Developments in insolvent trading law in 2015

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Liability for insolvent trading is a key area of risk for company directors and a frequent topic upon which the advice of inhouse counsel is sought. However, authorities dealing with directors' liability for insolvent trading are relatively few and far between. This year has already seen some key cases that have highlighted several important issues to be kept in mind when advising directors.

The legal framework

Directors may find themselves liable for insolvent trading, facing both civil and criminal prosecution. In the absence of a defence, liability will exist where there is a breach of the positive duty contained in s 588G of the Corporations Act 2001 (Cth) (the Act). This provision holds that liability for insolvent trading will exist where:[1]

(a) a person is a director of a company at the time when the company incurs a debt;
(b) the company is insolvent at that time, or becomes insolvent by incurring that debt or another debt;
(c) there are reasonable grounds for suspecting that the company is currently or will become insolvent;
(d) that time is at or after 23 June 1993; and
(e) such person fails to prevent the company from incurring the debt in circumstances where:
  - they're aware of reasonable grounds to suspect the company may be insolvent, or
  - a reasonable person in a similar position in the company's circumstances would be so aware.

Solvency

An insolvent company is one that is not solvent.[2] This incorporates a cash flow test[3] as to whether a company is able to pay all of its debts "as and when they become due and payable".[4] A court will assess whether any inability to pay is simply the result of a temporary lack of liquidity, in which case the company may be solvent, or the result of a structural inability to restore liquidity, in which case the company is insolvent.[5] Liability for insolvent trading may exist if the company was insolvent at the time a debt was incurred, or became insolvent as a result of incurring the debt.[6]

There are two presumptions of insolvency that operate in civil proceedings; insolvency is assumed to continue from any point of insolvency within 12 months of the relation-back day (usually being the day a voluntary administrator is appointed or the day the winding-up application is filed), and insolvency is assumed where there has been a failure to maintain proper records.[7]

Directors

Liability for insolvent trading only extends to a person who was a director of the company at the time of incurring a debt.[8] The definition of director extends beyond formally appointed office holders, latching onto shadow directors, management acting in a capacity as director and those to whom the company or director is accustomed to taking directions.[9] Holding companies of subsidiaries, which are found to have engaged in insolvent trading, may also become liable.[10] Inhouse counsel ought to remain mindful of this so as to ensure relevant advice is given to the right people.

Reasonable grounds for suspecting insolvency

Directors will attract liability in situations where a reasonably competent[11] director would have had objectively[12] reasonable grounds for suspecting insolvency at the time the debt(s) was incurred.[13] Suspicion is taken to refer to some reason prompting investigation into the possibility of the company's insolvency.[14]

Failure to prevent incurring of the debt

Directors who suspect insolvency and fail to prevent the incurring of a debt are likely to fall within the operation of the regime.[15] This does not require an investigation as to whether the individual director could, as a matter of practicality, actually prevent the debt being incurred, but rather an examination as to whether the director was delinquent or indifferent in discharging their duty to prevent insolvent trading.[16] At the time of the failure, the director must either actually be aware of facts that would lead to the reasonable suspicion of insolvency or such knowledge may be imputed by considering what a reasonable director would do in the shoes of the actual director.[17]

Defences

There are effectively four defences for directors to liability for insolvent trading, including that they:

- believed or had reasonable grounds to expect the company was solvent, (and a reasonable person in the director's position would have thought the same);[18]
- reasonably relied upon information provided to them that the company was solvent;[19]
- were not involved in the company's management when the debt was incurred because of illness or some other reason;[20] or
- took all reasonable steps to prevent the company from incurring the debt.[21]

Directors who are found to have contravened a civil penalty provision[22] may also seek to be excused from liability, if they acted honestly and if there are circumstances that ought to excuse the director.[23]

Incurring debts

With limited exceptions, debts for the purposes of establishing an insolvent trading liability must concern a monetary obligation regarding a liquidated amount, which is not wholly contingent such that it may never fall due.[24] Such debts must be enforceable.[25] It is important to determine the material date of when the debt was incurred as this will form the base reference point in deciding whether the company was trading while insolvent.

The insolvent trading regime is not particularly concerned with the implications of future debts, though in certain instances contracts may give rise to future liabilities that the company is accountable for. For instance, in a lease agreement the debt is said to have been incurred at the time the lease was entered into, as opposed to the time of each rental obligation.[26] However, contracts for goods to be paid at delivery will result in a debt at the delivery time and not the date the contract was entered into.[27]

Importantly, the regime requires an analysis of the company's ability to meet all of its debts that existed at the time the particular debt was incurred, and is not restricted to only examining the particular debt that enlivened the insolvent trading provision.

Key decisions in 2015

There have been four key decisions relating to insolvent trading that have been handed down so far this year.

