

Division 3 — Director's duty to prevent insolvent trading [ss 588G-588H]

[5.588G] Director's duty to prevent insolvent trading by company — Annotations to section 588G

Key principles

Elements of the section

This section imposes a statutory duty to prevent insolvent trading on a company's directors. The elements of this section are that: (1) a person was a director at the time the company incurred a debt; (2) the company was insolvent at the time the debt was incurred, or became insolvent by incurring the debt; (3) at the time the debt was incurred, there were reasonable grounds to suspect that the company was insolvent or may become insolvent by incurring the debt; (4) the debt was incurred after 23 June 1993, when Pt 5.7B commenced; and (5) the director was aware that there were reasonable grounds to suspect insolvency, or a reasonable person would have been aware of that matter. In *Woodgate v Davis* (2002) 55 NSWLR 222; 42 ACSR 286; [2002] NSWSC 616; BC200203846, Barrett J observed at [36] that:

Section 588G and related provisions serve an important social purpose. They are intended to engender in directors of companies experiencing financial stress a proper sense of attentiveness and responsible conduct directed towards the avoidance of any increase in the company's debt burden. The provisions are based on a concern for the welfare of creditors exposed to the operation of the principle of limited liability at a time when the prospect of that principle resulting in loss to creditors has become real.

Contingent and other liabilities

A debt can be incurred by undertaking a contingent liability prior to the liquidation, which later becomes one to pay a debt of an ascertained amount: *Hawkins v Bank of China* (1992) 26 NSWLR 562; 7 ACSR 349; 10 ACLC 588; *Commissioner of Taxation (WA) v Pollock* (1993) 11 WAR 64; 12 ACSR 217; 12 ACLC 28; 93 ATC 5220; *Shepherd v Australia & New Zealand Banking Corporation Ltd* (1996) 41 NSWLR 431; (1997) 15 ACLC 1802. Conduct giving rise to a quantum meruit claim may also give rise to liability under s 588G: *Edwards v ASIC* (2009) 264 ALR 723; 76 ACSR 369; [2009] NSWCA 424; BC200911613. A liability to pay unascertained damages is not a debt for the purposes of this section: *Commissioner for Corporate Affairs v Abbott* (1980) CLC 40-667; *Jelin Pty Ltd v Johnson* (1987) 5 ACLC 463.

Incurring obligation to pay tax

Earlier authorities suggested that an obligation to pay payroll tax or income tax was not "incurred" by the taxpayer: *Castrisios v McManus* (1990) 4 ACSR 1; 9 ACLC 287; [1990] Tas R (NC) N13; BC9000004. However, the balance of recent authorities indicate that taxes and employees' entitlements are debts incurred by the taxpayer for the purposes of this section: *Commissioner of Taxation (WA) v Pollock*, above; *Powell v Fryer* (2001) 159 FLR 433; 37 ACSR 589; [2001] SASC 59; BC200100756; *Australian Securities and Investments Commission v Plymin (No 1)* (2003) 175 FLR 124; 46 ACSR 126;

Easy navigation

Paragraph numbers for Corporations Act annotations follow an easy formula - the number of the chapter followed by the section number, to make browsing easier.

Paragraph numbers for annotations to the Australian Securities and Investments Commission Act follow a similar formula - ASICA, followed by the section number. Paragraph numbers for annotations to the Harmonised Corporations Rules follow the formula CR, followed by the rule number.

Structured annotations

The annotation begins by setting out key principles, explaining the elements of the section and referring to key relevant cases. Quotes from judgments are included where relevant, with a pinpoint paragraph reference.

Comprehensive and specific citations

Parallel citations are given for each case, to authorised reports, other reported judgments and medium neutral citations.

Concise annotation style

Annotations provide concise statements of law, supported by authority.
The law as it is.

[2003] VSC 123; BC200302080, aff'd *Elliott v ASIC* (2004) 10 VR 369; 48 ACSR 621; [2004] VSCA 54; BC200401688; *Shephard v Australia & New Zealand Banking Corporation Ltd*, above.

Time at which a debt is incurred

When the relevant debt was incurred for the purposes of this section depends on the nature of the transaction in question: see *Russell Halpern Nominees Pty Ltd v Martin* [1987] WAR 150; (1986) 10 ACLR 539; 4 ACLC 393 (a company incurs a debt when it enters into a lease agreement and not when periodic rental payments are due under the lease); *Hussein v Good* (1990) 1 ACSR 710; 8 ACLC 390 (goods delivered on a cash on delivery basis); *John Graham Reprographics Pty Ltd v Steffens* (1987) 12 ACLR 779; 5 ACLC 904 (debts due from time to time on a trading account); *Versteeg & Versteeg v R* (1988) 36 A Crim R 68; BC8800971 (work is done or services rendered under a contract under which payment is made by the application of a rate or price to the amount of work done or services performed); *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 at 119; 9 ACLC 946; BC9100656; *Standard Chartered Bank of Australia Ltd v Antico (Nos 1 and 2)* (1995) 38 NSWLR 290; 131 ALR 1; 18 ACSR 1 at 57; BC9505204 (bill of exchange); *Australian Securities and Investments Commission v Plymin (No 1)*, above at [516], aff'd *Elliott v ASIC*, above (sale of goods). Section 588G(1A) specifies when a debt is incurred in relation to various dealings with a company's shares and in relation to the entry into an uncommercial transaction.

