions and bringing directors’ duties with respect to insolvent trading into line with other duties imposed on directors such as the duty of care and diligence. The message is clearly that directors take responsibility for the financial management of the company.

7.2 Reasonable Grounds

(a) The standard is objective

Whether there are reasonable grounds for suspecting insolvency is determined according to an objective test. An individual’s director’s subjective awareness of the company’s state of solvency is not relevant.

The application of this test was considered in *Metropolitan Fire Systems Pty Limited v Miller* (1997) 23 ACSR 699. In this case, Metropolitan Fire Systems Pty Limited (**Metropolitan**) was owed approximately \$50,000 by Raydar Electrics Pty Limited (**Raydar**). In December 1993 Raydar contracted with another company, Reed, for Metropolitan to subcontract with Reed. In February 1994 assurances were provided by one of the directors of Raydar, Mr Miller, to Metropolitan that it would be paid because Raydar expected payment from Reed. At the time when the assurance was given, Raydar was in debt to another company which had applied to the Supreme Court in late 1993 for Raydar to be wound up.

Justice Einfeld had little trouble reaching the conclusion that when Raydar incurred the debt to Metropolitan it was insolvent.

The judge went on to find that at the same date, reasonable grounds existed on which to base the suspicion within the meaning of s588G that Raydar was insolvent. Even though Raydar was owed substantial amounts of money there was clear evidence that this money would not be available in the near future. There was evidence that the number of employees had been reduced from 14 in June 1993 to 4 or 5 in December 1993 and that neither Mr Miller the director nor his wife

had drawn wages for a period of some weeks. Raydar had also not made any instalment payments towards its tax liability. At this point having considered the authorities, Justice Einfeld found that the test “is one of objectively reasonable grounds which must be judged by the standard appropriate to a director of ordinary competence”. The state of a director’s knowledge and participation in incurring the relevant debt are not taken into consideration when establishing whether this element of liability exists. These factual matters relevant to a particular director may be relevant to establish a defence.

The standard is that of a reasonably competent director which is a highly objective test. At least one authority has suggested that you can fix that reasonably competent director with the state of knowledge of the director in question.¹⁹ This statement of the test which imports a subjective element was subsequently rejected by Tadjell J in *Commonwealth Bank of Australia v Friedrich* who found that there was no basis for importing a reference to the director’s state of knowledge.

Justice Tadjell also gave some guidance as to what is to be expected of a reasonably competent director. With commerce becoming increasingly complex and with people committing large sums of money by way of equity capital or loan to companies, a reasonably competent director would be one who:

- (i) keeps abreast of the company’s affairs, sufficiently abreast of them to act appropriately if reasonable grounds exist to expect insolvency (NB. this would now be to *suspect* insolvency);
 - (ii) is capable of understanding the company’s affairs to the extent of reaching a reasonably informed opinion of its financial capacity.
- (b) The standard requires there to be a continual monitoring of the company’s financial situation

In *Quick v Stoland* the company incurred debts to Stoland Pty Limited between 1 June 1992 and 31 August 1993. The issue in the case was whether there were reasonable grounds to expect that the company was insolvent between those dates. The evidence which the Court took into account consisted of a set of company accounts and the company’s correspondence. These were also considered in an expert auditor’s report.

The accounts disclosed that as at February 1992 the company had a deficiency of assets and a deficiency of working capital. By 30 June 1992 the company had a small surplus of net assets and a surplus of working capital. By 30 June 1993 the company had a very large deficiency of assets and a large deficiency of working capital. The Court rejected the expert auditor’s report that stated that the company had been insolvent as at all three dates but found that the company had been insolvent as at 30 June 1993.

¹⁹ *Heide Pty Limited t/as Farmhouse Smallgoods v Lester* (1990) 3 ACSR 159.

Three pieces of correspondence were also considered to be significant. The first piece of correspondence was a letter of January 1993 in which the company offered to transfer a bobcat in partial discharge of a debt due to a creditor. The letter stated that the company would be unable to pay its debt otherwise than by delivering the bobcat. The second piece of correspondence was a letter from the company to one of its creditors dated 3 June 1993 which advised creditor that the company was unable to pay an outstanding account of \$242,000. The final piece of correspondence was a letter dated 13 July 1993 to the ANZ Bank which stated that the company could only continue its operations with the assistance of the Bank's overdraft facility. The Full Court found that in light of the letter of January 1993 the company was not able to meet its outstanding obligations at least by 14 January 1993.

The Federal Court's decision in *Quick v Stoland* demonstrates the continual monitoring process which it will be necessary for a director to undertake in order to keep abreast of the company's financial affairs so that if action is required it can be taken as and when required. Whether reasonable grounds to suspect insolvency exists should not be an annual query but rather one that is performed on a more regular basis.

Another case which highlights the need for directors to be monitoring the financial situation of a company on a month by month basis (or even more often) is *Lee Kong & Ors v Pilkington (Australia) Limited* (1997) 25 ACSR 103. With the trial judge having found in favour of a creditor and holding the directors of a company called Bulk Glass Australia Pty Limited personally liable for certain debts of the company, the directors appealed to a Court comprised of three judges of the Supreme Court of Western Australia. The first ground of appeal was that the trial judge had erred by analysing the financial data in a way that the directors could not reasonably have been expected to at the time. It was submitted that the trial judge had analysed the facts with the benefit of hindsight and did not consider the position of the directors at the time. Secondly, it was claimed that the trial judge had applied a higher standard of analysis than was reasonable in the circumstances.

The Full Court found that the trial judge did not make undue use of hindsight. The Court pointed out that the trial judge was very careful in his analysis of the facts before him:

Rather than considering the facts as an amalgam, his Honour considered the company's situation on a month by month basis. That is, he considered the financial information which they received in June separately to the information the appellants received in August. This separate consideration illustrates that the trial judge was alive to the dangers of applying a judgment based on hindsight.

The Court also took into account that the trial judge was careful in noting all the factors the directors would have taken into account, such as loans from related entities and a slight improvement in sales. The Court also rejected the contention that the trial judge had applied a higher standard of analysis than was reasonable in the circumstances, finding that it was significant that the trial judge did not

demand an instantaneous assessment of the company's position by the directors. The trial judge had found that it was appropriate to allow 2 to 3 weeks for accounting checks, assessment and the obtaining of expert advice. In the Full Court's opinion, allowance of up to 3 weeks for the directors to comprehend the full effect of the company's situation could not be criticised as unfairly rigorous against the directors.

7.3 Awareness

Subsection 588G(2) states that there are two distinct tests for determining the level of awareness of possible insolvency required by a director before that section is contravened. The two tests are divided into a subjective (subsection 588G(2)(a)) and an objective limb (subsection 588G(2)(b)). Accordingly, a director contravenes subsection 588G(2) if at the relevant time the director was aware, or should have been aware, that there were reasonable grounds to suspect that the company was insolvent.

Under subsection 588G(3) actual subjective awareness must be established. This is due to the additional requirement of a dishonest intent under subsection 588G(3)(d). A dishonest intent can only be formed where there is an actual awareness of reasonable grounds for suspecting insolvency.

(a) Subsection 588G(2)(a) – subjective awareness

Although subsection 588G(2)(a) states that a director contravenes the insolvent trading provisions if they were aware of grounds for suspecting insolvency, this does not mean that a director must in actual fact know of the company's possible or impending insolvency. All that is required is to show that the director was actually aware that reasonable grounds existed for suspecting insolvency.

The subjective component will require the court to look at the actual state of mind of the director at the relevant time.