Trinick v Forgione[28]

The liquidator commenced proceedings seeking to render a director and former director liable for debts incurred by the company, relying upon the presumption of insolvency for failing to maintain proper records.[29] The directors unsuccessfully argued that the company had engaged an external accountant who they believed would inform them if the company ever became insolvent. The directors also unsuccessfully sought to contend that the company was not insolvent because one of the directors was personally willing to provide finance to the company to meet its debts.

Key points

It was held that the obligation to maintain records for a period of 7 years after the date of the relevant transaction is one of strict liability[30] and accordingly the failure to do so will constitute a breach, regardless of whether or not such failure was caused by an officer or agent of the company.

The burden of factually establishing that a director was at all material times ready, willing and able to provide finance to the company is a heavy one, requiring evidence of conduct prior and in the lead up to the period of financial distress. It is not enough to simply allege that such finance exists.

The case establishes that reasonable directors must monitor whether the company is meeting tax and superannuation obligations, as well as the state of bank accounts and the company's ability to honour cheques. The activities of reasonable directors may be enough to impute an awareness of reasonable grounds to suspect insolvency.

On the facts, the company's external accountant had never assumed a role other than providing tax and accountancy services, and the evidence did not establish that solvency advice was their responsibility. It is not enough that the company has an external accountant who provides general advice. Accordingly, the company's accountant could not be relied upon as a competent person to provide information which could reasonably lead the directors to expect the company was solvent. The directors' defence that they relied upon the advice of an expert accordingly failed.

Smith v Offermans[31]

The director successfully appealed a summary judgment for loss and damage arising from insolvent trading. The company had entered into a payment plan with various creditors prior to entering external administration.

Key points

The court found that the mere fact of a payment plan with a creditor does not, of itself, amount to a concession of insolvency. A distinction is to be drawn between commercial leniency in the repayment of a debt and some agreement with a creditor altering the time for payment. In this case, the circumstances of entry into the payment plan did not summarily establish the company was insolvent at the relevant time. The court also confirmed that compensation pursuant to s 588M of the Act requires evidence of loss and damage, which may not necessarily be in the amount of the provable debts in the liquidation.

Smith v Bone[32]

The liquidator sought relief against the director for losses caused by the alleged insolvent trading of the company. The director unsuccessfully sought to defend the claim on the basis of having taken reasonable actions to prevent the company from incurring the debt and having a reasonable expectation that the company was solvent at that time. The director also unsuccessfully tried to rely on the defence that he had frequently sought external advice regarding the company's financial affairs.

Key points

The immediate future must be considered when examining the company's ability to pay debts as they become due, though precisely how far into the future this examination extends will depend on the individual circumstances of each case and to what extent future liabilities are known. The time for payment of a debt is that stipulated in the contract, unless a party provides sufficient evidence that there was some agreement or course of conduct sufficient to alter this date.

Payment arrangements entered into between the director and the Australian Taxation Office (ATO), unless strictly in accordance with the relevant tax legislation, do not operate as an estoppel to prevent the Chief Commissioner of Taxation from enforcing an outstanding tax liability. Further, payment arrangements and extension of credit terms do not necessarily place the company in a better financial position when considering its solvency. Although the company may be managing its trade creditors, it may remain insolvent if this is at the expense of repaying its tax liability, which remains, at all times and notwithstanding various payment arrangements, due and payable.

It is appropriate to draw inferences as to the dates debts are incurred in cases of alleged insolvent trading, where there is no direct evidence. In the usual course of business, creditors will issue invoices shortly after providing goods or services, which will be delivered shortly thereafter. This general course of business may enable an inference to be drawn that particular debts were incurred within about 3 or 4 months from the date of an invoice and entry into the company's accounting system.

It was also held that it is not enough that the director was receiving frequent advice as to the company's financial state of affairs. The director, in the face of what was found to be clear issues of the company's insolvency, failed to actively seek out advice as to the company's solvency and thus could not be said to have acted to a standard of conduct warranting liability exemption.

Chan v First Strategic Development Corp Ltd (in liq)[33]

The director unsuccessfully sought to appeal a judgment where compensation was ordered to be paid as a result of insolvent trading. The director had entered into a financial instrument where support would be provided to the company subject to strict commercial conditions.

Key points

The court held that:[34]

> Where the financial support is being provided by a director or related entity, and in circumstances where there is no formalised agreement or understanding, what is required is cogent evidence which enables the court to conclude that there is such a degree of commitment on the part of the provider of the financial support to continue it, such that it can be said that at any point of time it was likely to be continued, with the result that, at any of those times, the company was able to pay its debts as and when they fell due.

In particular, where funding from a director is made conditional and subject to various contingencies, the court will more readily find that this was not a reliable source of funding for the company. The decision demonstrates that if directors wish to avoid exposure to liability for insolvent trading by reason of their personal financial support of the company, formal arrangements detailing the provision and continuation of that financial support need to be put in place, and adhered to.

