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Legal Alert

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Unreasonable director-related transactions – no more 'direct benefit' restriction

Key Summary

- Section 588FDA of the Corporations Act requires that the impugned transaction is made to a director, a close associate of a director or *a person on behalf of, or for the benefit of* one of those persons.
- Previously, this section was limited to where there had been a *direct* benefit received by a director or a close associate. However, the Court now only needs to be satisfied that there was a benefit associated with the transaction which legally or financially advantages the director or close associate in question.

Part of a liquidator's role when appointed to wind up a company is to recover assets for the benefit of the company and its creditors. To assist them, the *Corporations Act* provides liquidators with a range of potential recovery tools aimed at directors, certain classes of creditors and other third parties.

One such tool is contained in s588FDA of the *Act*, namely the ability to examine unreasonable director-related transactions. A liquidator can attack any such transaction if it has taken place during the period up to four (4) years prior to the commencement of the winding up. Further, as there is no requirement to prove insolvency, this is a very powerful weapon in the liquidator's arsenal.

For the transaction to be caught, the section requires that there be a payment, transfer or disposition of property of the company, or the issue of securities by the company, which was made to:

- a director of the company (including a shadow director);
- a close associate of a director of the company – this is defined as being a relative of the director, or their spouse; or
- a person on behalf of, or for the benefit of, a director or close associate of a director,

and which a reasonable person would not have undertaken having regard to the benefits and detriments to the parties to the transaction.

The Decision

In the recent decision of *Vasudevan & Ors v Becon Constructions (Australia) Pty Limited and Anor* [2014] VSCA the Court had cause to consider the application of the third category of recipient, and particularly the meaning of the words '*on behalf of, or for the benefit of*'.

The case before the Court involved a transaction by which a company (WCo) assumed a joint liability to pay a debt owed by another company (MCo) to its creditor (B), in return for which B covenanted not to sue the sole director and shareholder of WCo and MCo in respect of guarantees he had given for the debt. WCo was subsequently wound up.

It was clear that WCo had received no benefit from the transaction, and in fact that WCo's entry into the transaction involved a substantial detriment to it. Therefore, it was not a transaction which a reasonable person would have entered into.

At first instance, the Court found that while the director had received a benefit from the transaction WCo entered into, it was not an 'unreasonable director-related transaction'. In reaching this conclusion, the Court followed two earlier decisions which had determined that an indirect benefit arising from a payment or disposition in favour of the company is not sufficient to attract s588FDA. Those cases had both involved a benefit being received by a company of which the director/close associate was also a shareholder.

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That decision was overturned on appeal. The Court of Appeal was satisfied that there had been a direct benefit received by the director as a consequence of the transaction, namely the agreement relating to his obligations as guarantor.

The director asserted that he had only derived a contractual right as a consequence of the transaction, which was not enough to enliven the operation of s588FDA. He argued that this was not the 'right kind' of benefit, as the section required there to be at least some form of equitable interest in the disposed property in favour of the director being created, which had not occurred in this instance.

The Court of Appeal rejected this submission. In so doing, they reasoned that:

- the ordinary meaning of a requirement that something be 'for the benefit of' someone is that it be for the advantage, profit or good of that person; and
- this ordinary meaning accords with the object of s588FDA, namely to prevent directors stripping benefits out of companies for their own advantage, including where that benefit is channeled to another company in which they have a financial interest,

and concluded that:

> *"…the natural and ordinary meaning of 'for the benefit of' in s588FDA is calculated to catch a benefit which legally or financially advantages the director in question regardless of whether it is paid or directed to a close associate of the director.*

Impact of the decision

This decision widens the application of the section, allowing liquidators to attack transactions undertaken in which a director or their close associate has received any indirect benefit, including those involving an entity in which the director or close associate has a financial interest.

Given that s588FDA applies to transactions which took place at any time in the four years prior to the commencement of a winding up, liquidators now have a much wider pool of potential recoveries in any winding up, and directors should take care to consider the implications of transactions in respect of which they or their close associate receives a legal or financial benefit

Relief available

While not raised in the context of the appeal, any relief which can be given by the Court in the context of s588FDA is limited by the terms of s588FF(4), such that:

> *"…where a transaction is liable to avoidance solely because it is an unreasonable director-related transaction, the court is to make an order only for the purpose of recovering the difference between the value if any provided by the company and the value that it may be expected that a reasonable person in a company's circumstance would have provided having regard to the benefits and detriment to the company of entering into the transaction, the benefits and detriments to other parties to the transaction, and any other relevant matter.*

Thus, where a third party has changed its position in reliance on a transaction and it would be unjust for the Court to avoid the transaction *ab initio*, any relief which might be given by the Court could be significantly limited.

This article was written by Colin Brown, a partner in our insolvency and reconstruction team. We invite you to contact Colin, or Michael O'Neill, should you have any questions or require any further information about the matters discussed in this article.

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