Parent, Director and Related Company Exposures

The Erosion of Limited Liability – Extending the Reach of Liquidators

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1. Introduction

If there is little or no money in the bank when a company goes into liquidation and few easily realisable assets, practitioners and creditors may seek to look elsewhere in order to recover funds. One source may be claims against directors for insolvent trading or other breaches of the Corporations Act (Cth) (the Act) or common law duties. The other common source that may be considered are parent companies (referred to in the Act as ‘holding companies’) or related companies of the company in liquidation.

The expression 'holding company' is defined in relation to the expression 'subsidiary' in Division 6 of part 1.2 of the Act. A company is a subsidiary of another body corporate (the holding company) if, and only, if:

(a) the holding company:
   (i) controls the composition of the company's board of directors; or
   (ii) is in a position to cast, or control the casting of, more than one-half of the maximum number of votes that might be cast at a general meeting of the company; or
   (iii) holds more than one-half of the issued share capital of the company (excluding any part of that issued share capital that carries no right to participate beyond a specified amount in a distribution of either profits or capital); or

(b) the company is a subsidiary of a subsidiary of the holding company.\(^1\)

Related companies are defined in the Act in the following terms:

Where a body corporate is:

(a) a holding company of another body corporate; or
(b) a subsidiary of another body corporate; or
(c) a subsidiary of a holding company of another body corporate;

the first-mentioned body and the other body are related to each other.\(^2\)

One of the main benefits of creating a company is that, if it a company limited by shares or a company limited by guarantee, the liability of the shareholders will be limited, meaning that, in the case of financial disaster the shareholders only have to provide funds to the company to the extent of the fully paid-up value of their shares in the company.

The concept of limited liability, emphasised and confirmed in the decision of Salomon v Salomon,\(^3\) is still a very important concept in British and Australian law. In recent history, however, there have been a number of movements away from strict limited liability and towards the imposition of liability – the 'piercing of the corporate veil' – through statutory

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1 Section 46 of the Act.
2 Section 50 of the Act.
3 [1897] AC 22.
and judicial action. Some recent examples of this have included the enactment of the 
Corporations Law Amendment (Employee Entitlements) Act in 2000 and the Corporations 

One of the original reasons for limited liability companies is to encourage entrepreneurial 
zeal rather than risk averse behaviour. When a company is insolvent it would appear that 
the consideration which outweighs entrepreneurial risk-taking is the protection of creditors.

Corporate groups pose particular problems for creditors. When a subsidiary is at imminent 
risk of becoming insolvent, the temptation of limited liability is for the parent to cut its losses 
and let the subsidiary fail. Creditors of the subsidiary must then either bear the loss or find 
a way to hold the parent liable for the failure. Faced with the courts’ traditional reluctance 
to pierce the corporate veil, the parent's ‘responsibility’ for the actions of the directors of the 
subsidiary is one of the few avenues left open whereby creditors might reach the holding 
company's assets.4

This paper will consider some of the actions available to liquidators in attempting to recover 
funds from directors, holding companies and related companies of insolvent entities. The 
primary focus is on the strongest tool available to the liquidator – an action for insolvent 
trading – but other available actions available under general law and statute will be also be 
addressed together with a consideration of the circumstances in which the law will permit 
the corporate veil to be pierced and a parent company held liable.

2. Overview

The insolvent trading provisions in the Act are aimed largely at ensuring that directors do 
not abuse the privilege of limited liability.

In order for the duty to prevent insolvent trading to be imposed, a number of elements of 
liability must be fulfilled:

• the person must be a director at the time the relevant company incurred a debt;

• the company must be insolvent at the time the debt is incurred, or become 
  insolvent by incurring that debt;

• at the time the debt was incurred there must have been reasonable grounds to 
  suspect that the company was insolvent or may become so by incurring the debt; 
  and

• the director was aware that there were reasonable grounds to suspect insolvency, 
  or a reasonable person would have been so aware.

Breach of the duty to prevent insolvent trading can have both civil and criminal 
consequences. Under subsection 588G(2), if the director failed to prevent the incurring of 
the debt and he or she knew that there were reasonable grounds for suspecting 
insolvency, or a reasonable person in their position would have been so aware, then a civil

4 Ross Grantham, 'Liability of parent companies for the actions of the directors of their subsidiaries' (1997) 18 The Company 
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penalty may be imposed. Under subsection 588G(3), if this failure is done with a dishonest intent a criminal offence will have been committed.

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

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

The court also has the power under sections 1317S and 1318 to excuse a director from liability under subsection 588G(2).

A holding company can be liable for the debts of its insolvent subsidiary.

There were a large number of reported cases dealing with the predecessors of section 588G. We have seen few reported cases under the new section. The main reason for the lack of reported cases is that fewer companies are being wound up in insolvency. There has been an increasing use of voluntary administration followed by deeds of company arrangement as preferred forms of insolvency administration.

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

3. To Whom do the Duties Apply?

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

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

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

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

3.1 De Facto Directors

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

In the case of Deputy Commissioner of Taxation v Austin7 the Court considered the concept of de facto directorships. Mr Austin and his wife were friends with another couple. The two wives ran a restaurant business. The company in question was a $2 company incorporated to incur debts for the supply of goods and services for the restaurant and the wages of the employees. Mr Austin was appointed as a director of the company for 3 months to assist at a time when the families were experiencing personal problems. Mr Austin then sought to resign his directorship and his accountant prepared documents to this effect. These documents were never lodged with ASIC. Following his purported resignation, Mr Austin undertook numerous negotiations with the Deputy Commissioner of Taxation (DCT) for the payment of outstanding group tax and penalties, countersigned company cheques in favour of the DCT, issued stop notices to the company’s bank and negotiated with other creditors.

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

3.2 Shadow Directors

Section 9 includes shadow directors within the definition of ‘director’. This seeks to situate the true source of decision-making within the corporation and to hold persons responsible for the consequences of their decisions8. Shadow directors are also subject to the same duties and liabilities as directors properly appointed, including the duty to prevent insolvent trading.

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

5 Mistmorn Pty Ltd (in liq) v Yasseen (1996) 14 ACLC 1387.
6 Corporate Affairs Commission v Drysdale (1978) 141 CLR 236.
(a) Person

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

(b) Instructions or Wishes

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

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

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

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

(c) Directors of the body

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

Although there has been some commentary supporting the need for all directors to be accustomed the case of Re Lo-Line Electric Motors Ltd⁹ suggested that 'the board' must act in accordance with the instructions. This implies the requirement of a simply majority of directors to be so accustomed.

The decision in *Kuwait Asia Bank v National Mutual*\(^\text{10}\) indicated that a minority of directors accustomed to act in accordance with a person’s instructions or wishes will be insufficient to form a shadow directorship.

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

(d) Accustomed to Act

This element is intended to cover those persons with effective control of a corporation, making decisions that the directors of the corporation simply follow without independent thought, analysis or discretion. It suggests some sort of ongoing control or interference in internal affairs. As stated by Millet J in *Re Hydrodam (Corby) Ltd*:

> What is needed is . . . a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the direction of others\(^\text{11}\).

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

### 3.3 Professional Capacity or Business Relationship Exemption

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

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

\(^{10}\) [1990] 3 All ER 404.