Whether a company is insolvent

The test for solvency is set out in s 95A, which provides that a person (including a company) is solvent if, and only if, that person is able to pay all the person's debts as and when they become due and payable. This section adopts a cash flow test of insolvency rather than a balance sheet test: *Dunn v Shapowloff* [1978] 2 NSWLR 235; (1978) 3 ACLR 775; (1977-78) CLC 40-451; *Melbase Corporation Pty Ltd v Segenhoe Ltd* (1995) 17 ACSR 187 at 198; 13 ACLC 823; BC9507719; *Leslie v Howship Holdings Pty Ltd* (1997) 15 ACLC 459; BC9700572; *Keith Smith East West Transport Pty Ltd v Australian Taxation Office* (2002) 42 ACSR 501; [2002] NSWCA 264; BC200204577 at [33]. Unless the company is unable to raise additional cash resources from the use of its assets, a temporary lack of liquidity will not necessarily give rise to an inference that the company is unable to meet its debts as and when they fall due: *Expo International Pty Ltd (rec apptd) (in liq) v Chant* (1979) CLC 40-513. Whether a company is able to pay its debts as and when they fall due is to be determined on an objective test, and is a question of fact to be ascertained from consideration of the company's financial position taken as a whole: *White Constructions (ACT) Pty Ltd (in liq) v White* (2004) 49 ACSR 220; [2004] NSWSC 71; BC200400572 at [289]. For a listing of matters suggesting insolvency, see *Lewis v Doran* (2004) 28 ALR 335; 50 ACSR 175; [2004] NSWSC 608; BC200404328, followed in *Austin Australia Pty Ltd v de Martin & Gasparini Pty Ltd* [2007] NSWSC 1238; BC200709417.

What resources may be taken into account in determining solvency

The court may have regard to whether the company's assets are realisable by sale or borrowing upon security and when such realisations are achievable: *Sandell v Porter* (1966) 115 CLR 666; 40 ALJR 71; BC6600670; *Australian Securities and Investments Commission v Plymin (No 1)*, above, aff'd *Elliott v ASIC*, above; *Emanuel Management Pty Ltd v Foster's Brewing Group Ltd* (2003) 178 FLR 1; [2003] QSC 205; BC200303844; *Iso Lilodw' Aliphumeleli Pty Ltd (in liq) v Commissioner of Taxation* (2002) 42 ACSR 561; 50 ATR 391; [2002] NSWSC 644; BC200204305; *White Constructions (ACT) Pty Ltd (in liq) v White*, above at [289]. The court may take account of undertakings to provide financial support given by third parties such as a promise to provide financial assistance by way of a loan to the company, a subscription for shares or the provision of a guarantee, whether or not that undertaking is legally binding: *Dunn v Shapowloff* [1978] 2 NSWLR 235; (1978) 3 ACLR 775; (1977-78) CLC 40-451; *Deputy Commissioner for Corporate Affairs v Caratti* (1980) 5 ACLR 119; (1980) CLC 40-660; *3M Australia Pty Ltd v Kemish* (1986) 10 ACLR 371 at 378; 4 ACLC 185; BC8601172. The company's ability to borrow funds can be taken into account: *Lewis (as liquidator of Doran Constructions Pty Ltd) v Doran* (2005) 219 ALR 555; 54 ACSR 410; [2005] NSWCA 243; BC200506071 at [109]–[112]; *Australian Securities and Investments Commission v Plymin (No 1)*, above, aff'd *Elliott v ASIC*, above; *Australian Securities and Investments Commission v Edwards*, above.

Relevance of creditors' terms of payment

In assessing solvency, the court acts upon the basis that a contract debt is payable at the time stipulated for payment in the contract unless there is evidence proving that there has been an agreed extension of time, conduct giving rise to an estoppel or a well-established and recognised course of conduct by which debts are payable at a time other than that stipulated in the creditors' terms of trade or are payable only on demand: *Pioneer Concrete (Vic) Pty Ltd v Stule (No 2)* (1996) 20 ACSR 480; 14 ACLC 534; BC9600590; *White Constructions (ACT) Pty Ltd (in liq) v White*, above at [289].

