Recent developments

Editor: Dr David Morrison

DIRECTOR'S LIABILITY FOR INSOLVENT TRADING, STATUTORY FORGIVENESS AND LAW REFORM

The recent decision by the Federal Court in *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* [2009] FCA 1415 (hereinafter *Stake Man*) excused a director from liability for insolvent trading based on statutory considerations concerning, inter alia, honesty and fairness under the *Corporations Act 2001* (Cth). Significantly, this is the first case where a director has been fully exonerated from personal liability through the exercise of judicial discretion and follows the pragmatic decision in *Hall v Poolman* (2007) 215 FLR 243; [2007] NSWSC 1330 where a director was partially excused from insolvent trading liability through reliance on the same statutory provisions (ss 1317S and 1318).

Before discussing the decision in *Stake Man* and its potential impact on insolvent trading law reform foreshadowed recently by Treasury,[1] it is appropriate to discuss the relevant legal framework in which the director's personal liability arose for consideration in this case.

STATUTORY FRAMEWORK

As part of the deterrence regime under Pt 5.7B the *Corporations Act*, directors may incur civil or criminal liability or on "pain of personal liability"[2] pay compensation to the creditors if they permit their company to trade while insolvent. The effect of s 588G and s 588M(2) of the Act is that a company's liquidator can recover from a director of the company loss and damage suffered by creditors. Section 588G(2) is also a civil penalty provision enforceable by the Australian Securities and Investment Commission. Consequently, directors are potentially liable to a pecuniary penalty, a disqualification order and compensation orders for loss arising from breach of the duty to prevent insolvent trading. Criminal proceedings are reserved for offences linked to fraud and dishonesty and may lead to prison terms for up to five years. The statutory purpose of the insolvent trading law was recently considered by the New South Wales Court of Appeal in *Edwards v Australian Securities and Investment Commission* (2009) 235 FLR 207 at [4] (Campbell JA):

> [It] is to discourage and provide a remedy for a particular type of commercial dishonesty or irresponsibility … [which] occurs when a company that is at or approaching insolvency obtains a loan, or obtains property or services on credit, and either there is a director who knows or suspects the insolvency or approaching insolvency, or a reasonable person in the director's position would know or suspect it. In that situation, any director (whether or not personally involved …) can be made personally liable … The section aims to encourage directors to carry out their duties properly if the company is at or approaching insolvency, and provides a sanction if they do not.

Section 588G applies to impose liability upon a person if:

- the person is a director of the company when the company incurs a debt;
- the company is insolvent or becomes insolvent when it incurs the debt;
- when it incurs the debt there are reasonable grounds for suspecting that the company is insolvent or would become insolvent because it incurs the debt; and
- the directors are aware at the time the debt is incurred that there are reasonable grounds for suspecting the company is insolvent, or a reasonable person in a similar position in the company in the company's circumstances would be so aware.

Directors, however, can avoid liability in recovery proceedings through successful reliance on s 588H which provides for the following defences:

[1] The Treasury, Commonwealth Government of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (The Treasury, January 2010), http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1713 viewed 31 May 2010.

[2] *Woodgate v Davis* (2002) 55 NSWLR 222; 42 ACSR 286.

- reasonable grounds to expect solvency (s 588H(2));
- reasonable reliance on other competent and reliable person (s 588H(3));
- absence from management due to illness or some other good reason at the time of original payment (s 588H(4)); and
- reasonable steps to prevent the company from making the payment (s 588H(5)).

Sections 1317S (which deals with contraventions of civil penalty provisions) and 1318 (which deals with breaches of duty more generally) are applicable to insolvent trading claims and confer judicial discretion to grant forgiveness and thereby relieve directors from liability. Both provisions turn on the director having acted honestly and that, having regard to all the circumstances of the case, the person ought fairly to be excused.

The central issues in *Stake Man* was whether the director engaged in insolvent trading under s 588G and, if so, whether the statutory defences relied upon under s 588H(2) and s 588H(3) were applicable. In the alternative, the director relied on the forgiveness provisions of the Act. Before exploring these legal issues with reference to the decision in *Stake Man*, attention is turned to the facts of the case.

FACTS

The liquidator of The Stake Man Pty Ltd (in liquidation) commenced proceedings against Mr Anthony Carroll, the sole director, for trading while insolvent and sought an order pursuant s 588M(2) that the director pay the company (and its creditors) the sum of the outstanding debts totalling $426,469.37. This amount was later reduced to $356,952.02 by the court following its finding that some of the debts fell outside the relevant period (31 December 2005 to 10 May 2006).

