
1. Introduction

The present global meltdown has put directors in an invidious position: they may have assets on their books that they consider to be very valuable but little access to funding to borrow against them and little interest from buyers at what they consider to be appropriate values. This may be because potential buyers of assets are also having trouble accessing credit.

When faced with those issues, directors who have debts falling due may find that their company has become insolvent under Australian law. They then have to consider their willingness to expose themselves to the risk of insolvent trading.

Of course, this is not a phenomenon limited to Australia. But Australia has some of the most punitive insolvent trading laws in the world. This leaves Australian directors more exposed than their foreign counterparts.

In Australia, the Federal Government's response to the credit crunch has, so far, been to increase government guarantees for approved deposit taking institutions and to seek to provide some fiscal impetus to the economy. However, relief for directors does not seem to have made it onto the table.

In that context, this paper addresses the latest developments (and lack of them) in the law relating to insolvent trading in Australia. Specifically, it:

- (a) provides an overview of Australia's statutory regime;
- (b) compares Australian insolvent trading laws with analogous laws in other jurisdictions, including recent amendments to German law to make conditions easier for directors in the current economic conditions;
- (c) discusses future directions for Australian law in this area; and
- (d) reviews the most recent cases on insolvent trading and why you need to know about them.

2. Insolvent trading – general principles

2.1 What is insolvent trading?

A director will engage in insolvent trading in breach of section 588G of the *Corporations Act 2001* (Cth) (the **Corporations Act**) if the company incurs a debt and:

- (a) the company is **insolvent** at the time of incurring the debt or becomes insolvent by incurring the debt;
- (b) at the time the debt is incurred, there are **reasonable grounds for suspecting** that the company is insolvent or will become insolvent;

- (c) the **director is aware of such grounds or a reasonable person** in a like position in a company in the circumstances of the company **would be so aware**; and
- (d) the director **fails to prevent** the company from incurring the debt.

2.2 Consequences of breach of section 588G

There are three primary consequences for directors of a breach of the insolvent trading provisions of the *Corporations Act*.

- (a) **Civil Penalty** – A breach may attract a pecuniary penalty for the director personally of up to \$200,000. In addition, ASIC may apply for the disqualification of a director from taking part in the management of companies.
- (b) **Compensation** – If the relevant company is wound up, proceedings may be brought against a director personally to pay compensation to the company in an amount equal to the debts incurred in contravention of the section. A compensation claim may be brought against directors by a liquidator, a creditor (with the consent of the liquidator) or ASIC.
- (c) **Criminal Liability** – In some cases, where there is actual suspicion of insolvency and the failure to prevent the incurring of the debt is dishonest, criminal liability may apply with a fine of up to \$200,000 or imprisonment for up to five years, or both.

2.3 What is insolvency?

As discussed above, liability under section 588G arises if debts are **incurred** by the company when it is **insolvent**.

Under section 95A of the *Corporations Act*, a company is insolvent if it is **unable to pay all of its debts as and when they become due and payable**. This has generally been viewed as importing a cash flow test rather than a balance sheet or net assets test.

As Owen J said in the newly handed down decision in *The Bell Group Ltd (in liq) v Westpac Banking Corporation & Ors [No 9]* [2008] WASC 239 (**Bell**), "The former [test] focuses on income sources that were available to the entity and expenditure obligations it had to meet. The latter concentrates on the value of the assets and liabilities reflected in the company's books".¹

Although the cash flow test has generally been regarded in Australian jurisprudence as the applicable test for determining solvency under the *Corporations Act*, Owen J remarked in *Bell* that the balance sheet test should not

¹ *The Bell Group Ltd (in liq) v Westpac Banking Corporation & Ors [No 9]* [2008] WASC 239 at [1065].

be dismissed as irrelevant.² It can, for example, be useful in providing contextual evidence for the proper application of the cashflow test.³ His Honour cited with apparent approval an academic opinion that the cash flow test should be viewed as the basic starting point but that the ultimate consideration will be:

in the light of commercial reality, all things considered, could the company pay its debts as and when they become due? Such an approach includes the balance sheet test, and other commercial realities such as access to money from third parties, raising capital or credit and financial support are all relevant considerations in determining a company's ability to pay debts.⁴

For the purpose of the insolvent trading provisions of the *Corporations Act*, the solvency test must be conducted at the time the relevant debt is incurred and not when the debt becomes due for payment. At the time the debt is incurred, the company must be able to pay all of its debts as and when they become due and payable. In this respect, the directors must look to the future to some degree to determine whether, at the time the company incurs a debt, it has the capacity to pay all of its debts as and when they become due for payment in due course. Reliable and well-prepared cash flow forecasts are obviously critical to this assessment.

A question that will often arise is "how far into the future must one look to determine a company's current solvency or insolvency?" In *Bell*, after a detailed examination of the authorities in the area, Owen J rejected the notion that there was a legal test that establishes a single relevant time span for all cases. Rather, "This is quintessentially an area in which each case must be determined according to its own peculiar circumstances".⁵ As Barwick CJ suggested in *Sandell v Porter*,⁶ the time period over which the court will consider the company's ability to pay is relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor.

2.4 What is a debt and when is it incurred?

The term "debt" is not defined in the *Corporations Act*. However, there are certain actions that are expressly taken to constitute the incurring of a debt by a company for the purpose of the insolvent trading provisions. Those actions are set out in section 588G(1A). They primarily relate to capital raising and disposition. They include paying a dividend, making reductions in share capital, buying back shares,

² Ibid, at [[1073].

³ Ibid.

⁴ N Coburn, *Coburn's Insolvent Trading* (2nd ed, 2003) 66, cited in ibid at [1073].

⁵ *The Bell Group Ltd (in liq) v Westpac Banking Corporation & Ors [No 9]* [2008] WASC 239 at [1128].

⁶ Cited in ibid at [1125].

redeeming or issuing redeemable preference shares, financially assisting a person to acquire shares in itself or its holding company and entering into an unauthorised uncommercial transaction. The subsection qualifies the circumstances in which such actions are deemed to be debts. Such debts are incurred at the times specified in section 588G(1A).

Except in respect of actions that are deemed under section 588G(1A) to constitute the incurring of a debt, the question of whether a debt has been incurred is a legal question determined by common law principles. Whether a debt has been incurred will generally depend upon the circumstances surrounding the particular action or conduct in question. The answer is not always clear but there are some guiding principles that can be drawn from judicial authority.

First, to qualify as a debt a liability must generally be for a certain or readily quantifiable amount in contrast, for example, to a liability for unliquidated damages.

Second, a debt is generally considered to be a voluntarily-incurred liability, such as a contractual or otherwise voluntarily-assumed obligation to pay a sum of money either now or at some future time. One formulation of the rule is that 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.