\(^{11}\) [1994] 2 BCLC 180 at 183.
3.4 Holding Companies as Shadow Directors

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

Particularly relevant in this regard is the decision in *Standard Chartered Bank of Australia Ltd v Antico*\(^{12}\). Although the facts of the *Standard Chartered Bank* case are quite complex, it is sufficient to note that the holding company (*Pioneer*) owned 42 per cent of its subsidiary (*Giant*) and had three nominee directors appointed to the board of Giant. Giant had entered into a number of financial agreements with Standard Chartered, particularly the provision of a discount and bill acceptance facility of A$30m, the payment of which was extended on a number of occasions. When Giant was wound up, Standard Chartered commenced proceedings against Pioneer under the insolvent trading provisions, claiming that Pioneer was a director of Giant and was liable for the insolvent trading of Giant. After reviewing relevant circumstances such as the financial reporting requirement imposed on Giant by Pioneer, the making of strategic decisions by Pioneer, and other financial and management control issues, Hodgson J concluded that Pioneer was a shadow director of Giant and was liable for the debts of Giant under the insolvent trading provisions. In the words of Hodgson J, these circumstances showed a:

> ‘…willingness and ability [of Pioneer] to exercise control, and an actuality of control, over the management and financial affairs of Giant’.

Clearly, these circumstances indicated that Pioneer was not merely providing advice, but was giving instructions to Giant that were being implemented by Giant without any independent consideration. The effective source of decision-making within Giant was to be found in Pioneer. For this reason, Pioneer was a shadow director of Giant. Whilst it is possible for a holding company to be a shadow director of its subsidiary, the way in which advice is communicated to the subsidiary will be determinative in deciding whether or not it amounts to direction or instructions. If the emphasis is on the form or content of identifiable instructions or wishes the holding company may escape liability.

The case of *Dairy Containers Ltd v NZI Bank Ltd*\(^{13}\) dealt with the law of shadow directorships relating to holding companies and their subsidiaries.

*Dairy Containers* (*Dairy*) was a wholly owned subsidiary of the New Zealand dairy Board (*NZDB*). All of Dairy’s directors were nominee directors appointed by NZDB and were senior executives within NZDB. After Dairy made substantial financial losses, particularly due to the fraudulent activities of Dairy’s managers, Dairy sued its auditors for failing to

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\(^{13}\) (1995) 7 NZCLC 260.
detect these frauds. The auditors counterclaimed for contributory negligence, asserting that NZDB was a shadow director of Dairy.

In his judgment, Thomas J recognised the close working relationship between Dairy and NZDB:

'In truth, [Dairy's] operation was an integral part of NZDB's overall operation of making, processing and selling dairy products'.

His Honour acknowledged the almost total control of Dairy's operations by NZDB, arguing that their operating relationship was 'symbiotic'.

However, Thomas J did not find that the directors of Dairy were accustomed to act in accordance with directions or instructions from NZDB. Although as employees of NZDB the directors of Dairy were accustomed to act in accordance with directions or instructions from NZDB, his Honour failed to identify as a matter of fact any such directions or instructions.

3.5 The Section 187 Exception

The Corporate Law Economic Reform Program Act 1999 specifically amended the Corporations Law (as it then was) to expressly allow the directors of a wholly owned subsidiary to act in the best interests of the holding company, even though that may not be in the best interests of the subsidiary.

This amendment is encompassed in section 187 of the Act which reads:

A director of a corporation that is a wholly-owned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if:

(a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and

(b) the director acts in good faith in the best interests of the holding company; and

(c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

4. When Might The Corporate Veil Be Pierced?

General law

4.1 Company as agent of shareholder

In limited circumstances a company may be identified with its parent. This is more likely to happen if the parent is a company rather than an individual. An example would be where a company forms a subsidiary ostensibly to do something for which the subsidiary needs a

minimum level of resources but the parent does not give it adequate capital or loan money or otherwise give it a reasonable chance of obtaining credit or resources from a third party.

4.2 Group enterprise with another company

The corporate veil may be pierced if a corporate group is operating in such a manner as to make each entity indistinguishable. Factors that indicate that two or more companies were engaged in a group enterprise include overlapping directors, officers and employees, obvious influence of the control extending from the top of the corporate structure and the extent to which the companies were thought to be participating in a common enterprise with mutual advantages.15

4.3 Avoidance of an existing legal duty

While it is generally permissible to form companies to avoid a future liability, for example in a risky business venture that may fail, courts may not allow a company to be formed to avoid performing an existing legal duty.

In *Gilford Motor Co Ltd v Horne*16, Horne had covenanted as part of his employment agreement with Gilford that he would not at anytime solicit customers of Gilford. Horne left his employment with Gilford and opened a business under his own name that competed with Gilford. Horne’s solicitor then received a copy of the service agreement with Horne and a new company was incorporated in the name of Horne’s wife. The only shareholders were Horne’s wife and a business associate of Horne. Horne conducted the business of the new company. The court found against Horne. Note that this decision could also be regarded authority for incorporating a company for an illegal purpose or inducing a breach of contract.

4.4 Fraud or where company is a sham

These topics may be grouped together as fraud can only be perpetrated if the company is a sham17. The corporate veil will be pierced if the corporation is being used as a vehicle for fraud.

In *Re Darby*18, Darby and Gyde formed a company. They were the sole directors and together with 5 nominees constituted the only shareholders. The company purchased a licence to operate a quarry and then floated another company. The second company was incorporated for purpose of purchasing the licence at far more than its true value. Using the funds from the float the second company purchased the licence. The second company then failed and the liquidator claimed against Darby for the secret profits made by him. Darby was ordered to repay his profits as he had only incorporated a “dummy company” formed for the purpose of perpetrating a fraud.

15 See further Ramsay, I. “Piercing the Corporate Veil in Australia” (2001) 19 C&SLJ 250 at 257.
16 [1933] Ch 935
17 see Ford’s Principles of Corporations Law para 4.350
18 [1911] 1 KB 95.
4.5  **Knowingly involved in a breach of duty**

The corporate veil may be pierced if the holding company is knowingly involved in a breach of duty by a director of the subsidiary. This situation may occur when directors of one company are also directors of another company.

In *Green v Bestobell Industries Ltd*[^19] (1982) WAR 1, Green, a manager of Bestobell, discovered that Bestobell was preparing a tender for certain construction works. Without Bestobell’s knowledge Green incorporated his own company, Clara Pty Ltd. Green caused Clara to also tender for the construction work and Clara won the tender. Bestobell discovered this and sued Green and Clara. The Western Australian Supreme Court held that:

- Green had breached his fiduciary duty to Bestobell by placing himself in a position where his duty to it conflicted with his own interests; and
- as Clara knowingly and for its own benefit participated in Green’s breach, it was ordered to account to Bestobell for the profits it derived.

**Corporations Act**

4.6  **Company structure**

Unlimited liability companies clearly give rise to claims against members. Further, holders of partly paid limited liability shares are liable for the full value of their shares (that is until the shares are fully paid)[^20].

Shareholders may also be liable if the company is limited by guarantee. When a company limited by guarantee is wound up without adequate funds to discharge its liabilities each person who is a member at the commencement of the winding up is liable to pay an amount that the member has undertaken to contribute if the company is wound up[^21]. If it appears to the court that members are unable to meet the company's liabilities, persons who have been members within a year before the commencement of winding up are liable to honour their guarantees. But those past members are liable to contribute only towards payment of the company's debts incurred before they ceased to be members[^22].