(b) Subsection 588G(2)(b) – objective awareness

If it cannot be established that the director had actual awareness of reasonable grounds for suspecting insolvency, contravention of the insolvent trading provisions can also result if the director should have been aware that there were reasonable grounds for suspecting insolvency. Accordingly, the court will determine whether a reasonable person in a like position in a company in the company's circumstances would have been so aware.

On a general level, the model reasonable person would be able to read and understand in general terms the company's accounts and auditor's report (*Commonwealth Bank of Australia v Friedrich*). However, the inclusion of the term "in a like position in a company in the company's circumstances" allows the court to have regard to a wide range of factors, including:

- (i) the size of the company;
- (ii) the type of business conducted by the company;
- (iii) the composition of the board;

- (iv) whether the director was an executive or non-executive director;
- (v) the delegation of functions and responsibilities between directors;
- (vi) the distribution of work between board members and management; and
- (vii) professional qualifications and special expertise held by the director.

This objective component clearly recognises the differences between executive and non-executive directors through the inclusion of the term “in a like position”. A higher onus is placed on executive directors to remain informed of the state of solvency and the general financial affairs of the company than non-executive directors.

7.4 Time to Assess Awareness

The time that the awareness of the director is assessed is immediately before the particular debt was incurred.²⁰ This eliminates all sense of hindsight.

7.5 Dishonesty

Liability under subsection 588G(3), the criminal offence provision, can only be established if the director’s failure to prevent the company incurring the debt was dishonest.

Dishonesty is not defined within the Act. Generally, an act is done dishonestly where it is done with the knowledge that it will produce adverse consequences.²¹ “Dishonesty” is likely to mean an intentional, willed, or deliberate act.²² It is likely to involve an element of deceit or fraud. In this way, a reasonable but mistaken director would not be at risk under subsection 588G(3).

7.6 Checklist – Assessing the Reasonableness of a Director's Solvency Assessment

Whether directors have acted reasonably in assessing grounds of possible insolvency may be assisted by considering that :

- (a) Directors of a large company should ensure that among their number there should be one or more who are talented in the field of corporate financial management.
- (b) Directors of a large company should read, be able to understand and seek any necessary clarification of the key financial information put before the Board, such as a balance sheet and a profit and loss statement.
- (c) The Board should ensure that appropriately skilled people are engaged to carry out the company's accounting functions.
- (d) The Board should require relevant accounting information to be supplied ahead of regular Board meetings at which key financial decisions are to be made, and that, where a significant borrowing is to be undertaken, the management should supply the Board with a statement of the company's current financial position as well as

²⁰ *Metropolitan Fire Systems Pty Ltd v Miller, 3M Australia Pty Ltd v Kemish.*

²¹ *R v Bonollo* [1981] VR 633.

²² *Chew v R* (1991) 173 CLR 626.

the particulars of the way in which the principle, interest and other charges are to be serviced over the anticipated term of the loan.

- (e) The Board should make arrangements for monitoring the use of any authorisation granted in relation to the use of the company seal, the entering into contracts with financiers or the signing of cheques and bills of exchange.
- (f) Where the nature of the business may expose the company to a high risk of sudden liquidity restriction, or the company is known by the director to be in a delicate financial position, extra care and more rigorous safeguards may need to be adopted.

8. Statutory Defences

There are a number of defences provided to directors in the Act. These only apply to the civil penalty provision under subsection 588G(2). If a criminal offence is committed under subsection 588G(3), there are no defences available to a director. The only way he or she can escape liability is to rebut the elements of liability. The defences are that:

- (a) there were reasonable grounds to expect that the company was solvent and would remain solvent even if it incurred the debt;
- (b) the director relied on a competent and reliable person who was responsible for providing information as to the solvency of the company. On the basis of this information he or she expected that the company was solvent;
- (c) through illness or other good reason the director did not take part in the management of the company; and
- (d) the director took all reasonable steps to prevent the company incurring the debt.

The court also has the power under sections 1317S and 1318 to excuse a director from liability under subsection 588G(2). Each of these defences is considered below.

9. Reasonable Grounds to Expect Solvency Defence

The defence in subsection 588H(2) excludes from liability directors who can prove that, at the time the debt was incurred, they had reasonable grounds to expect, and did in fact expect, that the company was solvent at that time and would remain solvent even if that debt, or any other debt, was incurred. This “reasonable grounds to expect solvency” defence requires the director to establish the existence of grounds to expect solvency, the reasonableness of these grounds, and his or her actual belief in the fact of solvency.²³

9.1 Existence of Grounds to Expect Solvency

While primary liability accrues under the insolvent trading provisions where there exist grounds for “suspecting” insolvency, the defence available under subsection 588H(2) is expressed in terms of “expecting” insolvency.

²³ *3M Australia Pty Ltd v Kemish*.

The meaning attributed to the terms “suspect” and “expect” has already been considered in section 7 of this paper.

Clearly, the standard of exculpation is higher than that attracting primary liability.

9.2 Reasonableness of Grounds to Expect Solvency

It is unclear what the phrase “reasonable grounds” means within the context of subsection 588H(2). The essential issue is whether “reasonable grounds” requires an objective consideration of what the director ought to have known, or refers to a mix of objective elements and subjective facts actually known by a director.

If the wholly objective criteria test is adopted as the appropriate standard for exculpation under subsection 588H(2), what will be fundamentally required of directors is to carefully monitor the financial situation of the company and its solvency, and to stay informed of the company’s affairs. If the subjective and objective test is adopted, the development of the case law under predecessor sections suggests that the standard required of directors is becoming increasingly onerous and largely objective in any event (see *Commonwealth Bank of Australia v Friedrich*). Accordingly, what is fundamentally required of directors under the “subjective and objective” test will also be to stay carefully informed as to the financial standing of the company.

9.3 Actual Expectation of Solvency

This defence requires the director to prove that he or she believed in actual fact in the solvency of the company and its continuing solvency.

The meaning of “expect” has already been discussed above in section 7. In order to satisfy the requirements of the defence, a director must prove that he or she had a large degree of confidence in the solvency of the company, and anticipated its continuing solvency in a manner displaying more than a mere hope or possibility.

All subjective elements personal to the defendant will be considered in determining the actual belief of continuing solvency. Such factors will include the knowledge, experience and position held by the director.

10. Reasonable Steps Taken to Prevent the Incurring of the Debt Defence

Subsection 588H(5) provides a defence to proceedings against a director under subsection 588G(2). It is available to directors who took all reasonable steps to prevent the company incurring the relevant debt. It interacts with Part 5.3A of the Act where subsection 436A(1)(a) allows the directors of a company to appoint an administrator if they believe that the company is likely to become insolvent at some future time. It also interacts with subsection 1317S which makes clear what the court can take into consideration when excusing a director for contravention of section 588G.

10.1 What are Reasonable Steps?

What is reasonable will depend upon the circumstances of each case. In determining whether the steps the director took were reasonable, subsection 588H(5) provides that the court may have regard to a number of factors including:

- (a) any action the person took with a view to appointing an administrator of the company;
- (b) when that action was taken; and
- (c) the results of that action.

Although subsection 588H(6) looks at any action the director took to appoint an administrator, this appointment must be reasonable and timely in the circumstances. The mere appointment of an administrator will not be satisfactory where this action was left to the last minute.

Other factors will also be relevant in determining whether the steps taken were reasonable, including the size and nature of the company, the size of the relevant debt, and the grounds that gave rise to the suspicion of insolvency. Clearly, the court will consider whether adequate steps were taken to minimise the risk to creditors, consistent with the policy behind the insolvent trading provisions.

10.2 Genuine Effort and Unequivocal Action

It is clear that in order to qualify for the defence a director must have made a genuine effort to prevent the incurring of the debt. Once a director suspects insolvent trading, he or she must take clear, positive and unequivocal action to execute what powers and function they possess either to prevent the incurring of the debt directly or to bring the matter to the attention, either of an officer with the necessary authority to prevent the incurring of the debt, or to the board of directors when that is required.