The company, which operated a business of processing and wholesaling raw timber, was incorporated in 1986 and traded profitably until 2004. Thereafter the company embarked on an expansion plan which involved the purchase of plant and equipment to enable it to kiln dry and machine its own timber.

The expansion plan proved to be costly, troublesome and ultimately affected the viability of the business. From the outset, the company incurred cost blow outs and had major problems with installation and operation of the kilns. By the middle of 2004, the delay in having the kilns operational started to impact on the company's cashflow.

By March 2005, it was apparent that the company had significant problems with its kiln drying operations. At that time, the company appointed a new accountant (Mr Bright) who specialised in business advisory services for participants in the timber industry. Mr Carroll requested Mr Bright to provide advice regarding the company's cashflows, costs and expenses and an analysis of the business model and its profits and losses.

Mr Bright reported to the company, in July 2005, that he considered the business was close to insolvency and recommended a significant capital injection until such time as the new plant and equipment became operational or a decision was made to abandon the kilns. Mr Carroll, through personal loans and other sources of funding, advanced further funds to the company which went towards the repayment of the earlier bank loan.

In February 2006, Mr Carroll sought the advice of an insolvency practitioner who recommended the need for an investor or further capital. In March 2006, Mr Carroll engaged a consultant to help find potential investors. Shortly after contact from the Australian Taxation Office (ATO) regarding outstanding tax liabilities in May 2006, Mr Carroll met a business restructure specialist (Mr McLellan) who recommended the company go into voluntary administration. On 10 May 2006 Mr Carroll appointed Mr McLellan as voluntary administrator. On 6 June 2006 creditors resolved that the company be wound up and appointed Mr McLellan as liquidator who pursued the director for insolvent trading.

DECISION

The court (Goldberg J) held that Stake Man Pty Ltd was insolvent throughout the relevant period (31 December 2005 to 10 May 2006) when the debts were incurred. Although the director failed to

satisfy the statutory defences relied upon under s 588H, for reasons canvassed below, the director was the beneficiary of judicial discretion and was granted forgiveness for contravention of s 588G of the Act. Consequently, the director was relieved wholly from any liability to pay the liquidator any amount in respect of the loss and damage suffered by creditors.

Test for Insolvency

Under s 95A of the *Corporations Act*, a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they became due and payable. Goldberg J relied on the seminal authority in *Sandell v Porter* (1966) 115 CLR 666 at 670; [1966] HCA 28 and held (at [104]) that insolvency means:

> an inability to pay debts as they fall due out of the debtor's own money. But the debtor's own moneys are not limited to his cash resources immediately available. They extend to moneys which he can procure by realisation by sale or mortgage or pledge of his assets within a relatively short time – relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor. The conclusion of insolvency … ought not to be drawn simply from evidence of a temporary lack of liquidity.

The court endorsed (at [116]) the cashflow test as the basis to determine insolvency and the following analysis (at [106]) in *Re United Medical Protection Ltd (prov liq appt)* (2003) 47 ACSR 705; [2003] NSWSC 1031 where Austin J usefully collated the following points on the determination of insolvency which emerge from a review of the authorities:[3]

- Whether or not a company is insolvent … is a question of fact to be ascertained from a consideration of the company's financial position taken as a whole – and is a question to which commercial realities will be relevant;[4]
- It is useless to say that if its assets are realised there will be ample to pay 20 shillings in the pound: this is not the test. A company may be at the same time insolvent and wealthy;[5]
- The question is not whether the debtor would be able, if time were given to him, to pay his debts out of his assets, but whether he is presently able to do so with moneys actually available;[6]
- It is the debtor's inability, utilising such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency;[7]
- If, as a matter of substance, the company is not able to pay its debts as they become due, the circumstances that the relevant creditors may give the company some time before they actually seek to enforce their remedies, and the company may well be able to pay them out given that time, will not negative the application of the section [s 95A of the Act];[8]
- A contractual debt is taken as payable at the time stipulated for payment … unless there is evidence of an express or implied agreement … for an extension of time, or a course of conduct sufficient to give rise to an estoppel against the creditor, or an established practice in the industry …[9]

Having regard to the authorities and principles above, Goldberg J concluded (at [108]) that the company was insolvent as at 31 December 2005 and thereafter throughout the relevant period up to 10 May 2006. His Honour reached this conclusion by relying, inter alia, on the following factors (at [109]-[143]):

- director's admission of awareness of a cashflow shortage after 31 December 2005;

[3] Austin J, in turn, relied on a review of the authorities by Mandie J in *Australian Securties and Investment Commission v Plymin* (2003) 175, FLR 124; 46 ACSR 126; [2003] VSC 123.