4.7  **Holding company’s liability for debts of subsidiary (Section 588V of the Act)**

A holding company may be liable for debts of its subsidiary incurred while there were reasonable grounds for suspecting that the subsidiary was insolvent (or would become insolvent as a result of the transaction). The holding company or its directors must also be aware, or should have been aware, that the subsidiary was insolvent. In this case the liquidator may recover from the holding company an amount equal to the loss or damage[^23].

[^21]: Section 517 of the Act.
[^22]: See sections 520 to 522 of the Act and further, *Ford’s Principles of Corporations Law* para 5.090.
[^23]: See further sections 588V and 588W of the Act.
4.8 Compensation orders for contraventions of civil penalty provisions

Section 1317H of the Act provides that a court may order a person to compensate a corporation for damage suffered by the corporation if:

(a) the person has contravened a civil penalty provision in relation to the corporation; and

(b) the damage resulted from the contravention.

Only the corporation or ASIC may apply for a such compensation order.24

Many civil penalty provisions are formulated in terms of “involvement in” a contravention of a specific provision of the Act. Section 181 is typical and provides as follows:

181 Good faith – civil obligations

(1) Good faith – directors and other officers A director or other officer of a corporation must exercise their powers and discharge their duties:

(a) in good faith in the best interests of the corporation; and

(b) for a proper purpose.

(2) [Contravention] A person who is involved in a contravention of subsection (1) contravenes this subsection.

Each of subsections 181(1) and 181(2) is a civil penalty provision.25 Other civil penalty provisions framed in terms of “involvement in” a contravention of a specific provision include:

- subsection 182(2) (use of position – civil obligations);
- subsection 183(2) (use of information – civil obligations);
- subsection 209(2) (related party transactions);
- subsection 154L(2) (redemption of redeemable preference shares);
- subsection 256D(3) (capital reductions); and
- subsection 260D(2) (financial assistance).

Section 79 of the Act provides that a person is involved in a contravention if, and only if, the person:

(a) has aided, abetted, counselled or procured the contravention; or

(b) has induced, whether by threats or promises or otherwise, the contravention; or

(c) has been in any way, by act or omission, directly or indirectly, knowingly concerned in, or party to, the contravention; or

(d) has conspired with others to effect the contravention.

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24 Section 1317J of the Act.
25 Section 1317E(1)(a) of the Act.
It is possible, given the wide definition in section 79, that a holding company could be involved in a contravention of a civil penalty provision by a director of its subsidiary (for example, by being knowingly concerned in the contravention). If this were the case, a liquidator of the subsidiary may be able to seek a compensation order against the holding company under section 1317H of the Act.

4.9 Shadow directors and nominee directors

The definition of 'shadow director' has been set out above. A 'nominee director' is a director appointed by a particular shareholder to represent that shareholder’s interests.

The Act imposes personal liability on directors in a range of circumstances. Shadow directors and nominee directors raise similar issues for piercing the corporate veil because:

(a) a controlling shareholder may (perhaps unwittingly) be a shadow director; and
(b) a nominee director will typically be indemnified by his appointor.

In either case, the controlling or appointing shareholder may find itself subject to a liability which the Act imposes on directors.

4.10 Directors’ liability for unpaid tax (Section 588FGA of the Act)

If a company goes into liquidation and a court orders that a payment to the Australian Tax Office is void under section 588FE and the court orders that it is void under section 588FF then the directors are must indemnify the Commissioner of Taxation for the tax debt26.

4.11 Personal liability of directors of trustee corporations

Directors of trustee companies that have no right of indemnity against the trust fund can be personally liable for certain debts incurred by the company27.

5. Insolvent Trading

To Which Companies Does Section 588G Apply?

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

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

26 Section 588FGA of the Act.
27 Section 197 of the Act.
Although it is possible for section 588G to apply to companies in a form of external administration other than liquidation, such as a deed of company arrangement under Part 5.3A, in practice this will prove difficult. Due to the standing rights reserved for liquidators under the insolvent trading provisions, unless ASIC brought a claim or the Minister authorised it, a claim would only be brought against a director under these provisions after the commencement of winding up of the company. Accordingly, where it is intended to prosecute a director under section 588G creditors will often choose to place the company into liquidation.

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

The Elements and Proof of Insolvency

5.1 What is insolvency?

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

The Act defines a person which is not solvent as being insolvent\(^\text{28}\). Section 85A states that the term ‘person’ includes a body corporate as well as a natural person. The enquiry which should be made under the section to ascertain whether the company is insolvent is as follows: Is the company able to pay all of its debts as and when they become due? To answer this question it may be necessary to consider the following:

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

\(^{28}\) Section 95A(2) of the Act.
Justice Emmett in *Quick v Stoland*\(^{29}\) set out four factors which should be taken into account. They are as follows:

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

In the same case, Justice Finkelstein stated:

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

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

### 5.2 Rebuttable Presumptions of Insolvency

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

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

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

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

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

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\(^{29}\) (1998) 157 ALR 615 at 622.
administrator was appointed), it is presumed that the company was insolvent from that time until the relation-back day.

(b) Presumption of Insolvency based on Insufficient Accounting Records

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

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

5.3 Indicators of Insolvency

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

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

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ASIC’s National Insolvent Trading Program, ASIC Information Sheet available at www.asic.gov.au
6. What is a Debt and When is One Incurred?

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

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

There is no definition of ‘debt’ within the Act. There is no ‘quick and fast’ rule of what constitutes a debt as its meaning varies according to the type of transaction in question. Generally, a company incurs a debt when by its choice, it does or omits to do something which, as a matter of substance and commercial reality, renders it liable for a debt for which it otherwise would not have been liable.31

'Debt' has been interpreted to bear its ordinary technical meaning as something recoverable by an action for debt and thus must be ascertained or capable of being ascertained.32 Therefore, a 'debt' signifies an obligation for the payment of money or money’s worth. Many authorities suggest that the obligation must be for an ascertained liquidated sum.33

At a fundamental level, the company must commit a positive act to bring a debt into existence. In this sense a debt can only be incurred by a positive, voluntary act that signifies the company’s willingness and intention to be bound. Its ordinary use implies that it is an obligation actually incurred.34

6.1 General Checklist – Has a Debt Been Incurred?

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

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

32 Ogden’s Ltd v Weinberg (1906) 95 LT 567 per Lord Davey. See also Hussein v Good (1990) 8 ACLC 390.
33 3M Australia Pty Ltd v Watt (1984) 9 ACLR 203. See also Jelin v Johnson (1987) 5 ACLC 463.
34 Hawkins v Bank of China.
7. **Failure to Prevent the Company Incurring a Debt – Reasonable Grounds to Suspect and Awareness (588G(1)(c) and 588G(2))**

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

- there were reasonable grounds for suspecting that the company was insolvent or would become insolvent\(^{35}\); and
- either that:
  - the director was aware at the time that there were such grounds\(^{36}\); or
  - a reasonable person in a like position in a company in the company’s position would have been so aware\(^{37}\).

