Insolvent Trading & A Directors Duty not to be in Breach

Insolvent Trading

The Directors duty to prevent Insolvent Trading – Section 588G

One of the fundamental benefits of a Corporation was that it is capable in its own right to operate as a separate legal entity with its Directors & Shareholders not personally liable for the debts of the Company.

As a Consequence of this fundamental concept our law has recognised the necessity of developing Director Duties and in particular the need to make Directors liable for the debts of a Company in certain circumstances.

Section 588G of the Corporations Act creates a specific duty upon Directors to prevent a Company from incurring a debt when it is insolvent.

(1) This section applies if:

(a) a person is a director of a company at the time when the company incurs a debt; and

(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and

(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and

(d) that time is at or after the commencement of this Act.

Consequences that may flow from a breach of Section 588G are:

- Where the failure to prevent the incurring of the liability was dishonest, Section 588G establishes a criminal offence, which by operation of Section 1311 of the Act and schedule 3, is punishable upon conviction by a penalty of 2000 units or imprisonment of 5 years or both;

- Where a director is found guilty of an offence under section 588G(3) the Court may order the director to pay compensation to the company for the loss incurred by the creditors by reason of the breach of duty (section 588K);

- Section 1317E prescribes a civil penalty provision by which the director can be ordered to pay a pecuniary penalty of up to $200,000 per charge (section 1317G) on the application of the ASIC and/or be ordered to pay compensation for loss and damage (section 588J/1317H) on the application of ASIC or to the company where the liquidator intervenes;

- A director can be ordered to pay compensation to the Company on the application of the liquidator for a breach of section 588G(2) pursuant to section 588M; and

- A director can be ordered to pay compensation to the creditor on the application of a creditor pursuant to section 588R;

A holding company can also be made liable for the debts of its subsidiary in circumstances where the subsidiary is insolvent at the time of incurring the debt.

Questions to be Asked

First Limb – Is the Person a Director?

The first matter to establish is that the relevant person is a Director. This is usually not an issue and is defined under Section 9 of the Corporations Act to also include those who, though not validly appointed, act in the position of Director or a person upon whose directions the Directors are accustomed to act I.e. the so called “Shadow Director”.

This definition should be bought in mind particularly by those participating in undertaking consulting roles.

It extends also as seen in the case of David Hill V David Hill Electrical Discounts Pty Ltd even where an order was made to replace a Liquidator who had formerly been a Deed Administrator under Section 5.3A on the basis that there were some serious allegations the Administrator had been a “Shadow Director” and has allowed the Company to trade whilst insolvent.

Second Limb – Is the Person a Director at the time when the Company incurs a Debt?

The Liquidator must consider which of those debts that remain outstanding at the date of liquidation are relevant and determine that they were incurred at the relevant time (i.e. when the Company was Insolvent) as it is only those debts for which a compensation order can be made.

This area can though be somewhat problematic.

For Example:

Should a Company enter into a contract to hire and agrees to pay premiums every month and if at the time it entered into this Contract it was solvent but some 8 months later defaults it could not be held that this debt was incurred at the relevant time but at the date the initial Contract was executed.

Another example is highlighted in the decision of Box Valley Pty Ltd V Elizabeth Kidd and David Kidd. *(See over page)*

Insolvent Trading Decision

*Box Valley Pty Ltd **V** Elizabeth Kidd & David Kidd*

Facts:

•David Kidd Trading Pty Ltd (DKT) incorporated in 1993 and traded in grains and other rural commodities.

•Entered into futures contract for the purchase of those commodities at a specified price.

•29.04.01 DKT signed an agreement to purchase a quantity of grain from Box Fresh at $100,600

•Between 05.06.01 – 15.06.01 Grain delivered

•21.06.01 DKT entered Voluntary Administration and was Wound Up on the 27/07/01

•Box Fresh issued Insolvent Trading proceedings against Directors

•Plaintiffs appointed Accountant to undertake an analysis of DKT's financial position at sale date (viz. 29/04/01 to determine if it could be reasonable to assert DKT could pay its debts as and when they fell due. The Accountant contended the Company was Insolvent.