Third, a liability may be a debt even if it is contingent. This is provided that the liability that the entity will have if the contingency arises is unavoidable and quantifiable. Accordingly, a company may incur a debt when it subjects itself to a conditional (but unavoidable) obligation to pay a sum of money at some future time. Typical examples include a guarantee or a contract under which a sum of money is required to be paid upon the fulfilment of a condition or the occurrence of some event. In each case, the debt is incurred when the contract or guarantee is entered into, not when the condition is satisfied or a demand made under the guarantee.

The term "incurs" is to be applied flexibly in a practical and common sense manner. It is therefore difficult to formulate a general rule to apply to every debt the company may incur (other than those deemed by section 588(1A)) and each transaction must be considered on its facts.

2.5 When is a debt due?

As to when a debt should be regarded as falling *due*, this also is a factual question which must be determined in light of all the circumstances of the case. The time at which a debt is considered to be "due" obviously has a bearing on cashflow projections and therefore solvency. Usually, for the purposes of the insolvent trading provisions, a debt falls due when it is legally due for payment pursuant to

the relevant contractual terms or any agreed extension of time for payment arranged in advance with the creditor. In this regard, it should be noted that forbearance by creditors will not necessarily be sufficient to defer due dates for payment.

2.6 Ability to pay debts

In earlier versions of the corporations legislation, the insolvency test required a company to be able to pay its debts as and when they fell due **out of its own moneys**. The definition of solvency in section 95 of the *Corporations Act* no longer expressly contains the "own moneys" requirement. Does this mean that access to funding from external sources can be taken into account in determining whether a company is able to pay its debts? Set out below are some general observations based on the decided cases.

(a) Sale or pledge of assets

Even when there was an "own moneys" requirement, a debtor's "own moneys" were not limited to its cash resources immediately available. They extended to "moneys which [it] can procure by realization by sale or by mortgage or pledge of [its] assets within a relatively short time – relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor".⁷

As such, for solvency test purposes it is legitimate for cash flow forecasts to include proceeds from asset sales which directors reasonably believe will be available to the company to meet debts.

(b) Unsecured borrowings

Given the lack of an "own moneys" requirement, unsecured borrowings may, in principle, legitimately be taken into account in determining whether a company is solvent. However, if the availability of unsecured loan funds is critical to a company's solvency, a very pertinent question will be on what terms are the funds to be provided? A short term loan may result in the lender itself becoming a creditor whose debt cannot be repaid when it is due and payable.⁸ On the other hand, long term or fully subordinated, unsecured borrowings that can be applied to pay current debt are more likely to render a company solvent in the relevant statutory sense.

(c) Trading out of insolvency

It is not appropriate to base an assessment of solvency on the prospect that the company may be able to trade profitably in the future, thereby

⁷ *Sandell v Porter* (1966) 115 CLR 666 at 670 per Barwick CJ.

⁸ See *Lewis v Doran* [2005] NSWCA 243 at [109] per Giles JA.

restoring its financial position. The question is whether, at the time the company incurs a debt, it is able to pay all of its debts as they become due – not whether it might be able to do so in the future, if given time to trade profitably.

(d) **Offers of ongoing support by shareholders and related entities**

Provision of support by a holding company or other related entity often arises as a relevant consideration in assessing solvency. Generally, directors may have regard to promises of financial assistance by a related party when determining a company's solvency. There is no reason in principle why financial support from related parties should be treated differently from arm's length parties. But as Muir JA said in *Williams v Scholz* [2008] QCA 94 at [110], "The most important consideration is the degree of commitment to the continuation of financial support". Accordingly, the availability of financial support from a related party will generally only be taken into account as a factor indicating solvency if:

- (i) the assurance is clearly defined;
- (ii) the funds are likely to eventuate; and
- (iii) with the benefit of the assistance, the company *will* be able to pay its debts as and when they fall due.

The extent to which funds might objectively be regarded as likely to eventuate will depend on the surrounding circumstances, the events preceding the offer of support and the inferences that might be drawn from the identity of the provider of support. Other relevant factors will include whether support had previously been given and the extent to which the offer of support is legally binding.

(e) **The possibility that creditors might compromise their debts**

The upcoming decision of Justice McMurdo in the Octaviar proceedings is likely to provide significant guidance on the ability of directors to assert present solvency on the basis that a compromise with creditors is possible. In the meantime, the difficulties facing directors of companies under financial stress, and the countervailing need to protect creditors against the risks of insolvent trading, was underlined by Owen J in *Bell*⁹:

I accept that commercial life is complex. It would be unrealistic to say that a company under financial stress could not deal with a major creditor so as to buy time to get the remainder of its house in order unless it could spell

⁹ *The Bell Group Ltd (in liq) v Westpac Banking Corporation & Ors* [No 9] [2008] WASC 239 at [6054]-[6055].

out, chapter and verse, every single move it intended to make in that respect. Life is not that simple.

But here the first step in the restructure had far-reaching consequences in relation to future moves because of the pledging of all worthwhile assets and the effective ceding of control of asset sale proceeds to one creditor. In that situation it was incumbent on the directors, if they were properly to carry out their functions, to have investigated feasible solutions to rectify the position. This is especially so in a restructure where steps two and following may involve asking other creditors to cooperate and, perhaps, take something less than 100 cents in the dollar in respect of their debts. Counsel for the plaintiffs put it in blunt terms:

"You could just drive a truck through the insolvency laws if the directors could say, 'We're hopelessly broke. We've got \$800 million of debt. We can only support 200, but the creditors might come to the party – we haven't asked them – so we're solvent'.

2.7 Reasonable grounds for suspecting insolvency

In addition to proving actual insolvency, a plaintiff or prosecutor in a section 588G insolvent trading case must establish that (at the time the debt was incurred) there were reasonable grounds for suspecting that the company was insolvent when a debt was incurred or that it would become insolvent by incurring it. This is an objective test. The court must base its determination on the reasonably knowable financial circumstances of the company at the relevant time, not the financial circumstances as subjectively known to a defendant director. It is necessary to establish that those objective criteria gave rise to reasonable grounds for a "suspicion" of insolvency.

2.8 Awareness of grounds for suspecting insolvency

Under section 588G(2), in order to impose liability on the directors for insolvent trading, the court would also need to make a finding (and, again, the plaintiff or prosecutor bears the onus of proof in this regard) that:

- (a) the director was **aware** that there were reasonable grounds for suspecting that the company was insolvent; or
- (b) if actual knowledge cannot be proved, that a **reasonable person** in a like position in a company in the same circumstances as the company **would be so aware**.

The latter alternative is an objective test which must be viewed in the context of the subjective circumstances of the particular company and the director's position in the company.