[4] *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213; (2001) 39 ACSR 305 at 316-317.

[5] *Re Tweed Garages Ltd* [1962] Ch 404 at 410.

[6] *Bank of Australasia v Hall* (1907) 4 CLR 1514 at 1528.

[7] *Sandell v Porter* (1966) 115 CLR 666 at 670.

[8] *Standard Chartered Bank of Australia Ltd v Antico (Nos 1&2)* (1995) 38 NSWLR 290 at 331.

[9] *Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213; 39 ACSR 305 at 317.

- director's concession that, at least from January 2006, the company was not paying its debts as and when they became due and payable;
- there were no resources available to obtain or inject fresh capital into the company; and
- there was no evidence to show that stock could, or would, have been sold within the short period required to fund outstanding debt.

Under such circumstances, after taking into account the company's financial position as a whole and the commercial realities, his Honour held that the evidence failed to establish that the company's assets were readily realisable in a short space of time.

Where there reasonable grounds for suspecting insolvency or whether a reasonable person would have been aware of such grounds?

Turning attention to this threshold requirement under s 588G, his Honour found (at [145]) that factors which compelled an answer in the affirmative included the following:

- at the time of the appointment of the business advisor, the company suffered from "cash burn" which needed to be arrested;
- it was apparent to the director that the company had a major problem with its kiln-drying operation which was not capable of a quick-fix;
- the company was unable to pay its debts out of its cashflow and trade debts increased during the relevant period;
- the company's indebtedness to the ATO increased by the end of the relevant period.

SECTION 588H DEFENCES

The court rejected the director's defence, under s 588H(2), that he had reasonable grounds to expect solvency based on the inventory and value of the stock of timber held by the company and its ability to realise and sell that asset. After observing from the authorities[10] (at [170]) that "expectation" means a higher degree of certainty than mere hope or possibility, his Honour held (at [178]) that the extent of the outstanding and unpaid debts and the extent to which future debts would be incurred were such that it was unreasonable to expect that the company's stock could be sold within a sufficiently short timeframe to discharge the company's debts as and when they fell due.

His Honour also dismissed the "reasonable reliance" defence under s 588H(3) (at [185]) on the basis that the facts showed that Mr Bright, the business advisor, was not specifically given the role or task of providing the director with "adequate information about whether the company was solvent". According to his Honour (at [185]), Mr Bright was proving information as part of the general accountancy and advisory work. The absence of evidence to establish responsibility on the part of Mr Bright to provide the director with financial information for the express purposes of s 588H(3) was fatal to the discharge of this defence.

FORGIVENESS

Section 1318 reflects a broad legislative policy that the law should not inflict unnecessary liability for non-compliance with the Act if it is a result of honest error or inadvertence and where the court can avoid its effects without prejudice to third parties or to the public interest in compliance with the law.

Goldberg J, in reliance upon the test set out in *Hall v Poolman*, adopted the following criteria for determining honesty which centred on the ordinary meaning of the term (at [190]):

> the court should be concerned… whether the person has acted without deceit or conscious impropriety, without intent to gain improper benefit or advantage for himself, herself or for another, and without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been to carry out the duties and obligations of his or her office imposed by the *Corporations Act* or the general law.

His Honour was satisfied that Mr Carroll did not profit personally, nor did he disregard advice from Mr Bright in allowing the company to trade during the relevant period. The court placed

[10] *Tourprint International Pty Ltd v Bott* (1999) 32 ACSR 201 at 215; *Hall v Poolman* (2007) 215 FLR 243.

particular emphasis and considerable weight upon Mr Carroll's retainer of Mr Bright and the influential role he played in the circumstances of the case. Significantly, his Honour did not regard reliance on this ground for forgiveness as being in contradiction to the rejection of the reasonable reliance defence in s 588H(3) discussed above. The statutory wording and purpose of s 588H(3) and s 1317S was held (at [203]-[205]) to be sufficiently different to allow for this result.