•NSW Court of Appeal found Accountants report flawed on the basis it could not take into account DKT's exposure in respect to those future contracts when calculating DKT's Creditors.

•At best the sum could be considered an unliquidated sum and not a "debt" for the purpose of Section 95A of the Corporations Act.

•Debt would only arise upon contract falling due and DKT defaulting.

In ASIC V Peymin (I.e Waterwheel Case) his Honour placed emphasis on when considering the terms of a contract *"the Question when the debt is incurred within the meaning of the Section does not depend on strict legal analysis but turns on when in substance and reality the Company is exposed to the relevant liability*".

Step 3–"The Company is insolvent at the time it becomes insolvent by incurring that debt"

Section 95A of the Corporations Act defines Insolvency:

It states a person who is not solvent is insolvent. It goes onto further advise that a person is solvent if and only if that person is able to pay all that persons debts as and when they become due and payable.

Of greater assistance to a Liquidator is Section 588E(4) which creates a presumption of Insolvency.

"It provides where a Company fails to keep financial records in accordance with its obligations under Section 286 of the Act the Company it is presumed to be insolvent during the period of failure."

The Section 95A definition is more a "Cash Flow Test" for Insolvency and it is important not to confuse insolvency with a temporary lack of liquidity.

In Sandell V Porter (1966) 115 CLR 666 the High Court in considering Insolvency under the Bankruptcy Act held that the ability of one to pay its debts as and when they fell due was not limited to available cash resources but also the procurement of other available facilities which would crystallise available resources in the period required to meet debts as and when they fell due.

In the case of Lewis V Doran (2004) 208ALR385 Palmer J held in his analysis of Section 95A that the omission of those words "from its own monies" could allow the Courts to consider all arrangements etc that were is place rather than excluding them from consideration because arrangements did not fall within the definition of payments made from the Debtors own monies.

There is no single test of whether a Company is or is not insolvent whilst there continues to be a difference of approach by the Courts to forbearance by a creditor from enforcing strict contractual rights which means a debt is not due and payable.

Note: Tru Floor Services Pty Limited V Jenkins & Sundberg J

It is also not appropriate to base an assessment of Insolvency on the prospect a Company may be able to trade profitably in the future. The question is whether the debts can be paid as and when due.

In Hymix Concrete Pty Ltd V Gamitty it was held stock was not an asset that was available to meet current debts in the ordinary course as to do so would suggest a winding up of the company's business.

Accordingly it is no defence to an allegation of Insolvency that a Company can quickly realise its stock.

The question of whether a company is insolvent is a question of fact to be determined by the Court and not one to which expert evidence may be given. However it is usual for the Liquidator to provide to the Court a reconstructed balance sheet commenting upon each of the various matters pertaining to solvency as indicated above. The Court has held that such evidence is admissible.

The Water Wheel decision is useful in its specification of criteria a court will have regard to in determining insolvency. It noted the following matters as relevant indicia of insolvency.

1) Company was not in fact paying its debts as and when they fell due;
2) Creditors were demanding immediate action on overdue accounts;
3) Cheques in payment of accounts were being held back until funds became available;
4) COD terms were being required by suppliers;
5) Aging of debtors is extended progressively;
6) Business was unprofitable and losing money;
7) Overdue Taxes;
8) Poor relationship with banker/secured creditor;
9) Inability to raise further equity/debt
10) Inability to produce accurate and timely financial data.

Step 4 – “At a time there were reasonable grounds for suspecting the Company is Insolvent”

The test under Section 588G(1)(C) is objective in its requirement to satisfy the Court that there were reasonable grounds to **suspect** insolvency at the time of incurring the debt.

Barret J in ASIC V Edwards defined the test to be not an inquiry as to the particular Director whose conduct was under scrutiny but into the objectively formed state of mind of a person of ordinary competence.