2.9 Who is a "director"?

It should be noted that section 588G applies to a person who is a "director" of the company incurring the debt. This can include the following:

- (a) a person appointed to the position of director;
- (b) an alternate director acting in that capacity;
- (c) a "shadow" director, that is, a person who is not validly appointed as a director if:
 - (i) the person purports to act in that position; or
 - (ii) the directors of the company are accustomed to act in accordance with the person's instructions or wishes.

The notion of shadow directors may also extend to a company which gives instructions. In addition, section 588V provides that a holding company will be liable for insolvent trading if:

- (d) the subsidiary company is **insolvent** at the time of incurring the debt or becomes insolvent by incurring the debt;
- (e) at the time the debt is incurred, there are **reasonable grounds for suspecting** that the subsidiary company is insolvent or will become insolvent by incurring the debt;
- (f) the holding company or one or more of its directors is aware of such grounds or a reasonable person in a like position in a company in the circumstances of the holding company or one or more of its directors would be so aware.

2.10 Defences available to Directors

Below is a summary of the various defences upon which directors may seek to rely if a prima facie case of insolvent trading is established. Clearly, however, the prudent course for directors is to ensure that they act in a manner which avoids any allegation that there has been insolvent trading.

(a) **Reasonable grounds to expect solvency**

The first defence is that the director had reasonable grounds to **expect**, and did expect, that the company was solvent at the time the debt was incurred and would remain solvent even if it incurred the debt. The defence contains both the subjective element of actual expectation by the director of solvency and the objective element of reasonable grounds for that expectation.

This defence pre-supposes that a director can prove that he or she has in fact monitored the company's financial affairs and, on that basis, formed a

positive view as to the company's solvency. The grounds for expecting that the company is solvent must be objectively reasonable in all the circumstances, not subjectively reasonable from a particular director's perspective.

To rely on this defence, directors must be able to demonstrate that they participated actively in the company's affairs and informed themselves of its position appropriately.

(b) Information supplied by a subordinate

The second defence is that the director expected that the company was solvent and would remain so, on the basis of information supplied by another person (eg, a subordinate, another director or an advisor). This also requires the director to show that he or she believed on reasonable grounds that the other person was a competent and reliable person who was responsible for providing adequate information as to whether the company was solvent. To rely on this defence, a director must be able to show that, at the time the debt was incurred, the director had reasonable grounds to believe (and did believe) that the company had delegated to the other person the task of providing the director with adequate information regarding the company's financial affairs, that the other person was fulfilling that responsibility and that there was no basis for suspecting that the information provided was anything other than accurate.

(c) Ill health or other good reason

The third defence is that the director, because of illness or some other good reason, did not take part in the management of the company at the time the debt was incurred. What constitutes "some other good reason" will be defined by the courts on a case by case basis.

(d) Reasonable steps to prevent the debt being incurred

Finally, it is a defence to the insolvent trading provisions for a director to show that he or she took all reasonable steps to prevent the relevant debt from being incurred. This imposes on a director a positive duty to take preventative steps when the director suspects the company may be insolvent. In that context a director must be able to point to some positive act which he engaged in to prevent the company incurring the debt, such as convening a board meeting at which a resolution was proposed by that director to:

- (i) oppose the incurring of the debt;

- (ii) revoke the authority of officers to incur debts on behalf of the company and direct that the company conduct all transactions on a cash basis;
- (iii) propose a resolution that the company appoint a voluntary administrator under Part 5.3A of the *Corporations Act*.

A director may need to consider resigning from the board if previous action taken by the director fails to prevent the company from incurring the debt.

(e) **Section 1318 of the *Corporation Act***

Section 1318 of the *Corporations Act* also empowers a court to relieve a director from liability for contravening the *Corporations Act* (including the insolvent trading provision) if that person has acted honestly and, having regard to all the circumstances of the case, ought fairly to be excused.

Such relief may only be partial.

3. **Australia's insolvent trading regime in context: an Anglo-American perspective**

3.1 **Comparison between the insolvent trading regimes in Australia, New Zealand, the UK and the US**

It is arguable that Australia has the strictest insolvent trading regime in the Anglo-American world. The US academic Dale A Oesterle has compared the statutory regimes in Australia, New Zealand, the United Kingdom and the United States¹⁰. This section provides a summary of his analysis.

According to Oesterle, Australia has the most restrictive insolvent trading laws compared with New Zealand and the UK on a number of different measures. The comparison below is a summary of his analysis.

The Australian position is as follows:

- It is possible for a director to be liable under section 588G of the *Corporations Act* if there are reasonable grounds merely for *suspecting* that the company is insolvent, if the director was aware of this or ought reasonably to have been so aware.
- There is also no need for a director to have participated in the relevant transaction(s), as long as he or she did not stop the company from incurring the debt when insolvency was, or should reasonably have been, suspected.

¹⁰ Dale A Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' at 25 and 35-37, (ed) Ian M Ramsay, *Company Directors' Liability for Insolvent Trading*, CCH Australia Limited and Centre for Corporate Law and Securities Regulation, the University of Melbourne, 2000.

By contrast, the regime in New Zealand is slightly more lenient:

- Under section 136 of the *Companies Act 1993* (New Zealand), a director must not agree to the company incurring an obligation unless the director *believes* at the time on reasonable grounds that the company will be able to perform the obligation when it is required to do so. [This is more lenient than the Australian position because, logically, it is possible for there simultaneously to be reasonable grounds for *suspecting* that a company is insolvent but for *believing* that it is and will remain solvent.]
- The wording of the New Zealand statute also emphasises directorial participation more than its Australian counterpart (the director has a duty not to *agree* to the company incurring an obligation while it is insolvent rather than a duty to *prevent* the company from incurring it). That said, it is possible for a director in New Zealand to be liable under section 136 of the *Companies Act 1993* for *allowing* the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors, so the end result may not differ greatly.
- The requirement to take preventative or corrective action also commences later in New Zealand than in Australia. Instead of requiring directors to act when they ought to be suspicious (as in Australia), the *Companies Act* in New Zealand does not require the director to act until there are no longer "reasonable grounds" for belief in the firm's solvency.

The regime in the UK is more lenient still.

- A director may be liable for "wrongful trading" under section 214(2) of the *Insolvency Act 1986* (UK) if a director knew or ought to have concluded that there was *no reasonable prospect that the company would avoid* going into "insolvent liquidation".
- For relevant purposes, a company goes into "insolvent liquidation" if it goes into liquidation "at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up": *Insolvency Act 1986* (UK) section 214(6). This imports a balance sheet test of solvency rather than the cash flow test that prevails in Australia and New Zealand. This means that the time at which liability for insolvent trading is triggered commences later than in the other two jurisdictions, as a position of negative equity will occur later than an inability to pay debts as and when they fall due.