This element of liability raises two main issues:

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

### 7.1 Suspicion

Section 588G’s predecessors, section 592 and section 556, required that a director have reasonable grounds to *expect* insolvency which contrasts with the present requirement that a director have reasonable grounds to *suspect* insolvency. Some guidance as to the new standard of “suspicion” can be gleaned from the authorities concerned with the previous legislation. Foster J in *3M Australia Pty Limited v Kemish*\(^{38}\), one of the authorities dealing with the previous legislation, in exploring what was meant to *expect* said:

> ‘The word ‘expect’ must be accorded due significance. The passages already cited established that ‘expectation…goes beyond a mere hope or possibility’. Of course, ‘expecting’ is very different from ‘suspecting’ … It is, in effect, synonymous with ‘predicting’ to suspect that something will happen. It requires a lower degree of apprehension or anticipation than is associated with an expectation that the same thing will happen.’

In *Commonwealth Bank of Australia v Friedrich & Ors*\(^{39}\) there is a clear statement by Tadgell J that ‘evidence of a director’s mere suspicion will not afford evidence of his expectation’.

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\(^{35}\) Section 588G(1)(c) of the Act  
\(^{36}\) Section 588G(2)(a) of the Act.  
\(^{37}\) Section 588G(2)(b) of the Act.  
\(^{38}\) (1986) 4 ACLC 185.  
\(^{39}\) (1991) 9 ACLC 946.
Evidence of a mere suspicion would now be enough to establish liability. Apart from being a lower level of apprehension than an expectation what exactly does a suspicion require? Justice Kitto in *Queensland Bacon Pty Limited v Rees*\(^{40}\) described a suspicion as:

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

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

### 7.2 Reasonable Grounds

(a) The standard is objective

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

The application of this test was considered in *Metropolitan Fire Systems Pty Limited v Miller*\(^{41}\). In this case, Metropolitan Fire Systems Pty Limited (Metropolitan) was owed approximately $50,000 by Raydar Electrics Pty Limited (Raydar). In December 1993 Raydar contracted with another company, Reed, for Metropolitan to subcontract with Reed. In February 1994 assurances were provided by one of the directors of Raydar, Mr Miller, to Metropolitan that it would be paid because Raydar expected payment from Reed. At the time when the assurance was given, Raydar was in debt to another company which had applied to the Supreme Court in late 1993 for Raydar to be wound up.

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

The judge went on to find that at the same date, reasonable grounds existed on which to base the suspicion within the meaning of section 588G that Raydar was insolvent. Even though Raydar was owed substantial amounts of money there was clear evidence that this money would not be available in the near future. There was evidence that the number of employees had been reduced from 14 in June 1993 to 4 or 5 in December 1993 and that neither Mr Miller the director nor his wife had drawn wages for a period of some weeks. Raydar had also not made any instalment payments towards its tax liability. At this point having considered the

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\(^{40}\) (1966) 115 CLR at 303.

\(^{41}\) (1997) 23 ACSR 699.
authorities, Justice Einfeld found that the test 'is one of objectively reasonable
grounds which must be judged by the standard appropriate to a director of ordinary
competence'. The state of a director’s knowledge and participation in incurring the
relevant debt are not taken into consideration when establishing whether this
element of liability exists. These factual matters relevant to a particular director
may be relevant to establish a defence.

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

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

- keeps abreast of the company’s affairs, sufficiently abreast of them to act
appropriately if reasonable grounds exist to expect insolvency (NB. this
would now be to suspect insolvency);
- is capable of understanding the company’s affairs to the extent of reaching
a reasonably informed opinion of its financial capacity.

(b) The standard requires there to be a continual monitoring of the company’s financial
situation

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

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

Three pieces of correspondence were also considered to be significant. The first
piece of correspondence was a letter of January 1993 in which the company
offered to transfer a bobcat in partial discharge of a debt due to a creditor. The

42 Heide Pty Limited t/as Farmhouse Smallgoods v Lester (1990) 3 ACSR 159.
letter stated that the company would be unable to pay its debt otherwise than by delivering the bobcat. The second piece of correspondence was a letter from the company to one of its creditors dated 3 June 1993 which advised creditor that the company was unable to pay an outstanding account of $242,000. The final piece of correspondence was a letter dated 13 July 1993 to the ANZ Bank which stated that the company could only continue its operations with the assistance of the Bank’s overdraft facility. The Full Court found that in light of the letter of January 1993 the company was not able to meet its outstanding obligations at least by 14 January 1993.

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

### 7.3 Awareness

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

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

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

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

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

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

If it cannot be established that the director had actual awareness of reasonable grounds for suspecting insolvency, contravention of the insolvent trading provisions can also result if the director should have been aware that there were reasonable grounds for suspecting insolvency. Accordingly, the court will determine whether a reasonable person in a like position in a company in the company’s circumstances would have been so aware.
On a general level, the model reasonable person would be able to read and understand in general terms the company’s accounts and auditor’s report. However, the inclusion of the term ‘in a like position in a company in the company’s circumstances’ allows the court to have regard to a wide range of factors, including:

- the size of the company;
- the type of business conducted by the company;
- the composition of the board;
- whether the director was an executive or non-executive director;
- the delegation of functions and responsibilities between directors;
- the distribution of work between board members and management; and
- professional qualifications and special expertise held by the director.

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

7.4 Time to Assess Awareness

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

7.5 Dishonesty

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

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

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

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

(a) Directors of a large company should ensure that among their number there should be one or more who are talented in the field of corporate financial management.

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43 Commonwealth Bank of Australia v Friedrich

44 Metropolitan Fire Systems Pty Ltd v Miller; 3M Australia Pty Ltd v Kemish.


(b) Directors of a large company should read, be able to understand and seek any necessary clarification of the key financial information put before the Board, such as a balance sheet and a profit and loss statement.

(c) The Board should ensure that appropriately skilled people are engaged to carry out the company's accounting functions.

(d) The Board should require relevant accounting information to be supplied ahead of regular Board meetings at which key financial decisions are to be made, and that, where a significant borrowing is to be undertaken, the management should supply the Board with a statement of the company's current financial position as well as the particulars of the way in which the principle, interest and other charges are to be serviced over the anticipated term of the loan.

(e) The Board should make arrangements for monitoring the use of any authorisation granted in relation to the use of the company seal, the entering into contracts with financiers or the signing of cheques and bills of exchange.

(f) Where the nature of the business may expose the company to a high risk of sudden liquidity restriction, or the company is known by the director to be in a delicate financial position, extra care and more rigorous safeguards may need to be adopted.

8. **Statutory Defences to Insolvent Trading**

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

(a) there were reasonable grounds to expect that the company was solvent and would remain solvent even if it incurred the debt;

(b) the director relied on a competent and reliable person who was responsible for providing information as to the solvency of the company. On the basis of this information he or she expected that the company was solvent;

(c) through illness or other good reason the director did not take part in the management of the company; and

(d) the director took all reasonable steps to prevent the company incurring the debt.