As soon as the company's solvency is in doubt, a director must take action such as to call a board meeting, ensure accurate minutes are taken of this meeting, advise staff about the issue, and seek professional advice.

If a director does not have authority in the particular area in which the debt is being incurred, he or she must notify the person in charge of that area of the suspected insolvency. The fact that a director does not have authority in a particular area will not prevent liability being imposed under section 588G(2).²⁴ If the person in charge of the area does not take action to prevent the debt being incurred, the director must take clear, positive and unequivocal action to prevent the debt being incurred.

Where the company has liquidity problems of an on-going nature, constant monitoring of the company's solvency is required, although it is not intended for every transaction to be thoroughly scrutinised on the basis of possible insolvency.

10.3 Business Judgment Rule Does Not Apply

The business judgment rule does not apply to decisions made in relation to insolvent trading. It only applies in the context of the statutory duty of care and diligence in section 180. This is because the business judgment rule aims to encourage entrepreneurial risk taking by directors and thus conflicts with the creditor-protection rationale of the insolvent

²⁴ *Byron v Southern Star Group Pty Ltd* (1997) 15 ACLC 191.

trading provisions. The business judgment rule will not be relevant in determining the reasonableness of any steps taken by a director.

10.4 All Reasonable Steps Must be Taken

It is important to note that *all* reasonable steps must be taken by a director in order to qualify for this defence. This means that the requirements of the defence are potentially onerous and may require resignation in some circumstances. It may not be necessary for a director to resign if he or she cannot prevent the incurring of the debt if he or she was argued vigorously in favour of entering voluntary administration. There is some authority that such a failure to prevent the incurring of a debt may be due to an overbearing director or board of directors, in which case a particular director may escape liability.²⁵ However, mere protesting by a director that he or she has reservations about a particular course of action will not be enough to escape liability.²⁶ It may not be sufficient to merely clearly and consistently express reservations to the actions of the company. Clear, positive and unequivocal action must be taken.

11. Reasonable Reliance on a Competent and Reliable Person Defence

The so-called reliance defence under s588H(3) provides a defence where a director is able to prove that at the time when the debt was incurred he or she had reasonable grounds to believe, and did believe, that there was a competent and reliable person responsible for providing the director with adequate information concerning the company's solvency. In addition, the director must prove that there were reasonable grounds to believe that this person was fulfilling their responsibility. Under the second limb of the defence, the director must show that on the basis of the information he or she expected that the company was solvent or would remain so even if the debt were incurred.

The reliance defence is intended to encourage directors to ensure that proper and adequate financial management systems are in place and thus promote legal compliance.

The defence implies that a director must at least take a partially active role in ensuring that proper systems are set up for financial management and monitoring, reviewing the satisfactory performance of the responsible delegate, and thus still places a high standard on directors.

A director does not have to establish that the delegate was in fact competent and reliable, but rather that he or she believed on reasonable grounds that this was the case. It is not clear what inquiries should be made of a delegate's competence or reliability. Interestingly, this defence only requires a director to believe in the solvency of the company on the basis of information provided by a delegate responsible for the oversight to the company's financial position. In contrast to the philosophy of the insolvent trading provisions it does not require this belief of solvency to be based on reasonable grounds.

²⁵ *Dempster v Mallina Holdings Ltd* (1994) 15 ACSR 1.

²⁶ *Byron v Southern Star Group Pty Ltd*.

In addition, the reliance defence does not require the delegation or reliance to be reasonable, warranted or justified in the circumstances. This is consistent with the general delegation and reliance provisions in relation to other directors' duties under sections 189, 190 and 198D.

12. Non-Participation in Management Due to Illness or Other Good Reason Defence

The defence in subsection 588H(4) excludes from liability directors who through illness or other good reason did not take part in the management of the company at the time the relevant debt was incurred. It is based on the idea that it is not appropriate to hold a director liable if he or she was not in a position to influence the management of the company.

In the absence of any court decisions on the defence, the ambit of "illness" and "other good reason" are unclear. It is likely that "illness" will include nervous or psychological problems, such as nervous breakdowns or general stress. "Other good reasons" may include absence due to a personal material interest in the matter, being an alternate director, the appointment of a receiver or liquidator, or an extended stay overseas with the permission of the board.

A direct causal connection must be established between the illness or other good reason and the non-participation in management. A director who habitually fails to take part in the management of the company but who happens to be ill at the time that the relevant debt is incurred will not receive the protection offered by the defence. Accordingly, a passive director who was ill when the particular debt was incurred cannot rely on subsection 588H(4).

13. Holding Company Liability for the Insolvent Trading of its Subsidiary

Holding companies are exposed to liability for the insolvent trading of their subsidiaries.

The elements of liability establishing contravention by a holding company under section 588V parallels those for directors.

Section 588V provides that a holding company contravenes the Act if:

- (a) it was the holding company of a subsidiary at the time when the subsidiary incurred a debt; and
- (b) that debt caused, or was incurred during, the insolvency of the subsidiary; and
- (c) there were reasonable grounds to suspect that the subsidiary was insolvent or would become insolvent by incurring that debt, or any other debt at that time; and either
- (d) the holding company or any of its directors was aware of reasonable grounds for suspecting the subsidiary's insolvency; or
- (e) having regard to the nature of the holding company's control over the subsidiary, it was reasonable to expect that a holding company in the circumstances of the

holding company, or any of its directors, ought to have been aware of those grounds for suspicion.

A holding company that contravenes this section is not guilty of an offence but may be liable for compensation equal to the amount of loss or damages.

It is significant that the section refers to 'corporations' and not just 'companies'. A government parent corporation may be found liable under the provisions unless it is an 'exempt public authority' and outside the definition of a 'corporation' under section 9 of the Act. Section 588V also has extra-territorial operation.

13.1 Definition of a Holding Company

Under section 46 of the Act, the holding company – subsidiary relationship is formed when where a body corporate:

- (a) controls the board composition of another body corporate;
- (b) controls at least 51 per cent of the voting power of another body corporate;
- (c) holds at least 51 per cent of the share capital of another body corporate; or
- (d) is a subsidiary of a subsidiary of another body corporate.

In this way, it is a test of majority power. In brief, a holding company/subsidiary relationship is formed where one entity holds at least 51 per cent of the issued share capital in another entity, or 'controls' it.

13.2 Factors the Court Will Consider

When determining whether the elements of liability have been established, the court will have regard to the following.

- (a) the nature of the relationship between the holding company and subsidiary;
- (b) reporting arrangements;
- (c) the nature of the enterprise carried on by the subsidiary;
- (d) the extent to which the day-to-day activities are controlled by the subsidiary;
- (e) the relevant skill of the holding company's directors to perform their functions; and
- (f) the behaviour of the board in establishing mechanisms for the monitoring and control of both the holding company and of the subsidiary.

13.3 Penalties and Recovery of Compensation

If a holding company has contravened section 588V, under section 588W the liquidator of the subsidiary may recover from the holding company, as a debt due to the subsidiary, an amount equal to the amount of loss or damage suffered if:

- (a) the holding company has contravened section 588V in relation to the incurring of a debt by the subsidiary;
- (b) the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the subsidiary's insolvency;

- (c) the debt was wholly or partially unsecured when the loss or damage was suffered; and
- (d) the subsidiary is being wound up.

Proceedings by the liquidator must be commenced within six years of the commencement of the winding up of the subsidiary (subsection 588W(2)).