By contrast to all three jurisdictions, United States legislation does not impose personal liability on directors for insolvent trading. While there are provisions relating to fraudulent conduct by directors (as there is in all the jurisdictions mentioned above), potential creditors are left to protect themselves from the effect

of insolvent trading through contract. As Oesterle points out, they can do this by, for example, increasing the interest rate at which money is loaned to the company to in proportion to the perceived risks of not being repaid, or imposing restrictive conduct on the company, such as preventing the company from taking on a debt with a higher priority.

3.2 Policy context for these contrasts

The policy rationale behind insolvent trading legislation is the protection of creditors. This suggests that where, as in the US, there is no insolvent trading regime, there is an assumption that creditors do not need the protection or that insolvent trading laws would not be an efficient way of providing the protection. Oesterle argues¹¹ that insolvent trading laws in Australia, New Zealand and the UK have proved so complex that they have created uncertainty. He contends that the fear of incurring personal liability has also deterred talented people from becoming directors, or prevented directors from taking sensible risks when a company is facing financial difficulty.¹² These factors have discouraged the development of business and enterprise, which has ultimately had a detrimental affect on the capacity of creditors to expand their businesses, thereby failing to help the very parties the laws are aiming to protect.

On the other hand, an Australian academic, Ian M Ramsay, has observed that it is not always possible for creditors to adequately protect themselves through contract¹³. This may be because the cost of obtaining the necessary information to assess the risk level of a particular transaction may outweigh the value of the transaction itself. Some creditors, such as tort claimants, are of course not in a position to protect themselves through contract at all.

3.3 Changes to insolvent trading laws in response to current economic crisis

The current global economic crisis invites a reconsideration of how to strike the right balance between protecting creditors and allowing directors a reasonable opportunity to trade a company out of its financial difficulties without resorting to external administration.

Law firm Mayer Brown has recently released an article on changes to the German Insolvency Code which appear to have been made in response to the current

¹¹ Ibid.

¹² See also, John Martin, "Harsh insolvency laws are a template for disaster", *The Australian Financial Review*, 27 March 2009, 42.

¹³ Ian M Ramsay, 'An overview of the Insolvent Trading Debate', (ed) Ian M Ramsay, *Company Directors' Liability for Insolvent Trading*, CCH Australia Limited and Centre for Corporate Law and Securities Regulation, the University of Melbourne, 2000.

economic crisis and which will make it easier for directors to avoid liability for insolvent trading¹⁴.

Until these changes, the boards and directors of German companies were obliged to file for insolvency if the company was either "insolvent" or "over-indebted", subject to a three week cure period. If the directors did not file in that time, they could be liable for criminal prosecution for the delay and damages to the company's creditors.

Pursuant to the Code, a company is "over-indebted" if its assets do not cover its liabilities, (whereas "insolvency" is determined by a liquidity test).

According to Mayer Brown, as a result of the recent amendments, it is no longer compulsory to file for insolvency if the company is "over-indebted" as long as there is a "predominant probability" that the business of the company can continue. However, this relaxation of the requirement to file only exists until December 2010 and the obligation to file if the company is insolvent has not changed.

These changes should make it easier for directors to weather the current credit crisis without becoming personally liable if their company becomes "over indebted".

In April this year, Senator Nick Sherry, Minister for Superannuation and Corporate Law, announced that the Commonwealth would conduct an audit of its laws that impact on the issue of company director liability against the principles developed by the Council of Australian Governments¹⁵. The audit is due to commence in the second half of 2009. There is however no indication that the Australian Government will introduce changes to our statutory regime, such as that in Germany, in response to the current crisis. A spokeswoman for the Hon Nick Sherry, was recently quoted in the *Australian Financial Review*, stating: "The government believes our insolvency laws strike the right balance between maintaining confidence in our insolvency system and the obligations of directors"¹⁶. Nevertheless, business groups and insolvency practitioners continue to call for a review of voluntary administration laws to facilitate corporate restructuring¹⁷.

Indeed, the only response to the current crisis has been a recent announcement by the Australian Securities and Investments Commission offering directors of small to medium companies leniency in any actions for insolvent trading if they can

¹⁴ Mayer Brown, *Restructuring Bankruptcy & Insolvency Legal Alert*, 24 October 2008.

¹⁵ Senator The Hon Nick Sherry, "Commonwealth to conduct audit of laws impacting on directors' liability", *Media Releases*, The Commonwealth, 17 April 2009
<<http://minscl.treasurer.gov.au/displaydocs.aspx?doc=pressreleases/2009/034.htm&pageID=003&min=njs&Year=&DocType=0>> (20/05/09).

¹⁶ James Eysers, "Directors need more protection", *The Australian Financial Review*, 13 May 2009, 12.

¹⁷ *Ibid.*

demonstrate that they took appropriate advice from an accountant and acted in good faith.¹⁸ In a recent article in the *Australian Financial Review*, ASIC commissioner Michael Dwyer said ASIC's enforcement of insolvent trading laws would be guided by whether "directors of smaller companies have completed their obligations by taking appropriate advice. If, with the benefit of hindsight, we look back and see a small to medium-sized company and a director has traded whilst insolvent but has taken appropriate advice and followed that advice, he has probably acted in good faith and will be OK... If they don't take advice or have taken advice and they do not follow it, that is where we are going to crack down."¹⁹

It is questionable, however, whether ASIC's concession is a concession at all. Directors receiving legal and accounting advice and acting on it, are unlikely to be engaging in insolvent trading. As discussed above, the *Corporations Act* provides a defence to contravention of section 588G if, at the time when the debt was incurred, the director expected that the company was solvent and would remain so, on the basis of information supplied by another person.²⁰

4. Future Directions

On 5 March 2007, the Federal Treasurer at the time, Peter Costello, released a paper entitled *Review of Sanctions in Corporate Law*. The paper discussed the effect of such sanctions on commercial decision-making and the need to balance the deterrence of undesirable corporate conduct with tendency of such sanctions to discourage businesses from taking sensible risks.

In the context of insolvency, the paper proposes a new general defence for directors where they act in good faith and explores whether this defence should be extended to apply to insolvent trading.

The paper does not specifically explore how the new defence would interrelate with existing defences under section 588H of the *Corporations Act*, such as that the director had reasonable grounds to expect solvency, that reliance was placed on a competent and reliable adviser, that the director did not take part in the management of the company for some good reason, or that the director took reasonable steps to prevent the company incurring debt. However, it does acknowledge that on one view, the defence would have no practical effect, as a director that could not rely on an existing defence, could not be said to have acted in "good faith".

¹⁸ James Eyers, "ASIC leniency for business failure", *The Australian Financial Review*, 28 April 2009, 1, 60.

¹⁹ *Ibid* at 60.

²⁰ *Corporations Act 2001* (Cth), s 588H(3).