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

8.1 **Reasonable Grounds to Expect Solvency Defence**

The defence in subsection 588H(2) excludes from liability directors who can prove that, at the time the debt was incurred, they had reasonable grounds to expect, and did in fact expect, that the company was solvent at that time and would remain solvent even if that debt, or any other debt, was incurred. This 'reasonable grounds to expect solvency'
defence requires the director to establish the existence of grounds to expect solvency, the reasonableness of these grounds, and his or her actual belief in the fact of solvency.\(^{47}\)

(a) **Existence of Grounds to Expect Solvency**

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

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

(b) **Reasonableness of Grounds to Expect Solvency**

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

If the wholly objective criteria test is adopted as the appropriate standard for exculpation under subsection 588H(2), what will be fundamentally required of directors is to carefully monitor the financial situation of the company and its solvency, and to stay informed of the company’s affairs. If the subjective and objective test is adopted, the development of the case law under subsection predecessor sections suggests that the standard required of directors is becoming increasingly onerous and largely objective in any event\(^ {48}\). Accordingly, what is fundamentally required of directors under the 'subjective and objective' test will also be to stay carefully informed as to the financial standing of the company.

(c) **Actual Expectation of Solvency**

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

In order to satisfy the requirements of the defence, a director must prove that he or she had a large degree of confidence in the solvency of the company, and anticipated its continuing solvency in a manner displaying more than a mere hope or possibility.

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

8.2 **Reasonable Steps Taken to Prevent the Incurring of the Debt Defence**

Subsection 588H(5) provides a defence to proceedings against a director under subsection 588G(2). It is available to directors who took all reasonable steps to prevent the company incurring the relevant debt. It interacts with Part 5.3A of the Act where subsection 436A(1)(a) allows the directors of a company to appoint an administrator if they believe that the company is likely to become insolvent at some future time. It also interacts with

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\(^{47}\) 3M Australia Pty Ltd v Kemish.

\(^{48}\) see Commonwealth Bank of Australia v Friedrich.
subsection 1317S which makes clear what the court can take into consideration when excusing a director for contravention of section 588G.

(a) What are Reasonable Steps?

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

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

(b) when that action was taken; and

(c) the results of that action.

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

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

(b) Genuine Effort and Unequivocal Action

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

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

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

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

(c) Business Judgment Rule Does Not Apply

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

(d) All Reasonable Steps Must be Taken

It is important to note that all reasonable steps must be taken by a director in order to qualify for this defence. This means that the requirements of the defence are potentially onerous and may require resignation in some circumstances. It may not be necessary for a director to resign if he or she cannot prevent the incurring of the debt if he or she was argued vigorously in favour of entering voluntary administration. There is some authority that such a failure to prevent the incurring of a debt may be due to an overbearing director or board of directors, in which case a particular director may escape liability.50 However, mere protesting by a director that he or she has reservations about a particular course of action will not be enough to escape liability.51 It may not be sufficient to merely clearly and consistently express reservations to the actions of the company. Clear, positive and unequivocal action must be taken.

8.3 Reasonable Reliance on a Competent and Reliable Person Defence

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

The reliance defence is intended to encourage directors to ensure that proper and adequate financial management systems are in place and thus promote legal compliance. The defence implies that a director must at least take a partially active role in ensuring that proper systems are set up for financial management and monitoring, reviewing the satisfactory performance of the responsible delegate, and thus still places a high standard on directors.

A director does not have to establish that the delegate was in fact competent and reliable, but rather that he or she believed on reasonable grounds that this was the case. It is not

51 Byron v Southern Star Group Pty Ltd.
clear what inquiries should be made of a delegate’s competence or reliability. Interestingly, this defence only requires a director to believe in the solvency of the company on the basis of information provided by a delegate responsible for the oversight to the company’s financial position. In contrast to the philosophy of the insolvent trading provisions it does not require this belief of solvency to be based on reasonable grounds.

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

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

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

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

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

Holding companies are exposed to liability for the insolvent trading of their subsidiaries. The days of quarantining liability in a subsidiary have to some extent passed in Australia.

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

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

• it was the holding company of a subsidiary at the time when the subsidiary incurred a debt; and

• that debt caused, or was incurred during, the insolvency of the subsidiary; and

• there were reasonable grounds to suspect that the subsidiary was insolvent or would become insolvent by incurring that debt, or any other debt at that time; and either

• the holding company or any of its directors was aware of reasonable grounds for suspecting the subsidiary’s insolvency; or

• having regard to the nature of the holding company’s control over the subsidiary, it was reasonable to expect that a holding company in the circumstances of the holding company, or any of its directors, ought to have been aware of those grounds for suspicion.
The origin of these provisions is a report of the Australian Law Reform Commission\(^{52}\). The Commission recommended a broader provision than was eventually enacted\(^{53}\). Under the recommendations of the Commission, liability for insolvent trading could attach not just to a holding company but to any related company. The Commission proposed that a court could order a company liable for the debts of a related (insolvent) company if the court determined this to be just having regard to:

- the extent to which the related company took part in the management of the insolvent company;
- the conduct of the related company towards creditors of the insolvent company;
- and
- the extent to which the circumstances that gave rise to the winding up of the insolvent company were attributable to the actions of the related company.

The Commission's recommendations in this regard were not taken up and narrower provisions focussing on holding company's and their subsidiaries (rather than related companies) was enacted.

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

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

9.1 Factors the Court Will Consider

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

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


9.2 **Penalties and Recovery of Compensation**

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

- the holding company has contravened section 588V in relation to the incurring of a debt by the subsidiary;
- the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the subsidiary’s insolvency;
- the debt was wholly or partially unsecured when the loss or damage was suffered; and
- the subsidiary is being wound up.

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

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

9.3 **Defences**

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

10. **Sections 1318 and 1317S of the Act**

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

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

10.1 **Section 1318**

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

Section 1318 applies to an officer of a corporation (which includes a director), an auditor of a corporation, an expert, and a receiver, receiver and manager, liquidator or other person appointed or directed by the court to carry out any duty under the Act in relation to a corporation, including executive officers and company secretaries.
Section 1318 can provide relief in proceedings brought by a party other than the company. A person who merely apprehends that proceedings may be brought against them can apply for relief under the section (section 1318(2)).

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

10.2 Section 1317S

Section 1317S provides a basis for relief from liability under a civil penalty provision where the person has acted honestly and the person ought fairly to be excused in the circumstances of the case. It applies to the duty to prevent insolvent trading. When deciding whether or not to excuse a person for a breach of the insolvent trading provisions, the court can have regard to any action the person took to appoint an administrator to the company, when the action was taken, and the results of the action (section 1317S (3)). A person can apply for relief in advance if their apprehends that proceedings may be brought against them (section 1317S(4)).

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

11.1 Civil Penalty Orders

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

(a) Declaration of Contravention

Only ASIC can apply for a declaration of contravention\(^{54}\).

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

A corporation may intervene in an application by the ASIC for a declaration of contravention\(^{55}\). It can be heard on all matters except whether than declaration of contravention should be made\(^{56}\).

An application for a declaration of contravention must be made within six years of the contravention. When hearing proceedings for a declaration of contravention, the court must apply the rules of evidence and procedure for civil matters\(^{57}\). This means that the burden of proof will be on the balance of probabilities.

\(^{54}\) Section 1317J(1) of the Act.

\(^{55}\) Section 1317J(3) of the Act.

\(^{56}\) Section 1317J(3) of the Act.

\(^{57}\) Section 1317L of the Act.
Pecuniary Penalty Order

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

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

• materially prejudices the interests of the corporation or scheme, of its members;
• materially prejudices the corporation’s ability to pay its creditors; or
• is serious.