Whether the director had reasonable grounds for suspecting insolvency

A director contravenes s 588G by failing to prevent a company from incurring a debt, in the circumstances specified by s 588G(1), if the director is aware at the relevant time that there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent by incurring the relevant debt or debts, or a reasonable person in a like position in a company in the company's circumstances would be aware of that matter: s 588G(2). To "suspect" that a fact exists, one must have "an actual apprehension or fear" that the fact may exist, and not merely reason to question whether it might exist: *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303; [1966] ALR 855; BC6600470. That test may be satisfied either by proof that a director had a subjective awareness of grounds which constitute reasonable grounds for suspecting insolvency, or that a reasonable person in the position of the director who exercised reasonable competence and diligence would have been aware of such grounds: *Powell v Fryer* (2001) 159 FLR 433; 37 ACSR 589; [2001] SASC 59; BC200100756; *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115; 9 ACLC 946; BC9100656; *Standard Chartered Bank of Australia Ltd v Antico* (1995) 38 NSWLR 290; 131 ALR 1; 18 ACSR 1; BC9505204; *Kenna & Brown Pty Ltd v Kenna* (1999) 32 ACSR 430; 17 ACLC 1183; [1999] NSWSC 553; BC9902884; *Credit Corp Australia Pty Ltd v Atkins* (1999) 30 ACSR 727 at 741; 17 ACLC 756; [1999] FCA 335; BC9901295; *Australian Securities and Investments Commission v Plymin (No 1)*, above, aff'd *Elliott v ASIC*, above. A director may fail to prevent the company from incurring a debt by inactivity or a failure

to attempt to prevent the company from trading or incurring the debt: *Australian Securities and Investments Commission v Plymin (No 1)*, above, aff'd *Elliott v ASIC*, above.

Directors' duties in an insolvency context

Directors need also be conscious of their statutory and general law duties where a company is insolvent or near insolvency: see [2D.180]–[2D.181]. The duty of a director to the company will require that the director considers the interests of the company's creditors, at least in a case where the company's insolvency is likely, and shareholders do not have the power to absolve the directors from breach of a duty to take into account the interests of creditors: *Walker v Wimborne* (1976) 137 CLR 1; 50 ALJR 446; 3 ACLR 529; (1975–76) CLC 40-251; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; 10 ACLR 395; 4 ACLC 215; *Jeffree v NCSC* [1990] WAR 183; (1989) 15 ACLR 217; 7 ACLC 556; BC8901148; *Spies v R* (2000) 201 CLR 603; 35 ACSR 500; [2000] HCA 43; BC200004313; *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1; 70 ACSR 1; [2008] WASC 239; BC200809242 (directors breached their duties by authorising a restructuring and extension of loan facilities to a corporate group during which additional security over key assets was taken by lenders, by failing to consider the interests of the individual companies; causing companies which did not have a pre-existing obligation to give security over their assets in the interest of other companies that were insolvent, nearly insolvent or of doubtful solvency; not having critical financial information for each company which entered into the transaction; not identifying which creditors of the companies which might be affected by the transaction; and authorising the giving of the securities without a sufficient restructuring plan (at [4466])).

For more information about this work, please see <http://www.lexisnexis.com.au/products/campaign/austin-black.aspx>

Consistent and comprehensive structure throughout the work

Each annotation follows a consistent structure, distilling this complex legislation into its key elements. Subscribers can easily locate the section of the annotation that is relevant to them, saving valuable research time.

Definitions and cross-references

The term “director” is defined in s 9 to include a shadow de facto director. The concepts of “solvency” and “insolvency” are defined in s 95A.

History and explanatory materials

Companies Act 1929 (UK) (s 275) imposed liability on directors who carried on a company's business with intent to defraud, implementing a recommendation of the Greene Committee (1926). The prohibition on fraudulent trading was adopted in Queensland in 1931 and subsequently by other Australian states. UCA s 303(3) provided for a criminal offence where it appeared, in the course of a winding up, that an officer of a company was party to a company incurring a debt without a reasonable expectation that the debt could be paid. The Jenkins Report (UK) 1962 recommended that directors and others who carried on a company's business in a reckless manner be made personally liable for the company's debts in a winding up (Report of the Company Law Committee, Cmd 1749, para 503). Civil liability for incurring a debt without a reasonable expectation of payment was introduced in New South Wales in 1964, but applied only if a director was convicted for the associated criminal offence: Companies Act 1961 (NSW) s 304(1A). That section was replaced by Companies Act 1961 (NSW) ss 374C–374D in 1971, which provided that any amount recovered against a director for incurring a debt without reasonable expectation of payment would be paid to the company. CC s 556 imposed liability on a company's directors and managers for debts incurred if there were reasonable grounds to expect that the company would not be able to pay all its debts when they became due and CL s 592 was in similar terms; see the summary of the predecessors to this section in the ALRC General Insolvency Inquiry (Harmer Report) which noted that these provisions did not allow creditors collectively a suitable remedy where a company