Key learnings for inhouse counsel

It is imperative that directors are advised to monitor and analyse the company's financial information themselves, as opposed to simply relying upon general advice from managers and external advisors. This will necessarily require directors to actually review relevant financial data and for such data to be readily accessible in well maintained books and records.

It is also important to keep in mind that the relevant test of solvency is focused on cash flow and the ability to pay debts as and when they become due and payable. A company may appear strong from a balance sheet perspective, but nonetheless may be insolvent because cash is locked in assets not able to be realised in time to pay debts as they fall due.

Directors and management should develop a sound working relationship with operational managers and accounts payable to ensure any anticipated difficulties in payment are identified at an early stage, and any systemic shortage of funds are appropriately dealt with.

It is a reality of business that trade terms may be different to the date for payment on an invoice. Though it should be remembered that the court will not look favourably at continual extensions of trade terms and various payment arrangements, as juggling creditors may not materially improve a company's solvency position.

In situations where a company's solvency may be in doubt, it is essential that active steps are promptly taken to obtain expert advice and/or an independent report on the company's solvency. It is not enough to rely upon a general retainer with financial advisors. This advice may need to be frequently updated as the circumstances evolve. It is not uncommon to hear of prudent directors seeking insolvency advice at 9 am every morning during periods of financial distress.

If a director forms the view that the company is insolvent, they must act swiftly by appointing a voluntary administrator or getting the company to enter into another form of external administration. In circumstances where the company refuses to enter external administration notwithstanding insolvency, the director should resign.

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Footnotes

1. Corporations Act 2001 (Cth), s 588G.
2. Above, n 1, at s 95A(2).
3. *Keith Smith East West Transport Pty Ltd (in liq) v Australian Taxation Office* (2002) 42 ACSR 501; [2002] NSWCA 264; BC200204577.
4. Above, n 1, at s 95A(1).
5. *Hymix Concrete Pty Ltd v Garrityy* (1977) 13 ALR 321; 2 ACLR 559; (1977) CLC 40-312; BC7700028.
6. Above, n 1, at s 588G(1).
7. Above, n 1, at s 588E.
8. Above, n 1, at s 588G(1)(a).
9. Above, n 1, at s 9.
10. Above, n 1, at s 588V.
11. *Australian Securities and Investments Commission (ASIC) v Edwards* (2005) 220 ALR 148; 54 ACSR 583; [2005] NSWSC 831; BC200506193.
12. *Metropolitan Fire Systems Pty Ltd v Miller & Ewins* (1997) 23 ACSR 699; BC9702035.
13. Above, n 1, at s 588G(1).
14. *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266; [1966] ALR 855; (1966) 40 ALJR 13; BC6600470; *Hall v Poolman* (2007) 215 FLR 243; 65 ACSR 123; [2007] NSWSC 1330; BC200710202.
15. Above, n 1, at s 588G(2); *Green in his capacity as liquidator of Arimco Mining Pty Ltd (in liq) v CGU Insurance Ltd* (2008) 67 ACSR 398; [2008] NSWSC 825; BC200807333.
16. *Australian Securities and Investments Commission (ASIC) v Plymin (No 1)* (2003) 175 FLR 124; 46 ACSR 126; 21 ACLC 700; BC200302080; above, n 11, *ASIC v Edwards*.
17. Above, n 16, *ASIC v Plymin (No 1)*.
18. Above, n 1, at s 588H(2).
19. Above, n 1, at s 588H(3).
20. Above, n 1, at s 588H(4).
21. Above, n 1, at s 588H(5).
22. See, for eg, above, n 1, at s 588M.
23. Above, n 1, at ss 1317S and 1318.
24. *Hawkins v Bank of China* (1992) 26 NSWLR 562; 7 ACSR 349; 10 ACLC 588.
25. *Credit Corp Australia Pty Ltd v Atkins* (1999) 30 ACSR 727; 17 ACLC 756; [1999] FCA 335; BC9901295.
26. *Russel Halpern Nominees Pty Ltd v Martin* [1987] WAR 150; (1986) 10 ACLR 539; 4 ACLC 393.
27. Above, n 16, *ASIC v Plymin (No 1)*.
28. *Trinick as Liquidator of Forgione Family Group Pty Ltd (in liq) Re Forgione Family Group Pty Ltd (in liq) v Forgione* (2015) 106 ACSR 600; [2015] FCA 642; BC201505860.
29. Above, n 1, at s 588E(4).
30. Above, n 1, at s 286(3).
31. *Smith v Offermans* (2015) 105 ACSR 230; [2015] QCA 055; BC201502515.
32. *Smith Re ACN 002 864 002 Pty Ltd (in liq) v Bone* (2015) 104 ACSR 528; [2015] FCA 319; BC201502363.
33. *Chan v First Strategic Development Corp Ltd (in liq)* [2015] QCA 028; BC201501143.
34. Above, n 33, at [44].