The central word in Section 588G(1)(C) is **“suspecting”** I.e. of suspicion as against expectation which reduces the onus on the practitioner.

Breaching the Duty (Sect 588G (2))

To establish civil liability under Section 588G(2) the Liquidator must prove there was a failure on the part of the director to prevent the company incurring the debt at a time when either;

1)The Director was aware at the time that there were reasonable grounds for suspecting that the company was insolvent; or

2)A reasonable person in a like position in the Company's circumstances would be so aware.

The first issue in this regard is the liquidator must establish a failure to prevent the company incurring the debt on the part of the director. It has been held that this does not require that the director, acting alone, must be capable of preventing the incurring of the debt.

i.e. If a Director was entitled to protest that he could not act without the concurrence of one or more of his colleagues when he knew the Company was insolvent then the Section would have little practical purpose.

The fact that often a director may be unable to prevent the authorised person contracting a debt is irrelevant. If he is unable to persuade his fellow directors to withdraw that authority when the Company is insolvent he should seek to have the Company Wound Up or resign as Director.

It is though a difficult task under the first limb above to determine the Directors state of mind so more often Liquidators seek to rely on the second limb ***"i.e. a reasonable person in a like position"***

In the decision of Daniels V Anderson it was held that there is a positive duty for a Director to keep abreast of a Company's affairs and accordingly than they would be reasonably appraised as to the state of solvency/insolvency.

Director Defences to a Claim under Section 588G(2)

Section 588H

(1) This section has effect for the purposes of proceedings for a contravention of subsection 588G(2) in relation to the incurring of a debt (including proceedings under section 588M in relation to the incurring of the debt).

(2) It is a defence if it is proved that, at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

(3) Without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when the debt was incurred, the person:

(a) had reasonable grounds to believe, and did believe:

(i) that a competent and reliable person (the other person) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and

(ii) that the other person was fulfilling that responsibility; and

(b) expected, on the basis of information provided to the first-mentioned person by the other person, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

(4) If the person was a director of the company at the time when the debt was incurred, it is a defence if it is proved that, because of illness or for some other good reason, he or she did not take part at that time in the management of the company.

(5) It is a defence if it is proved that the person took all reasonable steps to prevent the company from incurring the debt.

(6) In determining whether a defence under subsection (5) has been proved, the matters to which regard is to be had include, but are not limited to:

(a) any action the person took with a view to appointing an administrator of the company; and

(b) when that action was taken; and

(c) the results of that action.

Defences Broken Down

Section 588H(2) – "Reasonable Grounds to expect Company Solvent"

(2) "It is a defence if it is proved that, at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time".

The Key word here is **"expect"** which means a higher degree of certainty than suspecting i.e. that the Company would continue to be solvent and the grounds for so expecting are reasonable.

It is not uncommon for Directors to allege that related entities have or will agree to support the Company or will extend terms for payments of debts thus giving a reasonable expectation of solvency. However just as the failure to strictly adhere to terms for payment of a trade creditor will not mean a debt is not payable so too it can not lead to a reasonable expectation of solvency.

Section 588H (3) – "Reliance on other Persons"

(3) "Without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when the debt was incurred, the person:

(a) had reasonable grounds to believe, and did believe:

(i) that a competent and reliable person (the other person) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and

(ii) that the other person was fulfilling that responsibility; and

(b) expected, on the basis of information provided to the first-mentioned person by the other person, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time".

Arguably the size and nature of the Company's business will dictate what is reasonable.

In Kenna & Brown B Brown the Director alleged his fellow Directors were responsible for keeping him informed and they failed to do so. This defence failed.

In Metropolitan Fire Systems Pty Ltd V Miller the wife who was a Director relied on her Director husband to control the day to day management of the Company and to keep her informed.

The wife undertook some general office duties in the office and was held to have had opportunity as a consequence to make her own inquiry. Her defence failed also.

The prime thrust of this defence is aimed at the large corporation where there are systems in place of competent accountants etc to ensure any problems arising are reported to the Board.

