



Insolvent Trading – Are Directors between a rock and a hard place?

Key Summary

When a company is struggling to pay its debts, the directors must face up to the issue of insolvent trading directly and with brutal honesty: they must not shirk from asking themselves the hard questions and from acting resolutely in accordance with the honest answers to those questions (Federal Court [2009] FCA 1415). In this article, we look at the Courts views as to some of the factors directors should consider when their company is in tricky financial waters.

Introduction

Whether a company is solvent or not is often not capable of being categorically determined without the benefit of hindsight. However, there are a number of readily identifiable markers that may indicate a company is insolvent, the most common being a cash-flow shortage.

The Corporations Act (Cth) 2001 (**Corporations Act**) imposes a positive obligation on directors to prevent the company from incurring a debt whilst there are reasonable grounds for suspecting that the company is insolvent, or would become insolvent, as a consequence of incurring the debt.

Translating that obligation into real world application is sometimes difficult, as directors constantly balance their obligations in respect of insolvent trading against other interests such as: their other duties as a director; the status of employees' jobs; maintaining the value of the shareholders' investment; and the loss of a venture into which much personal effort may have been invested.

Despite facing an unenviable decision of whether to wind-up a business, or to persevere in the face of financial difficulties, directors cannot afford to delay or avoid making that decision.

In its decision in the matter of *The Stake Man Pty Limited v Carroll* [2009] FCA 1415, the Court, for the first time, excused a company director from the personal liability to which he would otherwise have been subject as a consequence of his failure to comply with the obligation to prevent the company from trading whilst insolvent. In so doing, the Court has provided an indication

of some of the factors that should be at the fore-front of directors' minds when deciding whether to commit a company to continue trading in the face of financial difficulties.

The Claim

The appointed liquidator alleged the company (The Stake Man Pty Limited) had been trading whilst insolvent prior to his appointment, during which time the company incurred debts that remained outstanding upon the commencement of the winding up of the company. The liquidator sought payment from the director (Carroll) for those amounts.

The Defence

In response to the liquidator's claims, the director asserted a number of factors as being relevant in the circumstances, including:

- at all times he relied upon an industry-specialist accountant / business advisor (**Advisor**), who had been retained by the company to provide him with adequate information regarding the company's solvency and, on the basis of the information received, he expected the company would remain solvent even if it incurred debts (**Reliance Defence**); and
- the director acted honestly at all times and, having regard to all of the circumstances, ought fairly be excused from personal liability for repayment of the debts incurred by the company on account of the company trading whilst it was insolvent (**Honesty Defence**).

The Judgment

In considering each of the Reliance Defence and the Honesty Defence, the Court:

- acknowledged the Advisor was competent and reliable, and had been retained to provide the company's director with business advice including: financial analysis; cash flows; and the preparation of financial statements;
- was not satisfied that, in light of the scope of the Advisor's retainer and the work carried out by the Advisor for the company, the Advisor had been specifically given the task of providing the director with information about whether or not the company was solvent and therefore the Reliance Defence was not established as required under the terms of the Corporations Act;
- in contrast, accepted the director's assertion (which was uncontested by the liquidator) that the director had acted honestly in respect of his role as a director of the company for the whole of the relevant period examined by the Court; and
- carefully considered all of the circumstances associated with the operation of the company and the director's actions, with particular emphasis upon the retainer of the Advisor by the company.

The Court concluded that, whilst the director had permitted the company to incur debts in circumstances which gave rise to a contravention of the insolvent trading provisions of the Corporations Act, the Honesty Defence had been successfully established. Therefore, it was appropriate for the director to be relieved from any personal liability to compensate the company for an amount equal to the debts which remained outstanding at the commencement of the winding-up of the company.

Conclusion

It is important to recognise the Honesty Defence is not a true defence to a claim arising from an allegation of insolvent trading. Instead it is an indulgence of the Court that may be sought by a director.

Directors should therefore ensure that they continually take adequate steps to keep themselves appropriately informed of the financial position and affairs of the company so that should the financial affairs of the company appear unfavourable, the directors may determine whether the company is suffering from a

temporary illiquidity, or if a more endemic problem exists.

When directors must determine whether or not a company should press on in the face of financial uncertainty, they must ensure that they assess, with a 'brutal honesty', the current and continuing financial circumstances which are present. The Court's decision also highlights the importance of the following:

- whether or not professional advisors have been retained by the company and, if so, what is the scope of services they have been retained to perform,
 - an understanding of both the scope of work to be carried out by the company's professional advisors, and the actual information and advice given by those advisors;
- the regard had by the company to information and advice received from the company's professional advisors, including the steps taken to implement any recommended changes and to address any trading concerns; and
- any benefit or profit that may flow to the director as a consequence of taking a decision for the company to trade on in the face of financial difficulties.

This article was prepared 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.

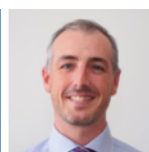
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