Section 588Y restricts the application of recovery compensation. It provides that the amount paid to a subsidiary is not available to pay a secured debt of the subsidiary unless its unsecured debts have been paid in full. This gives priority to unsecured debts in the application of compensation recovered from the holding company.

13.4 Defences

The legislation provides statutory defences to a holding company to escape liability. These defences are contained in section 588X and are essentially identical to those contained in section 588H.

14. Section 1318 and 1317S

Sections 1318 and 1317S both provide a possible basis for directors to escape liability under the insolvent trading provisions.

Section 1318 generally provides a basis for relief in civil proceedings resulting from negligence, default, or breach of duty or trust whereas section 1317S provides relief from civil liability arising out of a contravention of a civil penalty provision.

14.1 Section 1318

Section 1318 allows a court to relieve certain persons from liability in civil proceedings for negligence, default, breach of duty or breach of trust, if the person establishes that he or she acted honestly, and that he or she ought fairly to be excused for the negligence, default, breach of duty or trust having regard to all of the circumstances of the case including those connected with their appointment.

Section 1318 applies to an officer of a corporation (which includes a director), an auditor of a corporation, an expert, and a receiver, receiver and manager, liquidator or other person appointed or directed by the court to carry out any duty under the Act in relation to a corporation, including executive officers and company secretaries.

Section 1318 can provide relief in proceedings brought by a party other than the company. A person who merely apprehends that proceedings may be brought against them can apply for relief under the section (section 1318(2)).

The fact that the duty to prevent insolvent trading under section 588G imposes a *positive duty* on directors means that 1318 applies to section 588G.

14.2 Section 1317S

Section 1317S provides a basis for relief from liability under a civil penalty provision where the person has acted honestly and the person ought fairly to be excused in the circumstances of the case. It applies to the duty to prevent insolvent trading. When

deciding whether or not to excuse a person for a breach of the insolvent trading provisions, the court can have regard to any action the person took to appoint an administrator to the company, when the action was taken, and the results of the action (section 1317S(3)). A person can apply for relief in advance if their apprehends that proceedings may be brought against them (section 1317S(4)).

15. The Liability that is Imposed as a Result of Breaching the Insolvent Trading Provisions

15.1 Civil Penalty Orders

Section 588G(2) is a civil penalty provision. The following are civil penalties by virtue of section 9 of the Act.

(a) Declaration of Contravention

Only ASIC can apply for a declaration of contravention (section 1317J(1)).

When the court makes a declaration of contravention, it is conclusive evidence that a person has contravened a civil penalty provision. ASIC can not seek a pecuniary penalty order or a disqualification under section 206C unless it has obtained a declaration of contravention.

A corporation may intervene in an application by the ASIC for a declaration of contravention (section 1317J(3)). It can be heard on all matters except whether a declaration of contravention should be made (section 1317J(3)).

An application for a declaration of contravention must be made within six years of the contravention. When hearing proceedings for a declaration of contravention, the court must apply the rules of evidence and procedure for civil matters (section 1317L). This means that the burden of proof will be on the balance of probabilities.

(b) Pecuniary Penalty Order

After the court has made a declaration of contravention ASIC can apply to the court for a pecuniary penalty order. The corporation can intervene in the application for a pecuniary penalty order (section 1317J(3)). It can be heard on all matters except whether the pecuniary penalty order should be made (section 1317J(3)). The application for a pecuniary penalty order must be made within 6 years after the contravention (section 1317K). When hearing proceedings for a civil penalty order the court must apply the civil rules of evidence and procedure (section 1317L).

Under subsection 1317G(1)(b) the pecuniary penalty order will not be made unless the contravention:

- (i) materially prejudices the interests of the corporation or scheme, of its members;
- (ii) materially prejudices the corporation's ability to pay its creditors; or
- (iii) is serious.

A pecuniary penalty order can be made of a sum up to A\$200,000. There are a number of factors the court is likely to consider when deciding the amount of the pecuniary penalty order, such factors may include whether:

- (i) the contravention involved a deliberate, systematic and unauthorised misuse for personal or private purposes of the funds and facilities of the association of a regular basis;
- (ii) the conduct engaged in constituted an abuse of trust and confidence placed in the respondent by his employer;
- (iii) the contraventions were camouflaged from discovery in a manner which gave rise to serious concern of the respondent's honesty and integrity; and
- (iv) the respondent attempted to justify his conduct and failed to display any remorse or contrition in respect of the contravention.

Arguably, the type of factors which the court will take into account in determining the amount of a penalty order will include:

- (i) the nature and extent of the contravening conduct;
- (ii) the amount of loss or damage caused;
- (iii) the circumstances in which the conduct took place;
- (iv) the size of the contravening company;
- (v) the degree of power it has, as evidenced by its market share and ease of entry into the market;
- (vi) the deliberateness of the contravention and the period over which it extended;
- (vii) whether the contravention arose out of the conduct of senior management or at a lower level;
- (viii) whether the company has a corporate culture conducive to compliance with the Act, as evidenced by educational programs and disciplinary or other corrective measures in response to an acknowledged contravention; and
- (ix) whether or not the company has shown a disposition to co-operate with the authorities responsible for the enforcement of the Act in relation to the contravention.

A pecuniary penalty order is a civil debt payable to ASIC (s1317G(2)). It is not money payable to the corporation.

(c) Compensation Order

A compensation order may be made against a director of the company under section 588J(2). If the ASIC makes an application for a compensation order, the liquidator of the company has the right to intervene (subsection 588J(2)). The liquidator is entitled to be heard only if the court is satisfied that the person committed the contravention and only in regards to whether or not the court should

order the person to pay compensation to the company. The amount of compensation ordered under section 588J will be equal to the amount of loss or damage caused. It is possible that this measure could exceed the amount of the relevant debt and include the entire disadvantage suffered by a person or corporation.

This compensation order under subsection 588J(1) can be made whether or not the court has also made a pecuniary penalty order under section 1317G or an order under section 206C disqualifying the person from managing corporations.

(d) Disqualification from Managing Corporations

After the court has made a declaration of contravention under section 1317F, ASIC may apply to the court to disqualify a person from managing corporations for a period that the court considers appropriate (section 206C(1)).

The court can only disqualify a person from managing corporations if it is satisfied that the disqualification is justified. In determining whether the contravention is justified, the court will consider:

- (i) the person's conduct in relation to the management, business or property of any corporation; and
- (ii) any other matters that the court considers appropriate.

Other matters may include:

- (i) the character of the defendant;
- (ii) the nature of the offence;
- (iii) the structure of the companies concerned and the nature of their business;
- (iv) the interests of shareholders, creditors and employees;
- (v) the risk to those persons or to the public of the defendant continuing in his present function;
- (vi) his honesty and competence;
- (vii) hardship resulting to him, his personal and family business interests; and
- (viii) his appreciation that future breaches could result in fresh proceedings for the court to disqualify.²⁷

ASIC itself has the power under s206F to disqualify a person from managing corporations for up to 5 years if that person has been an officer of 2 or more corporations and each of those companies was wound up during or within 12 months of that person's directorship.

15.2 Criminal Offences

Subsection 588G(3) outlines when a breach of the insolvent trading provisions will constitute a criminal offence. A person will commit an offence under the insolvent trading

²⁷ *Commissioner for Corporate Affairs v Ekamper* (1987) 12 ACLR S19.

provisions where the director's failure to prevent the company incurring the debt was dishonest. Sections 6.1 and 6.2 of the *Criminal Code* apply to aspects of an offence under s588G(3). In particular, the question of whether a debt has been incurred under s588G(3)(a) is an absolute liability offence (as spelt out in section 6.2 of the *Criminal Code*) which means that no defence is available.