The Board though can not be complacent as in the Water Wheel case where it was determined non-executive Director Mr John Elliot could not rely upon the Managing Directors obligated to keep non-executive directors informed.

It was held Mr Elliot had grounds to believe the Managing Director was not fulfilling his duty and should have made appropriate enquiries in that regard.

Section 588H(4) - Illness

(4) "If the person was a director of the company at the time when the debt was incurred, it is a defence if it is proved that, because of illness or for some other good reason, he or she did not take part at that time in the management of the company".

In Tourprint V Bott it was held deceptive conduct by fellow directors in excluding the defendant director from management was not an adequate reason for not taking part in the management of the Company.

Section 588M – Claim for Compensation (By Liquidator or Creditors)

Recovery of compensation for loss resulting from insolvent trading

(1) This section applies where:

(a) a person (in this section called the director) has contravened subsection 588G(2) or (3) in relation to the incurring of a debt by a company; and

(b) the person (in this section called the creditor) to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency; and

(c) the debt was wholly or partly unsecured when the loss or damage was suffered; and

(d) the company is being wound up;

whether or not:

(e) the director has been convicted of an offence in relation to the contravention; or

(f) a civil penalty order has been made against the director in relation to the contravention.

(2) The company's liquidator may recover from the director, as a debt due to the company, an amount equal to the amount of the loss or damage.

(3) The creditor may, as provided in Subdivision B but not otherwise, recover from the director, as a debt due to the creditor, an amount equal to the amount of the loss or damage.

(4) Proceedings under this section may only be begun within 6 years after the beginning of the winding up.

Role of the Australian Securities and Investments Commission (ASIC)

There is often a misconception on the part of practitioners and directors alike that insolvent trading claims can only be brought once a company is in liquidation. It is not unusual for directors to be persuaded to procure third party funds to support a deed of company arrangement under Part 5.3A of the Act as a means of preventing such claims being agitated by creditors and administrators in a liquidation.

However section 588G does not require that the company be in liquidation for there to have been a breach of the section.

This has led to some interesting results. In the Water Wheel administration the creditors accepted a proposal that the company enter into a deed of company arrangement. The company was still subject to the terms of that deed. However the ASIC has brought proceedings in the Supreme Court of Victoria against three directors for breach of section 588G this serves as a warning that ASIC will not be bound by the commercial decision of creditors to accept a deed proposal.

In a press release dated 4th August 2005 the ASIC announced its targeting of corporate insolvency. The press release detailed the progress made since the establishment of the National Insolvent Trading Program (NITP) in July 2003 in encouraging insolvent companies to take remedial action. It stated that in 2004-2005 the ASIC had visited 488 companies resulting in 63 of these companies having external administrators appointed. These companies included such names as Collins Booksellers and Henry Walker Eltin.

The aims of the program included making directors aware of their obligations with respect to the companies financial position, to encourage directors to seek external professional advice and to encourage directors to take preventative action if required.

Conclusion

The Law as to Insolvent Trading has developed significantly over the last few years however there still remains only a small number of cases being brought by Liquidators.

This though is very much a factor of costs and the knowledge of the substance of those being pursued.

Unfortunately insolvent trading cases are considered in hindsight and there is little way of definitive advice one can give to Directors of a Company facing an uncertain financial future as the decision to close the doors is usually final.

The assessment of the ongoing solvency of a company is a fluid process that required constant vigilance. It can be a day to day proposition. The assessment process requires up to date financial data and the availability of a sensitivity analysis by which a director can assess the feed back various events will have on the ability to trade. If such steps are taken directors will be able to prove they acted knowingly and diligently with a full appreciation of the facts. It will place the directors in the best position to be able to determine at what point, if at all, the company becomes insolvent. If ultimately the company does fail following the directors decision to cease trading it may prove difficult in such a case for the liquidator to prove the necessary element that there were reasonable grounds for suspecting solvency.