Comprehensive annotations

The annotation traces the history of the provision, noting any predecessors, significant amending legislation, and whether the provision was created or amended as part of a broader reform to the corporations law. References to relevant explanatory memoranda (with pinpoint references) and Australian Law Reform Commission and Corporations and Markets Advisory Committee reports are also provided.

had incurred debts without a reasonable prospect of payment ([278]–[279]). This section was introduced by the CLRA 1992 with effect from 23 June 1993, implementing recommendations of the ALRC General Insolvency Inquiry (Harmer Report) that the corporations legislation should impose a positive duty on directors to prevent insolvent trading; breach of that duty should give rise to civil liability to the company, but not criminal liability; an action for breach of those provisions should be brought by the liquidator or by an individual creditor with leave of the court; and certain defences should be available to directors: Harmer Report [283]; EM to the CLR Bill 1992 [1083]–[1089]. The duty to prevent insolvent trading under this section applies only to directors of a company, whereas CL s 592 also applied to persons who participated in the company's management.

Texts and literature

Ford [20.080], [20.090], [20.100], [20.120], [20.180]; *ACLPP* [3.2.0640]–[3.2.0645], [5.7B.0215], [5.7B.0500]–[5.7B.0550]; *Halsbury's* [120-15520] ff, [120-15545]; *Redmond* [7.140]; *McPherson's* [11.3059] ff; A Herzberg, "Insolvent Trading" (1991) 9 *C&SLJ* 285; R Mangioni, "Directors' personal liability: section 592 of the Corporations Law and related matters" (1991) *BCLB* [507]; I Trethowan, "Directors' Personal Liability to Creditors for Company Debts" (1992) 20 *ABLR* 41; R Langford, "The new statutory management rule: Should it apply to the duty to prevent insolvent trading?" *C&SLJ* 533; J Pascoe and H Anderson "Personal Recovery Actions by Insolvent Company Directors" (2002) 10 *Insolv LJ* 205; V Mitchell "The Water – What do we learn from it?" (2003) 16 *Aust Jnl of Corp Law* 65; P James, and P Siva "Insolvent Trading — An Empirical Study" (2004) 12 *Insolv LJ* 210; J Lipton, "The Insolvent Trading Provisions: What is an 'Active' Director Anyway?" (2005) 13 *Insolv LJ* 42; C Anderson and D Morrison, "Should Directors be Pursued for Insolvent Trading where a Company has entered into a Deed of Company Arrangement" (2005) 13 *Insolv LJ* 163; DG Goldman, "Directors Beware! Creditor Protection from Insolvent Trading" (2005) 23 *C&SLJ* 216; H Anderson, "Directors' liability for unpaid employee entitlements: Suggestions for reform based on their liabilities for unremitted taxes" (2008) 30 *Syd LR* 470; M Byrne "Directors to hide from a sea of liabilities in a new safe harbour" (2008) 22 *Aust Jnl of Corp Law* 255; G Magner, J Morvell & D Lym, "Insolvent trading — What should company directors do to avoid personal liability?" (2009) 9(9) *INSLB* 149. ASIC RG 217 *Duty to prevent insolvent trading: Guide for Directors* provides guidance to directors as to how to meet the obligation to prevent insolvent trading and notes that directors should keep themselves informed about the company's financial position and affairs; regularly assess the company's solvency and investigate financial difficulties immediately; obtain appropriate professional advice to help address the company's financial difficulties where necessary; and consider and act promptly on that advice.

Specific referencing to LN texts
Pinpoint cross-references to paragraph level in leading LexisNexis looseleaf texts, including *Ford's Principles of Corporations Law* and *Australian Corporation Law Principles and Practice*, are provided to assist with further research.

Specific referencing to relevant journals -
Cross-references are provided to relevant articles in scholarly journals, to assist with further research.

ASIC references - References to relevant ASIC regulatory documents (Class Orders, Regulatory Guides) and publications are provided, with a description of the scope of the document.

[5.588H] Defences to liability under s 588G — Annotations to section 588H

Key principles

Defence for reasonable grounds to expect solvency

This section allows a number of defences to proceedings against directors under s 588G. A defence is available where, at the time the debt was incurred, a person has reasonable grounds to expect and does expect that the company was solvent at that time

Easy navigation - The title of each annotation includes the name of the relevant section and the concept, allowing users to browse two different ways.