Although the exact meaning of "dishonesty" is not clear in this context, it is likely to mean an intentional, willed, or deliberate act (*Chew v R*). It is likely to involve an element of deceit or fraud. In this way, a reasonable but mistaken director would not be at risk under subsection 588G(3).

A director found guilty of a criminal offence under section 588G(3) will suffer a penalty of A\$200,000, five years imprisonment, or both.

The court may also order the person to pay compensation to the corporation under section 588K. The court may order compensation to be paid whether or not it has imposed a penalty under subsection 588G(3).

If a person is convicted of an offence under subsection 588G(3), they are automatically disqualified from managing a corporation (subsections 206B(1)(b)(i) and (ii)).

15.3 ASIC may Require Person to Assist

ASIC may require a person to assist them in an application for a declaration of contravention, a pecuniary penalty order, or criminal proceedings (subsection 1317R(1)).

15.4 Personal Subjection to External Administration

A director who cannot pay any order against him relating to his management of a company can be personally declared a "bankrupt" and subjected to personal external administration.

Even if a person is declared bankrupt, this does not extinguish civil penalty orders remaining to be paid. Subsection 82(3A) of the *Bankruptcy Act 1966* (Cth) states that a pecuniary penalty order is not provable in bankruptcy. This means that despite the bankruptcy, the person is still liable to pay the pecuniary penalty order.

15.5 Miscellaneous Sanctions

Other sanctions include injunctions (section 1324) and fines (section 1311)

16. Bringing Proceedings

The main power to bring proceedings for insolvent trading lies in the hands of ASIC (s1317J(1)) and liquidators (s588M(2)).

In limited circumstances, a creditor can initiate proceedings, but only after either the liquidator has failed to act within 3 months or if they receive the written consent of the liquidator (s588M(3) and s588R).

There were a large number of reported cases dealing with the predecessors of section 588G. We have seen fewer reported cases under the new section. The main reason for the lack of reported cases is that fewer companies are being wound up in insolvency.

There has been an increasing use of voluntary administration followed by deeds of company arrangement as preferred forms of insolvency administration.

In voluntary administration in making a decision as to whether to wind up the company or enter a deed of arrangement one of the factors which creditors must weigh up is the likelihood of a liquidator increasing the amount of the company's assets by bringing successful 588G proceedings and the likelihood of successful preference claims. Creditors usually base their decision on information provided to them by the administrator. The administrator must provide creditors with a report at the second creditors' meeting including a statement as to whether it would be preferable to enter into a deed of arrangement or for the company to go into liquidation. It is not prescribed but an administrator's report should ideally indicate if the directors would be potentially liable under section 588G.

Further, until recently the insolvent trading provisions have been utilised somewhat infrequently. Until recently, ASIC has instigated a small number of proceedings.

Liquidators have often failed to utilise the provisions because there are often insufficient funds available within the company to fund and sustain proceedings or to ensure that the liquidator's fees and costs are covered by the funds of the company. There are usually a large number of unsecured creditors to a failed company, each of which is often owed only a small amount of money. As a result, it is often not financially worth it to an unsecured creditor to bring an action for insolvent trading as the costs of bringing the proceedings are likely to be more than the money they would receive back if the action was successful.

However a number of developments, including litigation funding and an increasingly vigilant ASIC, have seen a rise in the number of insolvent trading actions brought in the last few years. It is likely that this trend will continue.

16.1 Ability of Liquidator to Bring Proceedings in the Name of the Company

In addition to the primary right of the liquidator to bring proceedings for insolvent trading, a liquidator has the general ability to bring or defend proceedings in the name of the company (section 477(2)(a)). Generally the liquidator will seek the approval of the creditors before commencing proceedings, particularly where it is likely to involve substantial expense.

There are usually insufficient funds left in a company to commence proceedings. If this is the case and there are substantial prospects of success the liquidator may seek an advance or indemnity from creditors. If a creditor provides such finance the liquidator can seek orders from the Court to permit him or her to treat the funds creditor more favourably than other creditors in the distribution of any property or funds that are recovered by the proceedings because of the risk assumed by them in financing the proceedings (section 564). The liquidator may also seek litigation funding or insurance from a third party as part of his or her ability to sell or assign the 'property of the company' (section 477(2)(b)). This is discussed below.

When a liquidator is defending proceedings brought against the company he or she is not usually liable for legal costs. However, where the proceedings are commenced by the liquidator he or she may be held liable for legal costs if the proceedings are ultimately unsuccessful and there are insufficient funds within the company to provide for

reimbursement. Usually a liquidator will not commence proceedings unless there are large prospects of success or there is available funding.

16.2 Significance of Litigation Insurance Funding for Liquidators

Litigation insurance funding arrangements between an insolvency practitioner, usually a liquidator, and an insurance company where the insurer funds the relevant action, indemnify the liquidator for any cost orders made against him or her in return for a share in the proceeds of a successful action. In this way, the liquidator is not exposed to any liability for legal costs if the action is unsuccessful and the insurer will be liable for the amount of any legal costs order which outweighs the proceeds recovered.

Generally, a liquidator will prepare a proposal for the insurance company outlining the nature of the relevant action, the risk and the proceeds which are likely to be recovered. The liquidator then gives the proposal to the insurer for consideration. Further negotiations may take place, but when the proposal is accepted in the final form the liquidator will usually, and is well advised to, seek the approval of creditors before accepting the proposal.

In order for the arrangement to be valid, some or all of the action must be sold to the third party, the third party should not have a role in the actual running or conduct of the proceedings and the arrangement must generally constitute a bona fide exercise of the liquidator's powers. If these steps are not taken the liquidator runs the risk of having the arrangement declared invalid and having to finance any legal costs incurred him or herself.

This development means that liquidators are these days more likely to bring an action against directors of an insolvent company for insolvent trading and this trend is likely to continue well into the future. Of perhaps equal importance liquidators can now threaten such proceedings more forcefully as a director can no longer simply assume that a liquidator of a company without funds of its own is a "toothless tiger".

The main benefit of litigation insurance funding is therefore obvious – it allows the recovery of funds for the benefit of creditors in circumstances where recovery would otherwise not be possible. By encouraging liquidators to take action against rogue directors without incurring further expense for creditors it may relieve creditors from a substantial financial burden in circumstances where they have often already lost funds.

Litigation insurance funding potentially increases the number of actions to be taken against delinquent directors and may act as a greater deterrent. It is possible that it may also increase the likelihood of settlement as the plaintiff is less involved emotionally in the proceedings. Settlement may also occur earlier if the plaintiff has sufficient funds as the plaintiff could continue the litigation until the hearing itself and thus, if the defendant wants to settle the litigation he or she may have to make a realistic offer of settlement earlier than he or she would otherwise have to if the plaintiff had no prospects of being able to continue the litigation in any event. It also has a considerable benefit for liquidators and insolvency practitioners themselves, allowing for a recovery of remuneration, costs and fees in cases where there would not otherwise be any funds to pay them.

There are, of course, concerns over litigation insurance funding arrangements. The main concern is that in practice the liquidator's control over the conduct of the proceedings could

be thwarted if he or she, as a practical matter, feels inclined to take the interests of the insurer into account when making decisions as to the conduct of the proceedings. This is no more obvious than in relation to settlement negotiations where the liquidator may feel obliged to reject offers of settlement which may cover his or her costs and fees and provide a minimal return for creditors but not a substantial return to the insurer. In this case the liquidator may wish to settle if there is little chance that more proceeds would be recovered for creditors if the litigation continued, however the insurer may wish to make a greater profit out of the litigation. Whilst taking such considerations into account could arguably mean that the liquidator is not exercising his or her powers bona fide, it is difficult to know what effect such pressures may be having on liquidators in their conduct of proceedings. Another concern is that liquidators may feel obliged to enter into funding arrangements as part of their duty to realise all the property of the company for the benefit of creditors, even where there is no prospect of a substantial return to creditors, and thus inadvertently 'line the pockets' of the insurance industry.