However, the paper emphasises that many directors who take risks while their company is close to insolvency, do so in a genuine belief that the company will be able to trade out of difficulties. The possibility that such directors may not be able to avail themselves of an existing defence appears to be the main point behind proposing the new one, referred to above.

Submissions on the paper were due by 1 June 2007, but there appears to have been no public response made by the Government to the submissions since that date.

5. 2007 – 2008 insolvent trading cases

5.1 Definition of insolvency in the context of reinsurance contracts – *New Cap Reinsurance Corporation (in liq) v Grant & Ors*

The decision in *New Cap Reinsurance Corporation (in liq) v Grant & Ors* [2008] NSWSC 1015 relates to whether future claims in respect of insurance or reinsurance contracts are "debts" for the purposes of the insolvency test under section 95A of the *Corporations Act*. This will be relevant to insolvent trading claims against directors of insurance and reinsurance companies, in the context of determining whether the company was insolvent at the time the relevant transactions were entered into by those directors.

New Cap Reinsurance Corporation (**NCRA**) was a reinsurance company that went into liquidation at the end of 1998. The liquidator brought proceedings against a number of parties, alleging that NCRA had entered into voidable transactions while the company was insolvent. The question of solvency was determined by White J in relation to one defendant only in these proceedings.

The first substantive issue addressed by the court was whether it was permissible to use hindsight to value the company's liabilities at a particular point in time.

White J held that it was permissible, stating at paragraph 50 that:

in my opinion, in determining whether NCRA was solvent, *as distinct from whether it may reasonable have appeared that it was solvent*, regard should be had to the quantum of its insurance liabilities as they are now known to be, even if it were reasonable at the time that NCRA not know the extent of those liabilities.
(emphasis added)

The next question was whether "debts", as referred to in section 95A of the *Corporations Act*, includes liabilities to pay unliquidated damages. This was relevant because at the time the liquidators alleged that NCRA was insolvent, a substantial proportion of its liabilities were for amounts to be paid at some time in the future to cedents under its reinsurance contracts. Such liabilities, for potential but highly probable liabilities to pay damages in respect of existing contracts, were held to be future obligations to pay unliquidated damage rather than "debts" for the

purposes of section 95A in *Box Valley Pty Ltd v Kidd* [2006] NSWCA 26 (**Box Valley**) by the New South Wales Court of Appeal.

White J observed that this decision appeared to be inconsistent with the High Court case of *Bank of Australasia v Hall (trustee of the estate of Robertson (in liq))* [1907] 4 CLR 1514 (**Bank of Australasia**). In that case, the court took the debtor's liability to pay unliquidated damages (in respect of an action for breach of warranty and fraudulent misrepresentation) into consideration in determining solvency, where the matter was listed for hearing within the month of the transaction at issue being made. White J held that, although *Bank of Australasia* is a decision of the High Court, it was his duty to follow the decision in *Box Valley* as a later decision of the intermediate court of appeal in his own jurisdiction.

However, contrary to a long line of authority cited at paragraph 87, White J found that claims made on NCRA's reinsurance policies were "debts" rather than claims for unliquidated damages. In support of this view, his Honour contrasted an insurer that fails to protect an insured from loss, and that may be sued in damages for failing to perform its primary obligation under the contract, with an insurer that breaches a promise to compensate an indemnified party for losses sustained, who may be sued in debt for the recovery of what was promised to be paid.

White J therefore held that the future claims under NCRA's reinsurance policies could be taken into account in determining its solvency.

This decision has broadened the definition of "debt" under section 95A. This may increase the likelihood of successful insolvent trading claims being made against directors of insurance and reinsurance companies in the future.

5.2 Possible return to creditors relevant to the exercise of the court's discretion under sections 1317S(2) and 1318? – *Hall & Ors v Poolman & Ors*

The decision of *Hall & Ors v Poolman & Ors* [2007] NSWSC 1330 relates to three separate proceedings arising out of the liquidation of the Reynolds Group of companies, which owned vineyards and a winery near Orange.

One of the claims to be determined was that Mr Irving, the Chairman of both Reynolds Wines Ltd (**Wines**) and its subsidiary, Reynolds Vineyards Pty Ltd (**Vineyards**), had engaged in insolvent trading.

Palmer J found that there were reasonable grounds for suspecting insolvency throughout the relevant period, and that Mr Irving was aware of those reasonable grounds for the purposes of section 588G(2)(a) of the *Corporations Act*.

Mr Irving raised a defence under section 588H, arguing that he believed on reasonable grounds that Wines and Vineyards were solvent because he relied upon the advice of senior management and external advisors. However, Palmer J found, on the basis of the information Mr Irving knew for himself, that he could not

have had a reasonable belief that the companies were solvent during the relevant period.

Mr Irving also raised discretionary defences under sections 1317S(2) and 1318(1) of the *Corporations Act*, seeking to be fairly excused from his liability on the basis that he had acted honestly. Palmer J noted that there is some debate on whether section 1318(1) applies to insolvent trading cases. While Palmer J supported the proposition that it does, he agreed with Lander J in *Scott v Williams* [2002] SASC 424 that it "ultimately does not matter" because the court must consider the same issues under both provisions.

The key consideration under both provisions is whether the person has acted "honestly". On this point, Palmer J stated that:

In my view, when considering whether a person has acted honestly for the purposes of a defence under CA s 1317S (2)(b)(i) or s 1318, the Court should be concerned only with the question whether the person has acted honestly in the ordinary meaning of that term, ie, whether the person has acted without deceit or conscious impropriety, without intent to gain improper benefit or advantage for himself, herself or for another, and without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been [made] to carry out the duties and obligations of his or her office imposed by the Corporations Act or the general law.

His Honour went on to state that a failure to consider the interests of the company as a whole, including creditors, should not necessarily lead to a finding that the person had not been honest, unless it was of such a high degree that it demonstrated a failure to act honestly in the sense discussed above.

In applying this definition of honesty, Palmer J found that Mr Irving had been "honest" for the purposes of sections 1317S and 1318. However, he found that Mr Irving should be excused of liability in relation to debts incurred only up until a certain date in the relevant period. After that point, his Honour held that Mr Irving had not acted as a reasonable, commercially experienced director and therefore should not be excused.

One of the most interesting aspects of the case was that Mr Irving's counsel argued that because the whole or the vast majority of the fruits of the insolvent trading claim were to go to a litigation funder and the liquidators rather than those that had suffered from the conduct, namely the creditors, Mr Irving should be excused of liability.

Palmer J discussed the majority decision of the High Court in *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd* (2006) 80 ALJR 1441, where the court accepted that litigation is a "reality of modern life". As a result of that decision, his Honour held that the circumstances of the litigation funding and the low return to creditors afforded no right of complaint to Mr Irving and could not be taken into

consideration in respect of the exercise of the court's discretion under sections 1317S or 1318. Nevertheless, his Honour considered that the conduct of the liquidators was such that an inquiry under section 536 of the *Corporations Act* was justified and made orders accordingly.