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

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

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

• the nature and extent of the contravening conduct;
• the amount of loss or damage caused;
• the circumstances in which the conduct took place;
• the size of the contravening company;

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58 Section 1317J(3) of the Act.
59 Section 1317J(3) of the Act.
60 Section 1317K of the Act
61 Section 1317L of the Act.
• the degree of power it has, as evidence by its market share and ease of entry into the market;
• the deliberateness of the contravention and the period over which it extended;
• whether the contravention arose out of the conduct of senior management or at a lower level;
• whether the company has a corporate culture conducive to compliance with the Act/Law, as evidenced by educational programs and disciplinary or other corrective measures in response to an acknowledged contravention; and
• whether or not the company has shown a disposition to co-operate with the authorities responsible for the enforcement of the Act/Law in relation to the contravention.

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

(c) Compensation Order
A compensation order may be made a director of the company under section 588J(2). If the ASIC makes an application for a compensation order, the liquidator of the company has the right to intervene. The liquidator is entitled to be heard only if the court is satisfied that the person committed the contravention and only in regards to whether or not the court should order the person to pay compensation to the company. The amount of compensation ordered under section 588J will be equal to the amount of loss or damage caused. It is possible that this measure could exceed the amount of the relevant debt and include the entire disadvantage suffered by a person or corporation.

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

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

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

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62 Section 1317G(2) of the Act.
63 Subsection 588J(2) of the Act.
64 Section 206C(1) of the Act.
• the person’s conduct in relation to the management, business or property of any corporation; and
• any other matters that the court considers appropriate.

Other matters may include:
• the character of the defendant;
• the nature of the offence;
• the structure of the companies concerned and the nature of their business;
• the interests of shareholders, creditors and employees;
• the risk to those persons or to the public of the defendant continuing in his present function;
• his honesty and competence;
• hardship resulting to him, his personal and family business interests; and
• his appreciation that future breaches could result in fresh proceedings for the court to disqualify.

11.2 **Criminal Offences**

Subsection 588G(3) outlines when a breach of the insolvent trading provisions will constitute a criminal offence. A person will commit an offence under the insolvent trading provisions where the director’s failure to prevent the company incurring the debt was dishonest:

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

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

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

If a person is convicted of an offence under subsection 588G(3), they are automatically disqualified from managing a corporation.

11.3 **ASIC may Require Person to Assist**

The ASIC may require a person to assist them in an application for a declaration of contravention, a pecuniary penalty order, or criminal proceedings.

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66 Subsections 206B(1)(b)(i) and (ii) of the Act.
67 Subsection 1317R(1) of the Act.
11.4 Personal Subjection to External Administration

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

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

11.5 Miscellaneous Sanctions

Other sanctions include injunctions\(^{68}\) and fines\(^{69}\).

12. Directors’ Personal Liability for Unremitted Tax

When a company is suffering liquidity problems, it is not uncommon for the company to fail to remit PAYE tax deductions to the Commissioner of Taxation (the Commissioner).

Subsection 221C(1) if the Income Tax Assessment Act 1936 (Cth) (ITAA) obliges an employer to make PAYE tax deductions from the salaries of its employee at the prescribed rate. Subsection 221F(5) of the ITAA obliges the employer to pay the Commissioner the amount of any deduction the employer makes.

Since 1 July 1993, the Australian Taxation Office (ATO) no longer enjoys a priority claim in insolvency administration over other secured creditors for unpaid group tax. The ATO merely ranks as an ordinary unsecured creditor for these unpaid taxes.

However, the ITAA has been amended by the Insolvency (Tax Priorities) Legislation Amendment Act 1993 (Cth) to introduce procedures for the collection of group taxes which must be paid to the ATO. These amendments introduce a system of issuing penalty notices by which the ATO can make a director personally liable for those unpaid group taxes, and certain other taxes.

These new provisions apply to a number of provisions within the ITAA. The provisions will apply to the collection of instalments of tax on persons other than companies (group PAYE tax), tax file number withholding tax, withholding tax on dividends and interest and prescribed amounts payable.

Directors must ensure that a company that becomes liable to remit an amount to the Commissioner of Taxation for PAYE deductions under Division 2 of the ITAA either remits that amount or pursues one of four options. Under subsection 222AOB(1) of the ITAA those four options are to:

- remit the amount due;

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\(^{68}\) Section 1324 of the Act.

\(^{69}\) Section 1311 of the Act.
• enter into an agreement with the Commissioner to pay the amount due over a specified period of time;
• become subject to voluntary administration; or
• be wound up.

If one of these four options is not taken, the Commissioner may impose a penalty on the director for an amount equal to the unpaid amount, after a number of steps have been taken.

The liabilities of a company under a remittance provision are deemed to be debts for the purposes of the insolvent trading provisions70.

12.1 Penalty Notice
Before the Commissioner can impose a penalty on a director, a notice must be sent to the director setting out the details of the unpaid amount, or an estimate of that amount71. This notice must state that unless one of the four options outlined above is entered into within 14 days of the notice being given, the director will be liable to pay to the Commissioner, by way of penalty, an amount equal to the unpaid amount. The notice is ‘given’ when it would be delivered to the director’s address in the ordinary course of post and does not have to personally be served on the director.

12.2 Estimate of Amount Owed
It is important to note that the Commissioner can make an estimate of the unpaid amount, and does not need to articulate the precise amount owing in order to impose a penalty on a director. This shifts the onus on the director to make the Commissioner aware of the actual liability outstanding.

12.3 Personal Liability for Directors
Directors are made personally liable for a penalty equal to the amount of the unremitted tax deductions or for the amount of the estimate made by the Commissioner.

The director can avoid this personal liability if within 14 days of the notice being given to the company to remit the unpaid amount, the company enters into an agreement with the Commissioner regarding payment, enters the company into voluntary administration, or causes the company to be wound up. This is the case even if the director had nothing to do with one of those options being taken. However, if the company fails to pay under a payment agreement made with the Commissioner, the director can be subjected to a penalty equal to the balance payable under the agreement. The Commissioner does not have to provide a notice for this liability to be imposed.

It should be noted that there is not prescribed order for these provisions to be applied and therefore it is possible that the Commissioner could serve an estimate, notice, and penalty at the same time.

70 Section 588F of the Act.
71 Section 222 AOE ITAA.
12.4 Defences for Directors

A director will not be personally liable if:

• the director took all reasonable steps to ensure that the company would take one of the four options;

• there were no reasonable steps that the director could take to ensure that the company complied; or

• the director did not participate in the management of the company for illness or some other good reason.

These defences are analogous to the defences under section 588H of the Act for a breach of the insolvent trading provisions.

In determining what is “reasonable”, regard may be given to:

• when, and for how long, the person was a director and took part in the management of the company; and

• all other relevant circumstances\(^2\).

Under the ‘reasonable steps’ defence, a director can not claim the he or she was unaware of the unremitted tax deductions because of the notice procedure. The notice procedure also means that it is unlikely that the courts will find that a director who made no inquiry took reasonable steps. It may not be sufficient for a director to rely on an accountant or other professional adviser in dealing with the unremitted tax deductions\(^3\), but rather positive action on behalf of the director is required.

The court will have regard to the circumstances of the particular director, their experience and expertise and role in the management of the corporation in determining what is 'reasonable'.