Regardless of these public policy considerations, litigation insurance funding arrangements are a tool increasingly utilised by liquidators and other insolvency practitioners. This trend is resulting in a growing number of actions taken against rogue directors for insolvent trading.

17. Recent Case Law

17.1 ASIC v Plymin & Others [2003] VSC 123 (the Water Wheel Case)

The facts of this case are extremely complex and lengthy. Whilst the case has attracted a lot of media attention, that is more a symptom of the characters involved than of the extent to which the case really represents any fundamental development in the law.

The case really turned on the application of the existing law to the set of facts and the Court's findings that Mr Plymin and Mr Elliott each failed to prevent the Water Wheel companies from incurring debts in the period from 14 September 1999 to 17 February 2000 (the **Insolvent Period**) during which time the Court found that Water Wheel was insolvent.

Some cases of legal principle which are worth mentioning in the case are that:

- (a) where ASIC seeks a civil penalty order and compensation orders rather than bringing criminal proceedings, the relevant standard of proof is a civil one ie. the balance of probabilities not beyond reasonable doubt. However, the test for a serious allegation like insolvent trading is the Briginshaw test – essentially, whilst you apply the civil standard you do so in a "stricter" way (at para 367);
- (b) with contracts for supply, working out when the debt is incurred can be difficult. Mandie J side-stepped this issue (at para 517) where he found that:

Relevantly to this proceeding, I think that it will often be the case, for the purposes of the section, that under a contract for the sale of goods where delivery times are left for future orders or instructions that, as a matter of substance and commercial reality, a debt will be incurred on each occasion when a delivery is ordered. Whether under such a contract a director may also be exposed to liability at an

earlier point of time (ie, when the contract is entered into), in relation to a contingent debt, need not be decided for the purposes of this case.;

- (c) in relation to the quantification of a creditor's loss and damage, Mandie J found that prima facie, the creditor's loss and damage would be the amount of the unpaid debt applying *Powell v Fryer* (2001) 37 ACSR 589, 602-3 (at para 355). However, he allowed for the benefit of the directors a reduction in the amount of loss to take into account the interim dividend which had been distributed by the administrators of the Waterwheel companies to the creditors (relevantly 10% to creditors of Mills plus an additional 4.5% being the expected further distribution to such creditors). The case is, however, dubious authority on this point because it appears to have been conceded as Mandie J observes:

To the extent that any allowance for actual and expected dividends is contrary to what was decided concerning the meaning of 'loss and damage' in *Powell v Fryer* (2001) 37 ACSR 589, 602-3, I understand the Plaintiff to have conceded that such allowance should be made and I tend with respect to think that the concession was correct in principle.

The Court found that throughout the Insolvent Period there were reasonable grounds for suspecting that each of the Waterwheel companies was insolvent and that those reasonable grounds existed when each of the debts incurred during the Insolvent Period were incurred. Based on the facts which were found by the Court, Mandie J also found that:

- (i) Mr Plymin and Mr Elliott each failed to prevent the Waterwheel companies from incurring each of those debts;
- (ii) Mr Plymin and Mr Elliott were each aware, throughout the Insolvent Period and at the time that each of the debts were incurred, that there were reasonable grounds of suspecting that the Water Wheel companies incurring the debt were insolvent;
- (iii) at the time that each of those debts were incurred a reasonable person in a like position to that of Mr Plymin and a reasonable person in a like position to that of Mr Elliott, in a company in the circumstances of the Water Wheel companies incurring the debt, would have been aware of reasonable grounds for suspecting that the relevant company was insolvent;
- (iv) in the circumstances, Mr Plymin and Mr Elliott had contravened s588G on each occasion when each such debt was incurred and that they had failed to establish any of the s588H defences;

17.2 *ASIC v Plymin & Others (No.2) [2003] VSC 230*

This second Water Wheel case considered whether the directors should be excused from liability for insolvent trading and, if not, whether the court should order the directors to pay compensation to the company or pecuniary penalties. It also considered whether the directors should have been disqualified from managing corporations.

Under then s1317JA of the *Corporations Law* (now s1317S of the Act), the Court can excuse a director who has acted honestly and who, having regard to all the circumstances

of this case, ought fairly to be excused for the contravention. ASIC conceded that the directors had acted honestly. Justice Mandie held that, in considering whether a person ought 'fairly' to be excused, the court could take into account:

- any action to appoint an administrator, the timing and result of that action;
- the way in which the breach occurred; and
- the circumstances of the person seeking to be excused.

Justice Mandie found that the conduct of Mr Plymin was reckless and grossly negligent and, in all the circumstances, was unreasonable and inexcusable. Although administrators were appointed to the Water Wheel companies, their appointment was made too late. Justice Mandie found that Mr Plymin showed no regard for the position of those who dealt with Water Wheel from 14 September 1999 (the date from which ASIC alleged the companies were insolvent).

While Justice Mandie accepted that Mr Elliott was significantly less culpable than Mr Plymin, he also accepted ASIC's submission that Mr Elliott was "confronted with unmistakable evidence and repeated warnings that Water Wheel was heading towards insolvency in the first half of 1999 and that it was insolvent by 14 September 1999". In the opinion of Justice Mandie, Mr Elliott disregarded the position of unsecured creditors.

For these reasons, neither Mr Plymin nor Mr Elliott were excused under s1317JA for their contraventions.

In relation to the making of prohibition orders preventing the directors from managing a corporation, Justice Mandie noted that the primary object was to protect the public from persons who were not fit and proper to do so. A secondary object was to deter both the offender and other directors from such conduct in the future.

On the question of compensation orders, the Court noted that, before awarding the companies compensation, it was necessary to calculate the amount of the loss and damage suffered by creditors. To do this, the estimated amount to be paid to creditors as a dividend from the DOCA had to be deducted from the total amount of the debts owed to them. The resultant figure for loss and damage was approximately \$1.7 million. From that amount, \$300,000, being the amount paid to ASIC by another director Mr Harrison, was deducted.

In relation to pecuniary penalties under s1317EA of the *Corporations Law* (now s1317G of the Act) the Court took into account the length of the prohibition orders, the size of the compensation orders and the costs orders. On that basis, only relatively small pecuniary orders were made. Justice Mandie noted that the principal purpose was of pecuniary penalties was to act as a personal deterrent and a deterrent to the general public to prevent repetition of like conduct.

Accordingly, the Court ordered that:

- (i) Mr Plymin be prohibited from managing a corporation for 10 years, pay compensation in the amount of \$1.43 million to the Water Wheel companies and pay a pecuniary penalty of \$30,000;

- (ii) Mr Elliott be prohibited from managing a corporation for 4 years, pay compensation in the amount of \$1.43 million to the Water Wheel companies and pay a pecuniary penalty of \$15,000; and
- (iii) Messrs Plymin and Elliott pay 80% of ASIC's costs of the proceedings.

17.3 ***Deputy Commissioner of Taxation v Clark [2003] NSWCA 91***

This case centred on the issue of what represents a "good reason" under the defence provided by s588FGB(5) of the Act. This defence is to the indemnity directors may be forced to give to the Commissioner of Taxation under s588FGA. It is worded in virtually identical terms to the defence in s588H(4).

The facts concerned Mrs Clark who claimed that she was not liable to the Commissioner of Taxation as she had not for a "good reason" participated in the management of the relevant company. In this regard, she relied on her husband and asserted that she was asked to become a director by her husband because the company needed to have 2 directors. She claimed to be unaware of her responsibilities as a director and stated that she would "often have a frying pan in one hand and be signing with the other".