COSTS

Ominously, despite the director's success in *Stake Man*, the court departed from the usual rule as to costs, that costs follow the event, and ordered the director liable for the liquidator's costs.[11] In reaching this conclusion, the court was heavily influenced by the fact that the liquidator succeeded in establishing all the integers of the claim under s 588G but was defeated by s 1317S of the Act which offers a ground of relief based purely on judicial discretion and, significantly, is not a defence.

IMPLICATIONS

The decision in *Stake Man* is significant for a variety of reasons. The exercise of the judicial discretion in granting forgiveness pursuant to ss 1317 or 1318 of the Act is a watershed decision on exculpation of director liability for insolvent trading. The court (at [199]) addressed the difficult question "to trade or not to trade" (with reference to the adapted words of Hamlet) and navigated a path which afforded the director a safe harbour from personal liability. *Stake Man*, together with the judicial approach adopted in *Hall v Poolman* which afforded a director partial relief from liability, raises broader issues on the need for, and relevance of, potential law reforms which have been foreshadowed by the Federal Government.

Law reform

In announcing a major review on the operation of Australia's insolvent trading law in January 2010 subsequent to the global financial crisis, the Minister for Financial Services, Superannuation and Corporate Law presented three options for law reform consideration which includes the prospect of the introduction of a safe harbour via a business judgment rule for insolvent trading.[12] The proposed business judgment rule would operate so that directors would be relieved of the duty not to trade whilst insolvent if the following elements are satisfied:[13]

(a) The financial accounts and records of the company presented a true and fair picture of the company's financial circumstances at the time that the rule was invoked;
(b) The director was informed by restructuring advice from an appropriately experienced and qualified professional with access to these accounts and records, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time;
(c) It was the director's business judgment that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring; and
(d) The restructuring was diligently pursued by the director.

Treasury envisages that the proposal would provide a high degree of protection for directors from the threat of personal liability for insolvent trading, while making bona fide attempts at company reorganisation outside of external administration.[14]

In light of recent judicial developments, it may be legitimate to query if law reform is warranted. It is arguable that the recent latitude shown by the courts which resembles the approach of a business

[11] *McLellan, in the matter of The Stake Man Pty Ltd v Carroll (No 2)* [2009] FCA 1540.

[12] The Treasury, n 1. The other two options are maintaining the status quo or the introduction of a moratorium during which a company is permitted to trade while insolvent for a limited period.

[13] The Treasury, n 1 at [5.3.6]. For discussion on the origins of the business judgment rule and its operation at common law, see Redmond P, "Safe Harbours or Sleepy Hollows: Does Australia Need a Statutory Business Judgement Rule?" in Ramsay I (ed), *Corporate Governance and the Duties of Company Directors* (Melbourne University Centre for Corporate Law and Securities Regulation, 1997).

[14] The Treasury, n 1 at [5.3.7].

judgment rule, as exemplified by the judicial approaches in *Hall v Poolman* and in *Stake Man*, makes law reform superfluous. Palmer J's approach to the question of judicial relief from the director's personal liability in *Hall v Poolman* is akin to applying the business judgment rule, as illustrated in the following passage (at [329]):

> There are often pressing interests involved in the decision; the jobs of employees will be lost, the investment of shareholders will evaporate, and a promising venture in which a great deal of personal effort may have been expended will end in failure. On the other hand, the livelihood of creditors whose businesses depend on reasonably prompt payment may also be ruined if a company continues to trade while insolvent.

A counterpoint to the retention of the status quo, however, is that the forgiveness provisions of the Act (ss 1317S and 1318) lack effective guidance to directors as to the criteria they must meet if a court is to excuse them from personal liability. Currently, directors are dependent on broad-brush obligations developed by the courts on a case by case basis. Furthermore, these forgiveness provisions operate on the basis of judicial discretion and cannot be characterised as a defence – as emphasised by Goldberg J in *McLellan in the matter of The Stake Man Pty Ltd v Carroll (No 2)* [2009] FCA 1540 at [12]. Such considerations, together with the stringent nature of the statutory defences under s 588H,[15] arguably swings the pendulum back in favour of a statutory business judgment rule for insolvent trading notwithstanding the dearth of case law and unresolved issues[16] on the operation of s 180(2) in the context of the directors duty of care.

The proposed business judgment rule, as currently framed, are not however free from defects or challenges[17] – eg, the absence of any reference to ensure that the "appropriately experienced and qualified professional" is genuinely independent of the company raises the potential for abuse of this statutory defence. The task ahead is to fashion a well defined statutory regime which balances risks and incentives and offers greater clarity as to the pre-conditions for a director's safe harbour from personal liability.