5.3 The role of liquidators in serving the public interest in relation to the failure of companies and the conduct of their directors – *Hall v Poolman*

Hall v Poolman [2009] NSWCA 64 was an appeal from the decision of Palmer J (above) to order an inquiry into the conduct of the liquidators. The application for leave to appeal and the appeal itself were heard concurrently. The Court of Appeal considered two main issues.

The first issue was the construction of section 536. The court found that section 536 has quite a broad reach because none of the powers conferred by that section depends upon there being a prima facie evidentiary case of a failure faithfully by the liquidator to perform or to observe legal requirements.²¹ Further, (per Hodgson JA and Austin J) a 'complaint' made for the purposes of section 536(1)(b) did not need to be a formal complaint. Criticism expressed to the court about the conduct of the liquidators by defendants as part of their defence of an insolvent trading claim could be sufficient.²²

The second issue was the exercise of the court's jurisdiction to order an inquiry and whether the exercise of that discretion miscarried. The Court of Appeal found that the liquidators' submissions identified two grounds for appellate intervention. Firstly, Palmer J failed to take into account or failed to give weight to the question of public interest in recovery proceedings. Secondly, the Court of Appeal found that Palmer J took into account an extraneous matter that he regarded as material the view that the liquidators should have, as a matter of course, sought directions from the court before entering into the litigation funding agreement.

Importantly, the Court of Appeal held that liquidators may bring proceedings legitimately and in accordance with their duties with the aid of a litigation funder even where there may be little or no benefit to the unsecured creditors with provable claims in the liquidation where:

- the liquidators have incurred costs in preliminary investigations and in creditors' meetings; and
- they consider that the prospective benefits to creditors justify further investigation in which they will incur more costs and expenses; and

²¹ *Hall v Poolman* [2009] NSWCA 64 at [79].

²² *Ibid.* Hodgson JA and Austin J agreeing; Spigelman CJ disagreeing at [93].

- there are then no assets, in the absence of litigation, to pay the costs already incurred.

However, the above is subject to the following:

- the pre-litigation costs must have been either necessary or reasonably considered to be justified because of the prospective benefits to creditors; and
- the litigation costs themselves must have been reasonably incurred and proportionate to the prospective benefits (including not only possible direct benefits to creditors but also the benefits derived through the reimbursement of the liquidator's fees and expenses); and
- the litigation funding agreement must not be on manifestly unreasonable terms.²³

The Court of Appeal found that where the creditors had approved entry into a litigation funding agreement on a fully informed basis there was no general principle requiring the liquidator to also seek court approval before entering into a litigation funding agreement.

Accordingly, the Court of Appeal granted leave to appeal and set aside Justice Palmer's orders that there be an inquiry into the conduct of the liquidators. The Court of Appeal elected not to re-exercise its discretion in deciding whether to order an inquiry.

From the perspective of directors, the decision confirms that there is a public interest in liquidators' pursuing insolvent trading claims against directors and that litigation funding can be an appropriate tool for that. The judgment will likely fortify liquidators in their pursuit of claims against directors, even where the prospects of significant recovery for creditors may be remote.

5.4 Insurer of directors and officers not obliged to pay out under insurance policy because directors were misleading – *Martin John Green in his capacity as liquidator of Arimco Mining Pty Ltd (in liq) v CGU Insurance Ltd*

In *Martin John Green in his capacity as liquidator of Arimco Mining Pty Ltd (in liq) v CGU Insurance Ltd* [2008] NSWSC 825, the liquidator of Arimco brought an insolvent trading action against the directors of that company. The ARL group, through Arimco, mined gold and copper at three Australian mines. Before the hearing, the liquidator settled with the directors, but proceeded with its claim against CGU Insurance Ltd (**CGU**), which provided directors' and officers' insurance to the company.

²³ Ibid at [150-151].

CGU denied liability on the basis of provisions of the *Insurance Contracts Act 1984* (Cth). Briefly, section 21 of that Act required the directors to disclose to CGU every matter that was known to them that they knew, or that a reasonable person in their position would have known, to be relevant to the decision of CGU whether and on what terms to accept the risk to be insured. To the extent that they failed to comply with that obligation, section 28 operated to reduce the liability of CGU to the amount that would place it in the position that it would have been in had the directors complied with their disclosure obligations.

Einstein J found that the directors had engaged in insolvent trading as they were either aware, or a reasonable person in their position would have been aware, of the facts giving rise to a reasonable suspicion of insolvency, including severe disruption to the mines' production, substantial losses and a drop in the copper price.

However, the court also held that CGU were not liable to pay the directors under Arimco's directors and officers' insurance policy. This was because the directors had failed to disclose relevant information that was known to them which they knew would be relevant to CGU's decision as to whether (and on what terms) to enter into the insurance contract with Arimco, or matters that a reasonable person in the circumstances could be expected to know would be so relevant to CGU. This resulted in a breach of section 21 of the *Insurance Contracts Act* by the directors. The judge accepted that, had the material information been disclosed to CGU at the relevant time, it would not have renewed the D&O policy without including a standard term excluding liability for insolvent trading. Thus, by operation of section 28 of the *Insurance Contracts Act*, it was not liable for the losses caused by the directors' insolvent trading.

This case emphasises the importance of directors providing full and frank disclosure as to their companies' financial positions before entering into director and officer insurance policies or risk having to pay the large liabilities that can arise from insolvent trading claims themselves. It also points to the potential danger in settling with a director on the assumption that further recoveries will be able to be made from an insurer.

5.5 To what extent is potential access to related party funding and guarantees relevant in determining solvency; unreasonable reliance on another to manage and provide financial information; indemnity costs of a spurious appeal – the *Williams v Scholz* cases

In *Williams v Scholz* [2007] QSC 266, the liquidator of a company that ran a car dealership brought insolvent trading claims against two of its directors, a husband and wife. After the trial judge, Chesterman J of the Queensland Supreme Court, gave judgment in favour of the liquidator, the defendant directors unsuccessfully

appealed to the Queensland Court of Appeal. The Court of Appeal's decision is contained in *Williams (as liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* [2008] QCA 094.

At first instance, the trial judge found that the company had been hopelessly insolvent at all relevant times. By the time it ceased trading, it had made a loss in every month of its 17 month trading history bar one and had accumulated losses of over \$3 million. It had no substantial capital assets and no working capital other than a bank overdraft facility, which it had steadily extended and frequently exceeded. Its only means of paying debts was to generate profits, which it never did.