The Court held that Mrs Clark's total reliance on her husband in the management of the company was not a "good reason" within the meaning of s588FGB(5), for her non-participation in the management of the company at the times when payment were made to the Commissioner of Taxation. Mrs Clark was therefore unable to resist her liability under s588FGA as a director.

This decision effectively limits the ambit of possible arguments to justify non participation by a director in the management of a company. While the Court did not specifically exclude the availability of arguments based upon duress, non est factum, undue influence, deceit, misleading and deceptive conduct or unconscionable conduct, it limited the ambit of s588FGB(5) by deciding that the words "good reason" must be read down so that they do not conflict with the obligation of director's generally to participate in the management of a company and that an argument attempting to justify why a director has never participated will not succeed and will never constitute a "good reason". This conclusion, therefore, indicates the strict stance that the Court has taken with regard to the responsibilities of directors and reinforces the importance and absolute nature of director's duties.

17.4 ***Geneva Finance Ltd (receiver and manager appointed) v Resource & Industry Ltd & Anor [2002] WASC 121***

Since the High Court decision in *Spies v The Queen* (2000) 201 CLR 603, it can no longer be said that the directors of a company facing insolvency owe duties to the company's creditors. The directors do, however, appear to have an obligation to consider the interests of creditors as part of their duty to the company.

The receiver of Geneva Finance Ltd (***Geneva Finance***) brought proceedings on behalf of the company to recover damages or compensation for alleged breaches of duty by Mr Hawkins, who had been a director of Geneva Finance. Mr Hawkins was also a director of Hawkins Court Ltd (***Hawkins Court***), which held shares in the ultimate holding company of Geneva Finance.

Hawkins Court had deposited A\$550,000, at call, with Geneva Finance as a secured debenture stockholder. Geneva Finance had also lent to Mr Oehlers, an employee and co-director of Hawkins Court, approximately A\$300,000.

In mid-1990, trading conditions for Geneva Finance were deteriorating sharply. During this period (and prior to the appointment of the receiver), Hawkins Court withdrew A\$300,000 of its secured debenture deposit with Geneva Finance and advanced this money to a related company which, in turn, used the money to repay the Oehlers loan of A\$300,000 to Geneva Finance.

Mr Hawkins admitted to being involved in the transactions but did not admit to having any knowledge that Geneva Finance was insolvent at the time of the transactions. Those transactions appeared to have the effect that Geneva Finance received full satisfaction in respect of the Oehlers' debt and that Geneva Finance paid out its full liability to a depositor and, accordingly, neither profited nor lost by virtue of the transaction.

The receiver argued that the effect of the transactions was that Hawkins Court received the full amount of its deposit with Geneva Finance, whereas if that money had not been paid out at that time, then, on the appointment of the receiver, it would have only received its proportionate entitlement with other secured creditors (it was not open to the receiver to argue that the payment was a voidable preference under the CA or *Bankruptcy Act* – the company was not in liquidation).

In essence, the receiver's case was that Mr Hawkins knew in early July 1990 that Geneva Finance was insolvent or was facing imminent insolvency, and organised the transactions in order to withdraw \$300,000 of the Hawkins Court funds on deposit from Geneva Finance in order to reduce its exposure in the event that Geneva Finance became or was insolvent. It was alleged that Mr Hawkins was in breach of his duty to the creditors of Geneva Finance because of the pending insolvency of the company, of which he knew, or should have known.

The receiver's argument assumed that there is a duty to creditors that not only involves an obligation to safeguard their interests generally, but also an obligation to see creditors of the same degree treated equally. Justice Heenan said that cases suggesting that such a duty may exist had been cast in a different light following the High Court of Australia authority, *Spies v the Queen*, which strongly suggests that the interests of the company should be seen as distinct from the interests of its creditors, whatever the circumstances. In *Spies*, it was held that directors do not owe an independent duty to, or enforceable by, creditors of a company by reason of their position as directors.

Justice Heenan characterised orthodox formulation of a director's duty to creditors in impending insolvency as

. . . a director of a company, especially if the company is approaching insolvency, is obliged to consider the interests of creditors as part of the discharge of his duty to the company itself, but that he does not have any direct duty to the creditors and certainly not one enforceable by the creditors themselves.

As such, the true question was the scope of the obligation of a director to take into account the interests of creditors when discharging his or her duty to the company, especially if it is approaching insolvency.

Justice Heenan concluded that Mr Hawkins had a fiduciary duty to Geneva Finance to exercise his powers in the best interests of the company as a whole and that the scope of this duty involved giving due attention to the company's creditors.

For liability to be established against Mr Hawkins or Hawkins Court, Justice Heenan said, it was necessary for the receiver to prove that decisions taken by the company to allow the transactions, regardless of their effect, were not made in the best interests of the company as a whole or, alternatively, the dominant purpose of securing a benefit for Hawkins Court at the expense of other creditors.

While the effect of the combined transactions was that Hawkins Court was able to withdraw A\$300,000 of its deposit with Geneva Finance in full, and escape being in a situation where it could only hope to obtain a pro-rata payment as one of many secured creditors faced with a deficiency, Justice Heenan was satisfied that was not a factor that prompted the transaction or was appreciated by the directors as a significant possibility at the time.

Directors of a company do not owe any direct duty to creditors of the company to consider their interests. Directors are, however, obliged to consider the creditors' interests as part of the director's duty to the company itself where the company is insolvent or approaching insolvency. Directors will not be found to have breached that duty unless it can be shown that the director's conduct was grossly negligent, unconscientious, or intended to prefer associated interests to the expense of other creditors.

17.5 *Manpac Industries Pty Ltd v Ceccattini (2002) 20 ACLC 1304*

In this case, the directors of a company in liquidation were faced with an allegation that they failed to prevent the company from insolvent trading. This case looks at the circumstances in which directors can defend such allegations on the basis that they relied on someone else to provide them with information in relation to the company's solvency.

Section 588M of the Act provides that where a person has contravened the duty to prevent insolvent trading (s588G of the Act) and an unsecured creditor suffers loss and the company is being wound up, the company's liquidator, or a creditor of the company (with the liquidator's or court's permission), may recover that amount from the directors of the company.

In this case, a creditor of a company in liquidation commenced proceedings against the former directors of the company seeking compensation under s588M of the Act.

The directors raised the defence that the company had engaged a financial adviser and that the directors had relied upon the financial adviser in relation to the question of the company's solvency and, as such, the defence contained in s588H(3) should apply.

The court found that the company was, in fact, insolvent at all relevant times. While the directors had relied upon their financial adviser in relation to the financial state of the company, the financial adviser's figures were not always accurate because the information and figures supplied to the financial adviser by the directors were either inaccurate or incomplete.

In the circumstances, Chief Justice Young found that it was not open for the directors to rely on a person to provide adequate information about solvency in circumstances where

the directors allegedly relying on the other person were the source of the information and the information provided was not 'completely full'.

Accordingly, any expectation of the directors that was founded on analysis by the financial adviser that the company was solvent was unreasonable in the circumstances, because the directors knew, or ought to have known, that the analysis provided by the financial adviser had been provided on the basis of incomplete information.

The Court held that the prime thrust of the defence is to cover the situation where there is a large corporation with bulky accounts and where there is a system in place of competent accountants, credit controllers and financial management reporting to the board. The defence does not deal with the situation where a small company with directors who have little idea of accountancy brings in a trouble-shooter, supplies that person with limited information and then relies on incomplete reports.