If the company has failed to comply with an agreement entered into with the Commissioner, the director cannot rely on any of the statutory defences unless it is proved that at the time the agreement was entered into, the director had reasonable grounds to expect, and did expect, that the company would comply with the agreement.

12.5 Considerations in 'Reasonable Steps' Defence

Although passive directors cannot plead ignorance as a defence due to the penalty notice system, subjective factors will be considered by the courts in determining whether the steps taken by a director to ensure the company complies with one of the four options in section 222 AOB in ITAA are ‘reasonable’. The question will be whether the particular director took reasonable steps with regard to his or her experience, role in the company’s management and any other relevant circumstances.

\(^2\) Sections 222 AOJ(3) and (4) of the ITAA.

\(^3\) Buist v Commissioner of Taxation (1988) 90 FLR 72.
12.6 **Right of Indemnity**

A director who is personally liable has a right of indemnity against the company\(^74\) and a right of contribution against other directors on the basis of joint and several liability\(^75\).

12.7 **Parallel Liability**

A director’s liability for a penalty is parallel to the liability of the company or other directors for that penalty. This means that although a penalty may have been imposed, the underlying liability to remit unpaid deducted amounts still remains. However, any amount paid to discharge either the penalty or the unremitted deducted amount reduces to other related parallel liability to the extent of that amount.

13. **Personal liability of directors for uncommercial transactions**

On 30 June 2000, the *Corporations Law Amendment (Employee Entitlements) Act 2000* came into effect. This legislation introduced a new Part 5.8A into the Act, prohibiting persons from entering into transactions with the intention of preventing the recovery of employees entitlements to wages, superannuation contributions etc. As well as the introduction of Part 5.8A, the legislation also amended Part 5.7B Division 3, which deals with a director’s duty to prevent insolvent trading. In particular, s588G was amended by adding ‘entering into an uncommercial transaction’ to the categories of circumstances where a company incurs a debt for the purposes of the insolvent trading provisions.

This amendment had the effect of exposing directors to personal liability upon claims by liquidators (or creditors with the leave of the Court) for insolvent trading, where the company enters into an uncommercial transaction and the company was insolvent at that time or became insolvent as a result of the transaction (and there were reasonable grounds to suspect that the company was insolvent or would become insolvent as a result of the transaction).

It is noteworthy that the amendment is not limited to transactions relating to employee entitlements but applies to all uncommercial transactions. Thus in any instance where an uncommercial transaction is potentially voidable, as well as seeking one of the orders available under s588FF, a liquidator may also wish to consider seeking compensation from the directors personally. However, the defences available to directors to claims of insolvent trading (reasonable grounds to suspect the company was solvent, reliance on other persons etc\(^76\)) would need to be assessed before making a claim against a director.

14. **Phoenix Companies**

Many corporations and directors abuse the corporate form and the widespread availability of limited liability for the sole purpose of avoiding debt. In many instances the avoidance of

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\(^74\) Section 222 AOI ITAA.

\(^75\) Section 272 APH ITAA.

\(^76\) See section 588H.
taxation and/or impending insolvency may cause resort to what is commonly known as a 'phoenix company'.

The term 'phoenix company' is widely used by lawyers and other professionals. On a basic level, a phoenix company is a limited liability company which houses individuals who abuse the corporate form by dissolving one company and creating another company to avoid payment of a debt.

The Victorian Law Reform Commission has described a phoenix company as:

'A limited liability company fails, unable to pay its debts to creditors, employees and the State. At the same time, or soon afterwards, the same business rises from the ashes with the same directors, under the guise of a new limited liability company, but disclaiming any responsibility for the debts of the previous company'.

ASIC defines 'phoenix activities' as those when a company:

• fails and is unable to pay its debts; and/or
• acts in a manner which intentionally denies unsecured creditors equal access to the available assets in order to meet unpaid debts; and
• within 12 months of closing another business commences which may use some or all of the assets of the former business, and is controlled by parties related to either the management or directors of the previous company.

Phoenix activities have a widespread effect on the Australian economy, but the failure of creditors to report it to the authorities means that it often remains undetected.

Corporate groups are often established for the purpose of facilitating phoenix activities. For example, undercapitalised companies are sometimes established for the purposes of hiring labour but where the true beneficiary, but not employer, is another stronger company in the same group. This stronger company exerts considerable influence over the terms and conditions of employment and has a strong influence over the workplace. However, when employees press for better conditions, the smaller employer company is wound up. When the employer company is wound up, employees are deprived of their legal rights, including long service leave and retrenchment or severance pay without any available resort to the other financially sound company.

14.1 Remedies Against Rogue Directors

There are two ways of dealing with the problem of directors who abuse the corporate form and limited liability through the use of phoenix activities:

The first is to prevent the directors concerned from doing it again by disqualifying rogue directors. The other is to make sure that they do not personally benefit at the expense of creditors by providing creditors with access to the directors' personal assets to satisfy the debts.

Section 206D provides that a director may be disqualified by the court from managing corporations for up to 10 years if they have been involved in the failures of at least two corporations within a seven-year period and poor management was wholly or partly responsible for the insolvency of the corporation. The court must be satisfied that the
disqualification is justified. In addition, under section 206F ASIC also has the power to disqualify a person from managing corporations for up to five years where the director has been involved in the insolencies of two or more corporations within a seven-year period and the liquidator of each corporation has lodged a report about the inability of the corporation to pay its debts. ASIC must give the person notice of their intention to disqualify them and an opportunity to be heard. ASIC must be satisfied that the disqualification is justified.

In addition to these disqualification provisions, the remedies available for a breach of insolvent trading will often be available to creditors against rogue directors. This is because in many cases phoenix companies will be used where a company is nearing insolvency or is insolvent and the directors are allowing it to incur debts to creditors with the intention of winding up the company before repayment is made. If a director has breached the insolvent trading provisions in this way, an individual creditor has a secondary right to bring proceedings for compensation equal to the amount of 'loss or damage' caused by the breach under subsection 588M(3). The amount of 'loss or damage' is likely to include the amount of the debt and other consequential losses.

Where directors are in the process of transferring corporate assets out of the rogue company to another associated company, such as through an intra-group loan, ASIC can obtain injunctive relief under section 1324 to stop this transfer and preserve the company’s assets.

15. Recent Case Law

15.1 Hanel v O’Neill [2003] SASC 409

In this case the Full Court of the Supreme Court of South Australia considered the personal liability of directors of corporate trustees for undischarged liabilities incurred by the company when acting, or purporting to act, as a trustee. The court held but a two to one majority that a director of a corporate trustee of a trading trust was personally liable for the trust’s debts under section 197 of the Act because the trust had no assets.

This was held to be the case notwithstanding the fact that the corporate trustee was 'entitled to be fully indemnified out of trust assets' under the provisions of the trust deed. The ruling has important implications for directors of all corporate trustees, as well as for third parties contracting with trustees.

The facts of the case are relatively straightforward. Mr O’Neill obtained a judgment against the corporate trustee, of which Mr Hanel was the sole director, for a debt owed to Mr O’Neill. When it became apparent that the trustee could not pay the judgment sum, Mr O’Neill commenced proceedings against Mr Hanel and succeeded in obtaining a judgment against him on the basis that he was personally liable under section 197. This judgment was appealed to the Full Court.
Section 197(1) of the Act states that:

(1) A person who is a director of a corporation when it incurs a liability while acting, or purporting to act, as trustee, is liable to discharge the whole or part of the liability if the corporation:

(a) has not, and cannot, discharge the liability or that part of it; and  
(b) is not entitled to be fully indemnified against the liability out of trust assets.