The defendants argued that the company was not insolvent because the directors could use their own resources to provide the company with long term loans in lieu of bank debt, thus reducing the company's current liabilities. The trial judge acknowledged that this might be right as a matter of theoretical accountancy, but noted that it was not – in fact – what happened.

Nor was it right, as the defendants argued, to say that the company had working capital "supplied as a result of guarantees by the shareholders or related parties and supporting securities". The defendants had given guarantees to secure the obligations of the company. When the company defaulted on debts, the guarantors were called on to pay. But as Chesterman J found, this was not a manifestation of the company paying its debt from its own working capital. It was because it had no such capital that the guarantees were called on.

Chesterman J referred to the 1966 High Court authority of *Sandell v Porter* (1966) 115 CLR 666 in saying that, although a debtor need not have on hand a sufficient supply of cash to pay all his debts to be considered solvent, he must have assets which can readily be converted to cash, by sale or charge, in order to pay his debts.

Sandell v Porter was decided at a time when the relevant definition of solvency expressly included a requirement that the company have the ability to pay its debts "out of its own moneys". This is no longer the case. In recognition of this, in 2005, the NSW Court of Appeal in *Lewis v Doran* (2005) 219 ALR 555 upheld a decision at first instance that there was no reason that unsecured borrowings could not be taken into account for determining solvency. In *Williams v Scholz*, Chesterman J did not refer to the authority in *Lewis v Doran*.

In the appeal proceedings, the defendants argued that the trial judge had erroneously ignored this "commercial reality" test, in particular the prospect of the company obtaining unsecured loans from the directors to pay its debts. The Court of Appeal recognised that unsecured borrowings can be relevant evidence against insolvency, provided they do not give rise to obligations that the company is unable

to meet. But as Muir JA noted, "The most important consideration is the degree of commitment to the continuation of financial support".²⁴ The fact was, as Chesterman J correctly found, the evidence established that the appellants were not firmly committed to continuing to provide financial support to the company. Regardless of their theoretical capacity to provide loans to the company, they had not done so despite \$9 million in dishonoured cheques having been issued by the company. As Muir JA noted, "There is...a vast difference between providing a company with funds so that it can pay its creditors in a timely way and not providing it with such funds but, after default by the Company, discharging its obligations to secured creditors by meeting demands under guarantees."²⁵

In summary, although the "commercial reality" test of solvency permits regard to be had to sources of funds beyond the company's immediate cash reserves, the emphasis is on the reality and not hypothetical possibility. It requires positive evidence that alternative funding was available to the company and that it was sufficiently certain of being forthcoming.

Aside from unsuccessfully disputing the company's insolvency, the defendant directors raised defences under section 588H, claiming that they had reasonably relied on another director, Mr Seymour, in relation to the management and direction of the company and that they had not appreciated the company's dire financial position because they were entirely reliant on him in relation to the management of the company.

At first instance Chesterman J found that the evidence did not support those claims (the finding was upheld on appeal). In particular, one of the directors had given evidence that she was concerned with the way that Mr Seymour was running the company and that she did not trust him. His Honour found that this destroyed the directors' case of reasonable reliance on Mr Seymour to provide reliable information. On their own evidence, they did not trust and could not reasonably rely on him and yet they did nothing. For example, they did not convene a company meeting to have Mr Seymour removed as a director or ask questions about the company's affairs.

The defendants also sought to have their liability reduced by half under section 1318 of the *Corporations Act* on the grounds that they had acted honestly and were misled by their co-director Mr Seymour in respect of transactions that occurred outside the ordinary course of business. The trial judge noted that the function of section 1318 is not to subvert the operation of sections 588G and 588M. He cited with approval the statement of French J in *Re Wave Capital Ltd*

²⁴ *Williams (as liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* [2008] QCA 94 at [110].

²⁵ *Williams (as liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* [2008] QCA 94 at [125].

(2003) 47 ACSR 418 at [29] that section 1318 reflects a broad policy of not inflicting unnecessary liability or inconvenience if a contravention is the product of honest error or inadvertence *as long as the court can do so without prejudice to third parties or the public interest*.²⁶ It was not fair to excuse the defendants when doing so would prejudice third parties whose debts would thereby go unmet.

During the appeal, all of the defendants' appeal grounds were abandoned. Keane JA held that the "pursuit of the appeal was quite unreasonable" and that that "unreasonableness was aggravated by the initial pursuit of arguments which were abandoned only after the respondent had been put to the expense of demonstrating their fatuity".²⁷ The court ordered that the appellants pay the liquidators costs on an indemnity basis.

5.6 Creditors' rights to bring actions under section 588G – *Edenden v Bignell*

Edenden v Bignell [2007] NSWSC 1122 provides an analysis of the court's approach to applications for consent to bring insolvent trading actions under section 588T of the *Corporations Act*.

In this case, the plaintiffs sought relief against Mr and Mrs Bignell (the first and second defendants) (the **Bignells**) and A J Bignell Pty Ltd (the third defendant) (**AJB**). AJB was in the process of being wound up. The Bignells were directors of AJB. The plaintiffs claimed to be creditors of AJB.

The plaintiffs claimed, amongst other things, that the Bignells had failed to prevent AJB from incurring debts while it was insolvent and that AJB had entered into voidable transactions within the meaning of section 588FE of the *Corporations Act*. The Bignells brought an interlocutory process seeking summary dismissal of the proceedings or that the plaintiff's claims be struck out.

Barrett J dismissed the claim on the grounds that the plaintiffs lacked standing to bring an action against the Bignells in relation to voidable transactions or insolvent trading. His Honour acknowledged that a creditor can bring such actions if the liquidator consents, or if the court grants leave, but as neither of these things had occurred, the plaintiffs did not have standing. However, his Honour did not strike out all of the originating process and the plaintiffs pursued their action under an amended application.

In *Egenden v Bignell* [2008] NSWSC 666, the plaintiffs sought the consent of the court under section 588T(2) of the *Corporations Act*, to bring the insolvent trading action against the defendants. Barrett J noted that there was little case law on

²⁶ Cited in *Williams v Scholz* [2007] QSC 266 at [74], emphasis added.

²⁷ *Williams (as liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* [2008] QCA 94 at [67].

how the court should approach such an application but discussed the purpose behind the requirement as follows, at paragraph 12:

The legislation proceeds on the footing that actions against directors who allow their company to incur debts while insolvent will, in the ordinary course, be taken by the company's liquidator so that recoveries become part of the fund applicable in the winding up for the benefit of creditors generally. The idea that an individual creditor may, for the creditor's own separate benefit, recover from directors because of insolvent trading runs counter to that general expectation. It is for that reason that a creditor intending to proceed in that way must either obtain the consent of the liquidator under s 588R(1) (indicating, in effect, that the particular recovery opportunity is one that the liquidator has not seen fit to pursue in the interests of creditors generally) or negotiate the two hurdles created by s 588T(2).