Statutory defences

The judicial approach adopted to the application of the statutory defences under s 588H(2) and s 588H(3) in *Stake Man* are also instructive for directors. In considering whether the director had reasonable expectations of solvency, as required under s 588H(2), the court relied on the influential judgment of Palmer J in *Hall v Poolman* for guidance on the steps required to discharge the defence and, in particular, on the following passage which is likely to evolve into benchmark criteria for this area of the law:[18]

> There comes a point where the reasonable director must inform himself or herself as fully as possible of all relevant facts and then ask himself or herself and the other directors: "How sure are we that this asset can be turned into cash to pay all our debts, present and to be incurred, within three months? Is that outcome certain, probable, more likely than not, possible, possible with a bit of luck, possible with a lot of luck, remote, or is there is no real way of knowing?" If the honest and reasonable answer is "certain" or "probable", the director can have a reasonable expectation of solvency. If the honest and reasonable answer is anywhere from "possible" to "no way of knowing", the director can have no reasonable expectation of solvency.

Stake Man also affirms the need for a director to take positive steps to satisfy the key elements in the wording of "reasonable reliance" defence under s 588H(3) – in particular, the need to show that "the other person" was "responsible" and was fulfilling that responsibility for providing the director with adequate information on corporate solvency. Consistent with the judicial approach adopted in

[15] For a fuller discussion on the operation of the statutory defences to insolvent trading, see Harris J, Hargovan A and Adams M, *Australian Corporate Law* (2nd ed, LexisNexis Butterworths, 2009) Ch 19.

[16] For identification of such legal issues, see judgment of Austin J in *Australian Securities and Investments Commission v Rich* (2009) 236 FLR 1; [2009] NSWSC 1229.

[17] See submission of Hodgson F (2 March 2010) to Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (Discussion Paper, January 2010).

[18] *Hall v Poolman* (2007) 65 ACSR 123 [at 269].

Manpac Industries Pty Ltd v Ceccattini (2002) 20 ACLC 1304 and *Williams v Scholz*,[19] the decision in *Stake Man* underscores the need for direct and positive evidence to establish this defence. All of these decisions demonstrate that it is inadequate, for purposes of this defence, for directors to simply latch onto a person who has an incidental or peripheral role to play in the supply of financial information to the director. The central role and specific responsibility this defence confers onto "the other person" for the supply of financial information was recognised by Young CJ:[20]

> It is extremely difficult for a person to say that a person is responsible for providing adequate information about solvency and was fulfilling that responsibility when the person allegedly relying on the other person was the source of the supply of information and that supply of information was not completely full … The prime trust of the [defence] is not to deal with the situation where a small company with directors … bring in a trouble shooter, supply the trouble shooter with information … receive reports back from the trouble shooter and then intend to rely on a report which is incomplete because they have provided incomplete information.

In adopting this stringent approach to the application of s 588H(3), the decision in *Stake Man* further illustrates the need for directors to specifically engage "the other person" with the role or task of providing the director with adequate information about whether the company is solvent.

CONCLUSION

In light of recent judicial developments, it is a moot point as to whether insolvent trading law reform is essential to provide directors a safe harbour from personal liability. Compelling arguments can be made for and against the introduction of a statutory business judgement rule.[21] What is free from doubt, however, is the clear message signalled from the decision in *Stake Man*.

The case echoes the warning from *Hall v Poolman* that a director of a company in financial difficulty cannot afford to procrastinate or to avoid confronting realities when confronted with a choice. *Stake Man* underscores the need for directors to be diligent and to understand their company's business, to pay attention to the company's financial affairs and, crucially, to be pro-active in seeking and acting on professional advice at the earliest sign of financial distress to maximise the opportunity for judicial forgiveness for insolvent trading.

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[19] [2007] QSC 266; affirmed [2008] QCA 94. For commentary, see Hargovan A, "Relevance of Directors' Unsecured Loans, Guarantees and Honesty in Determining Liability for Insolvent Trading" (2009) 17 Insolv LJ 36.

[20] *Manpac Industries Pty Ltd v Ceccattini* (2002) 20 ACLC 1304; [2002] NSWSC 330.

[21] See further, Hargovan A, *Australia's Insolvent Trading Laws: Policy, Analysis and Law Reform* (INSOL International Academics' Group Meeting Dublin, 2010) (forthcoming).