This is so even if the trust does not have enough assets to indemnify the trustee. The person is liable both individually and jointly with the corporation and anyone else who is liable under this subsection.

The judgments in *Hanel* make uncertain the precise circumstances in which section 197(1) is intended to operate. The ambiguity comes from the second part of the test, namely, that the corporate trustee 'is not entitled to be fully indemnified out of trust assets'.

The relevant trust deed in this case provided that 'the Trustee is entitled to be indemnified out of the assets for the time being comprising the Trust Fund against liabilities incurred by the Trustee…'.

The majority in *Hanel* determined that whether the corporate trustee was entitled to be indemnified out of the trust assets was not to be determined merely by reference to the trust deed provisions. If, in fact, the trust has no assets, then the directors are personally liable for the trust's debts. In this case, the trustee had disposed of all of the trusts assets. The majority held that, if there were no assets comprising the trust, the corporate trustee was not entitled to be fully indemnified against the liability out of trust assets and therefore was personally liable under section 197(1).

In the end, Mr Hanel won his appeal on other grounds and the matter was remitted to the Adelaide Magistrates Court for trial.

At this stage, it is not clear whether *Hanel* will be appealed to the High Court on the issue of directors' liability. An appeal may be unlikely as the matter was remitted to the Magistrates Court for trial. In the meantime, however, as a Court of Appeal decision, it is binding on all lower courts and single judges. Directors of corporate trustees and those contracting with trustees are left in a state of uncertainty about the extent of their personal liability for the trust's debts.

15.2 *R v Timothy Rhys Hawker Williams* (unreported, Supreme Court of Tasmania, 24 June 2004)

On 24 June 2004, the Supreme Court of Tasmania sentenced Mr Williams to 15 months imprisonment following his plea of guilty to 38 charges of insolvent trading and 2 counts of fraudulent conduct.

The charges were laid following an investigation by ASIC into the failure of Cotech Pty Ltd of which Mr Williams was a director. Cotech was a company producing baby furniture. It went into administration on 25 September 2000 and subsequently into liquidation on 20 October 2000 with debts to creditors of over $1.7 million.
The Court found that:

- between 20 December 1999 and 22 September 2000, Mr Williams, while a director of Cotech, dishonestly failed to prevent Cotech from incurring debts of $329,979 when there was reason to suspect that the company was insolvent in contravention of sections 1311 and 588G of the Act; and

- on 2 instances between 15 February 2000 and 3 March 2000, Mr Williams was knowingly concerned in Cotech doing an act with intent to defraud BRG Capital Facilitation Pty Ltd, a provider of cash flow funding, by representing to BRG that an entity owed Cotech $25,000 for services rendered knowing that the representation was false in contravention of section 592(6) of the Act.

The gross loss arising out of Mr Williams crimes was $367,479. Mr Williams personally repaid the $50,000 due to BRG and close to $30,000 was repaid to creditors who suffered from insolvent trading.

In sentencing Mr Williams, the Court noted that apart from his commission of the crimes of which he was convicted, Mr Williams had led an exemplary life and that his actions were done in an attempt to stave off Cotech's failure. It acknowledged that Mr Williams had gained no personal benefit from his actions and that he had provided, and was continuing to provide, significant assistance to ASIC in prosecuting both his case and ASIC's case against another Cotech director.

Nevertheless, Justice Evans noted that 'those involved in the commercial world are expected to conform to demanding standards of honest and if they engage in commercial crime, they must expect condign punishment…. Persons regarded as having been of good character and reputation often commit offences concerned with business morality and the offences will frequently attract custodial sentences as, in relation to such offences, the principle of general deterrence outweighs the personal circumstances of the offender.'

Mr Williams will be released after serving 6 months of his 15 month sentence upon entering into a recognisance in the sum of $2,000 to be of good behaviour for a period of 2 years following his release.

In commenting on this case, Jeffrey Lucy, Chairman of ASIC, stated that, 'this is the first occasion where a person charged with insolvent trading has been sentenced to serve time in jail. Preventing an insolvent company from incurring debts is one of the most fundamental obligations owed by company directors, and as this case shows, the consequences of failing to satisfy this obligation can lead to imprisonment.'

The imposition of a custodial sentence in this case, where the accused director entered a plea of guilty, gained no personal benefit and assisted ASIC in prosecuting fellow directors does not bode well for directors faced with insolvent trading charges in the future.

15.3 **Southern Real Estate Pty Ltd v Dellow [2003] SASC 318**

This case was another appeal to the Full Court of the Supreme Court of South Australia and is an example of a case in which a director was found to have placed their own self-interest above the interests of the company of which they were a director.
Ms Dellow was an executive director and shareholder of Southern Real Estate and managed rental properties on behalf of the clients of that company. Part of her responsibility included maintaining the rent roll of the business, being the list of clients whose rental properties are managed by the company.

From at least 8 January 2001, Ms Dellow had formed a firm intention to resign from her position at Southern Real Estate. From that time she took steps to establish a business in direct competition with her former company. On 30 January 2001, Ms Dellow resigned effective immediately. The next day she posted or delivered letters to 58 clients on the rent roll of Southern Real Estate informing the clients of her resignation and inviting them to call her. Eventually, 57 clients (approximately half of those on the rent roll of Southern Real Estate) transferred their business to Ms Dellow's new company.

The trial judge found that, in preparing her list of clients, Ms Dellow had relied on memory and had not used confidential information belonging to Southern Real Estate. He concluded, however, that as her memory was aided by her daily work for Southern Real Estate and her access to its records, her approach to at least some of the 58 to whom she wrote was wrongful.

In considering the duties owed by Ms Dellow, as a director of Southern Real Estate, to that company, the Full Court ruled that Ms Dellow was subject to both statutory and fiduciary duties and that she had acted in breach of both in failing to act in good faith and in the best interests of Southern Real Estate and in using her position as a director to improperly gain an advantage for herself or to cause detriment to the company.

The court considered the issue of when a former director of a company may begin to compete with that company and found that, at an appropriate time after her resignation, Ms Dellow would have been entitled to establish a business in competition with Southern Real Estate and could then have made a list of clients from her memory and actively solicited their custom. In the present case, however, the breaches of Ms Dellow's duties as a director occurred while she was a director and immediately upon her resignation and her resignation did not serve to discharge her of those duties. The fact that Ms Dellow had, while still a director, put everything in place to enable her to compete with Southern Real Estate upon her resignation led the court to conclude that Ms Dellow's fiduciary and statutory duties as a director of Southern Real Estate had been breached.

In assessing the damages to be awarded, the court assessed the diminution in the value of Southern Real Estate's rent roll that occurred as a result of Ms Dellow's conduct. Ms Dellow was held liable to restore Southern Real Estate to the position in which it would have been had she not acted in breach of her duties.

This case is of interest in the context of phoenix companies and the ability of liquidators to pursue directors for breaches of their fiduciary and statutory duties should it be found that the directors took steps to prepare for their departure (in transferring intellectual property or other company assets to be used in a new business) while they were still directors of the company now in liquidation.