Barrett J went on to state that:

In the light of the function of the court, thus understood, the essential elements of the creditor's cause of action under s 588M(3) – which, of necessity, include the elements essential to a finding of contravention of s 588G(2) – must be evident to the court, at least at a prima facie level, when leave under s 588T(2)(b) is sought.

His Honour found that, in this case, the plaintiffs had neither clearly and concisely articulated their case, nor had they presented evidence which would lead him to suppose that they had a good arguable case.

Barrett J allowed the plaintiffs to file a new originating process and made orders that the proceedings should stand dismissed unless the plaintiffs filed and served a re-pleaded case within 28 days.

5.7 Liabilities under section 588M are provable debts in a bankruptcy – *Taylor v Rudaks* and *Buzzle v Apple Computer*

Taylor v Rudaks [2007] FCA 1962 and *Buzzle v Apple Computer* [2007] NSWSC 930 concern related issues, namely whether direct and indirect claims against a director for compensation under section 588M of the *Corporations Act* are admissible to proof in the bankruptcy of the director.

In the *Taylor* case a company went into liquidation and its directors declared themselves bankrupt two months later. The company's liquidator lodged proofs of debt in the directors' bankruptcy for statutory claims under section 588M of the *Corporations Act* for compensation to the company for loss it incurred as a result of the directors allowing it to trade while insolvent.

The bankruptcy trustee rejected the proofs of debt. The liquidator challenged the rejection in court.

The issue in court turned on whether the insolvent trading claims were admissible to proof in the bankruptcy under section 82 of the *Bankruptcy Act 1966* (Cth). In summary, that section provides that all debts and liabilities, present or future,

contingent or certain, to which the bankrupt was subject at the date of the bankruptcy are provable in the bankruptcy. However, demands in the nature of unliquidated damages arising otherwise than by reason of a contract, promise or breach of trust are not provable.

The liquidator argued that the proofs of debt should be characterised as statutory debts capable of being admitted to proof. The bankruptcy trustee argued that they are excluded as unliquidated claims for damages arising otherwise than by reason of contract, promise or breach of trust.

Mansfield J held that because section 588M(2) entitles the liquidator to recover the loss of damage caused by insolvent trading, whatever its character, "as a debt due to the company" it has the legislatively determined characteristic of a debt, not an unliquidated claim. Accordingly, the section 588M claims were provable in the bankruptcy of the directors.

His Honour noted that if the result had been different it would mean that, upon discharge from bankruptcy, the directors would not be released from the section 588M claims and, indeed, would mean that separate insolvent trading proceedings could be maintained against the directors while they were bankrupt, because the *Bankruptcy Act* only stays claims capable of proof in the bankruptcy during its currency. This, as his Honour noted, would be a surprising result.

In the *Buzzle* case, Buzzle's liquidator applied for compensation by Apple Computer under sections 588G and 588M of the *Corporations Act* on the basis that Apple was a de facto director of Buzzle and allowed it to incur debts while it was insolvent.

Apple's primary position was that it was not liable. But its secondary position, reflected in a cross-claim, was that if it was liable, another director, Mr Liu, was liable for an equitable contribution to that liability.

Mr Liu was a bankrupt at the time the cross-claim was made against him. But the debts that were incurred by the company for which Apple was claimed to be liable (and which Apple claimed Mr Liu to be liable by way of contribution) were incurred before Mr Liu's bankruptcy.

Hammerschlag J held (although it was not in controversy before him) that if a director allows a company to incur a debt while it is insolvent but before the director entered into bankruptcy, the director's direct liability under section 588M for insolvent trading is a contingent debt that is provable in the bankruptcy under section 82(1) of the *Bankruptcy Act*. That finding was consistent with the decision in *Taylor* (although *Taylor* was decided later), which analysed the issue in greater detail.

Hammerschlag J also held that another director's liability for equitable contribution to that liability is also provable in the other director's bankruptcy if the insolvent trade took place before the other bankruptcy commenced. This was because the underlying facts giving rise to the contingent liability had occurred before the bankruptcy, even though the liability only crystallised after the bankruptcy when the first director's primary liability had been established.

Because the claim for equitable contribution was a provable claim under section 82(1) of the *Bankruptcy Act*, the leave of the court was required to proceed with the claim in court (rather than by way of proof of claim in the bankruptcy). Hammerschlag J stayed the claim.

5.8 **Warning to accountants and solicitors advising companies involved in avoiding liabilities – *Mark Damian Charles Roufeil and 1 Or & Noel Linder & 1 Or***

In *Mark Damian Charles Roufeil and 1 Or & Noel Linder & 1 Or* [2007] NSWSC 489, the liquidator of Easter Logistics Pty Ltd (in liq) (***Easter Logistics***) brought an action under section 588G against Mr Linder, a director of that company. The company had fallen into financial difficulties after it acquired the assets of a company called Macksville Haulage Pty Ltd (formerly KS Easter (Junior) Hauliers Pty Ltd) (***Macksville***) in exchange for Macksville's debts to key creditors. Those debts exceeded the value of Macksville's assets by more than \$370,000. Easter Logistics and Macksville had at least one director in common.

Less than a year later, Easter Logistics' business was transferred to a company called Easter Group Pty Ltd (***Easter Group***), on the basis that Easter Group would assume liability for Easter Logistics' trade debts. White J noted that:

there seems to have been a pattern of conduct by the officers concerned of ignoring the taxation liabilities of companies conducting the businesses, of transferring the company's assets and business to a new shell, which would pay key trade creditors, and leaving behind a company without assets to meet its other liabilities.

His Honour expressed concern that "well known firms of accountants and solicitors" were involved in the transaction between Macksville and Easter Logistics. He kept the exhibits after the hearing to give further consideration as to whether the individuals concerned should show cause as to why the papers should not be referred to appropriate bodies.

This decision serves as a reminder of the dangers to accountants and lawyers in acting for clients that are engaged in undesirable corporate conduct.

This paper updates a presentation titled '*Advising a Company in Financial Distress*' by Michael Quinlan and Mary Berton of Allens Arthur Robinson.

It also partially incorporates and updates a paper titled '*Jailbreak, The Latest Disturbing Developments in Insolvent Trading*' by Michael Quinlan of Allens Arthur Robinson and David Courtness (then of Allens Arthur Robinson), subsequently updated by Steven Fleming (then of Allens Arthur Robinson).

NOTE: This document is intended only to provide a general review on matters of concern or interest to readers. The text of this document should not be relied upon as legal advice. Matters differ according to their facts. The law changes. You should seek legal advice on specific fact situations as they arise. Parts of this paper have been extracted from the Allens Arthur Robinson Annual Review of Insolvency and Restructuring Law 2004 and Focus: Insolvency publications.

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