In order to establish the defence to an allegation of insolvent trading that the director was relying on a reliable and competent person to provide information in relation to the company's solvency, the director must ensure that the person is not only reliable and competent, but also has been charged with that responsibility and is provided with all of the necessary information available to enable the person to make the determination.

17.6 *Scott v Williams & Ors* [2002] SASC 424

The Supreme Court of South Australia ordered a company director to pay \$500,000 for breach of his duty under section 588G of the Act to prevent the company from trading while insolvent. Even though the director lived in another state, and relied on advice from other directors and management within the state about the company's finances, a defence under s588H(2) of the Act was not established because the director's belief about the company's solvency was not based on reasonable grounds.

The plaintiff was the liquidator of South Australian Ships Pty Ltd (SAS), a South Australian-based ship building company that went into liquidation on 21 March 1997. SAS had been in financial difficulty for some time before that, and the liquidator claimed that the company had been insolvent since 1 June 1996.

Mr Hercus admitted that SAS was insolvent at the relevant time. He relied on a defence under s588H(2), however, claiming that he reasonably believed that a competent and reliable person was responsible for providing him with adequate information about SAS's solvency and that, based on such information, he expected that SAS was, and would continue to be, solvent. In particular, as Mr Hercus lived outside South Australia, he claimed to have relied on two of SAS's executive directors and management generally for information on the company's finances.

Justice Lander held that, from 1 June 1996 onwards, there were reasonable grounds for suspecting that SAS was insolvent, and that the company was clearly insolvent from 25 September 1996. His Honour considered that Mr Hercus was misadvised about the company's finances from time to time, including about possible further financial support sources. However, Justice Lander decided that (even assuming that further financial support might come from the sources referred to by Mr Hercus) a reasonable director in the same position would have formed the opinion that SAS was insolvent during the whole of

the relevant period and, in particular, would not be able to pay its debts as and when they fell due. Therefore, the defence under s588H(2) was not made out because Mr Hercus did not have reasonable grounds to expect that SAS would remain solvent. Accordingly, Mr Hercus was held to have breached his duty under s588G to prevent insolvent trading.

Mr Hercus also relied on a defence under s588H(3) on the basis that a chartered accountant, Mr Sims, gave advice on 24 September 1996 that SAS was still solvent. However, this defence was unsuccessful since, on the evidence, the court found that Mr Sims had not given any such advice.

In assessing the quantum of Mr Hercus's liability, the court was required to take into account sums paid by the other directors who had settled insolvent trading claims against them, as s588N precludes double recovery under s588M.

The court also exercised its discretion under s1317JA(2) to partially relieve Mr Hercus from liability (although the judgment does not specify what amount was subtracted in the application of this discretion). Justice Lander was satisfied that Mr Hercus had acted honestly and that, having regard to the circumstances of the case (including those connected with his appointment as a director), he ought fairly to be partially excused from the contravention of his duty under s588G.

After these matters were taken into consideration, Mr Hercus was ordered to pay \$500,000 to the liquidator.

This case should serve as a cautionary tale for company directors who simply accept at face value the word of others that their company remains solvent. Even though the court, in this case, believed that the director had acted honestly and with the company's best interests at heart at all times, when he did not pay close enough attention to the company's financial position, he was found liable to reimburse the company to the tune of \$500,000.

17.7 *Deputy Commissioner of Taxation v Solomon; Deputy Commissioner of Taxation v Muriwai (2003) 199 ALR 235*

In this case, two related companies failed to remit to the Commissioner of Taxation PAYE deductions. Pursuant to s222AOB(3) (which relates to such payments):

If this section is not complied with on or before the due date, the persons who are directors of the company from time to time after the due date continue to be under the obligation imposed [to make such payments]

Dr Solomon was a re-appointed director of both of the relevant companies but subsequently resigned. However, Dr Solomon continued to act in the interests of the companies. The evidence was that he:

- had daily contact with directors;
- had the right of approval of the sale of the Singapore operations;
- attempted to generate revenue from stock sales;
- had an active involvement in the preparation of projected cash flows;
- had an active involvement in an arrangement with the ATO to receive a reduction of the group's taxation liabilities; and

- had an active involvement with the employees of the companies.

Mr Muriwai was a director who subsequently resigned but he remained on with the companies as an employee "to try to manage a way out of the [companies' financial difficulties] but not as a director" (at para 22). Mr Muriwai also:

- had conversations with Dr Solomon about the running of the companies;
- had involvement in the preparation of projected cash flows;
- entered into negotiations with various directors and third parties for the obtainment of funds to be injected into the companies to avoid liquidation;
- was attempting to convince the directors of the companies to place them into liquidation or administration;
- had involvement with the employees of the companies and instructions to the employees which the employees treated as superior to the instructions given by the directors of the company;
- was seeking financial advice and legal advice on behalf of the companies.

The Court held that Dr Solomon and Mr Muriwai were directors of the companies pursuant to s9.

With regard to Dr Solomon, it was argued that the facts indicated a similar situation to Dr Graiche in the *Natcomp Case* who had been found not to be a s9 director. However this submission was not successful as the Court distinguished the facts in this case on the basis that Dr Graiche was not involved in the company's main activity of retail sale of computer packages, his involvement being limited to the development and marketing of new products. By contrast, the Court found, Dr Solomon was involved in the main activity of the companies.

18. ASIC's National Insolvent Trading Program

The NITP is described by ASIC as a focused approach to dealing with possible insolvent trading before it occurs. It involves a review of companies to ensure compliance by directors of their duties under the Act.

Under NITP ASIC has hired and seconded additional insolvency specialist staff. These people have been kept busy conducting surveillance visits of 285 companies up to 31 December 2003.

Of the companies reviewed:

- 26 companies have appointed a voluntary administrator or liquidator following a visit;
- 105 companies have been asked to supply updated or additional information; and
- the directors of a significant number of other companies have sought restructuring advice.

In February this year, ASIC successfully brought its first winding up application on the grounds of insolvency under NITP.

The aims of the program according to ASIC are to:

- (i) make company directors aware of their company's financial position;
- (ii) make directors of potentially insolvent companies aware of their responsibilities and the implications of continued trading if they know they're insolvent;
- (iii) encourage directors to seek external advice from accountants and lawyers on restructuring; and
- (iv) encourage directors to seek advice from insolvency professionals where appropriate, and to take action to appoint a voluntary administrator or liquidator where necessary.

The thinking behind these aims is that early action maximises the chances of the company surviving, which in turn minimises hardship to creditors and costs to the Australian economy caused by insolvent trading.

Companies may be selected for review through one or more of the following sources:

- (i) complaints received from the public, including complaints from credit managers and company employees;
- (ii) listed companies that have their annual reports reviewed as part of ASIC's accounts surveillance program and are identified as financially-stressed;
- (iii) information from liquidators; and
- (iv) referrals from other areas within ASIC.

A review under NITP is not an audit or an investigation. It is initiated for the purposes of ensuring compliance by directors with certain duties under the Act and involves a discussion of the financial position of the company with the directors, and a review of financial records and forecasts.

Directors will be required to provide all documents requested under a notice issued under sections 30 or 33 of the *ASIC Act 2001* (Cth).

ASIC have indicated that Managing Directors should attend a review, however where appropriate, other directors, finance staff, external accountants and lawyers may also attend.

On completion of a NITP review, ASIC may:

- (i) write to the company setting out its concerns about the company's potential insolvency;
- (ii) ask that the company prepare up to date management accounts;
- (iii) ask that the company approach an insolvency professional for advice on the possible appointment of an external administrator; and/or
- (iv) take action directly.

Cases of suspected breaches of the Act, and where directors are not seeking to comply with their responsibilities, are considered for possible enforcement action.

The NITP will be a focus for ASIC for at least the next 4 years.