
CREDIT ISSUES

WOODGATE & CO.

Chartered Accountant

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BREACH OF DIRECTORS' DUTIES

Admissibility of transcripts of public examinations

In *Fodare Pty Limited v Shearn & Hirtzell* [2010] NSW 737 the Plaintiff company was in liquidation. The Plaintiff alleged that the First Defendant breached duties owed by her as a director of the Plaintiff by causing certain monies to be paid to her and for the benefit of the Second Defendant. The Plaintiff alleged that the Second Defendant was complicit in the First Defendant's breach of duty.

The First and Second Defendants were former directors of the Plaintiff. The Liquidator of the Plaintiff had conducted public examinations of the First and Second Defendants. During those public examinations the Defendants had made certain admissions regarding the receipt of monies which the Plaintiff subsequently sought to recover. The Defendants had signed the transcripts of the public examinations. The transcripts of the public examinations, along with documents obtained pursuant to Notices to Produce, substantially formed the Plaintiff's case against the Defendants.

The Defendants objected to the admissibility of the transcripts. They argued that the transcripts represented previous representations of the

examinees. The Defendants argued that, having regard to the hearsay rule in Section 59 of the *Evidence Act (NSW)*, the transcripts could not be used to prove the existence of any fact which it could reasonably be supposed the examinees intended to be asserted by their previous statements. Therefore, the Defendants contended that the Plaintiff had to prove that an exemption to the hearsay rule applied. The Defendants accepted that the business records exemption to the hearsay rule applied to the transcripts pursuant to Section 69(1) and (2) of the *Evidence Act*. However, the Defendants argued that the evidence recorded in the transcripts was prepared or obtained for the purpose of conducting an Australian proceeding. Therefore, the transcripts were inadmissible pursuant to Section 69(3) of the *Evidence Act*.

The Plaintiff submitted that pursuant to Section 597(14) of the *Corporations Act (Cth)* the written record of any transcript of a public examination signed by the examinee or which is authenticated by the Court Rules, may be used in evidence in any legal proceedings against the examinee.

Justice Barrett, of the Supreme Court of New South Wales, considered whether a public examination

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conducted in accordance with Part 5.9 of the *Corporations Act* was a proceeding of an Australian Court.

His Honour noted the judicial authority that a public examination conducted pursuant to the *Bankruptcy Act* was an inquisitorial process and not a legal proceeding. His Honour also noted the judgment of the majority in *Thomas v the State of New South Wales* which determined that a transcript obtained pursuant to a Royal Commission was inadmissible as evidence, pursuant to Section 69(3) of the *Evidence Act*.

Justice Barrett held that the provisions of the Commonwealth Law in respect of representations made in a particular examination context and in accordance with the particular examination recording procedure prevailed over any denial of admissibility, by reason of the general provisions with respect to hearsay contained in the New South Wales *Evidence Act*.

His Honour held that the effect of Section 597(14) of the *Corporations Act* was that notwithstanding the hearsay rule in the *Evidence Act*, the signed record of the First Defendant's examination transcript was admissible against her only and not the Second Defendant and that the signed record of the Second Defendant's examination transcript was only admissible against her and not against the First Defendant. The signed record of a third examinee, who was not a defendant to the proceedings, was not admissible against either the First Defendant or the Second Defendant.

Insolvency practitioners frequently conduct public examinations prior to the commencement of legal proceedings. This case provides important guidance as to the admissibility of the transcripts obtained during those public

examinations.

Breach of directors' duties

The facts in the case of *Fodare Pty Limited v Shearn & Hirtzell* [2011] NSW 479 were as follows:

- the Plaintiff was the Trustee of a Trust known as the Alexandria Trust;
- the Plaintiff, as Trustee, purchased a property at Menangle Park, NSW ("Menangle Park property") in March 1989 for \$195,000;
- the Menangle Park property was sold to independent purchasers in December 2003 for \$1.2M;
- on settlement the monies receivable by the Plaintiff amounted to \$1.082M;
- of those monies, \$634,958 was applied by the First Defendant, then the sole director of the Plaintiff, in ways which involved breach by her of her duties as a director; and,
- the claim against the Second Defendant was of knowing receipt and knowing assistance regarding part of the monies misapplied by the First Defendant.

The balance of the settlement monies amounting to \$423,862 was paid to a third party mortgagee. No claim was made against the First Defendant or the Second Defendant in respect of those monies.

The Second Defendant and her husband had previously borrowed money from Citibank Pty Limited ("Citibank") which was secured by a mortgage over property owned by her and occupied by herself and her family. From the settlement proceeds, the sum

of \$251,489 was paid to Citibank. Those monies were used to pay out the mortgage debt owed to Citibank.

On settlement, the sum of \$383,469 was received by the First Defendant by way of bank cheque in favour of "The Alexandria Trust". The cheque was deposited to the credit of a bank account described as "Doris Shearn – The Alexandria Trust". In the transcript of the public examinations, the First Defendant admitted receiving the cheque, banking the cheque and then closing the bank account, in order to pay debts that were allegedly owing to her.

At the time of the sale of the Menangle Park property, the Plaintiff owed its solicitor a substantial debt. The debt arose from legal proceedings commenced by the Official Trustee against the Plaintiff, the First Defendant, the Second Defendant and others, following the First Defendant's bankruptcy. The solicitor did not act for the Plaintiff on the sale of the Menangle Park property. In October 2006 the solicitor obtained judgment against the Plaintiff in the District Court of New South Wales in the sum of \$194,364. The Plaintiff was subsequently wound up following its failure to comply with a statutory demand.

Justice Barrett held that the First Defendant, as the then sole director of the Plaintiff, was duty bound to safeguard the Plaintiff's funds. His Honour stated that due and proper discharge of the director's duties in this respect did not allow for the payment of funds to herself or members of her family by way of gift for the personal benefit of the director or her family. His Honour noted that a cardinal rule binding upon a director is that the director's personal interest must always be subordinated to that of the company

and the director must account to the company for any profit or gain obtained or received by reason of the fiduciary position.

Justice Barrett noted that a company was required to maintain financial records pursuant to Section 286 of the *Corporations Act*. In this case, where there was only one director, His Honour stated that the need to ensure that adequate records of receipts and payments were kept should be regarded as a duty of a fiduciary kind, akin to that which a Trustee was subject. This was to ensure that there was available to the Plaintiff a means of being aware of what was its property and how it had been applied. His Honour determined that on the evidence, the First Defendant had contravened that duty.

His Honour held that based on the evidence, the Plaintiff owned the Menangle Park property and was entitled to the proceeds of its sale. The First Defendant was obliged to ensure that the proceeds were not applied for purposes and in ways that were inconsistent with the separate interests of the Plaintiff or, if the Plaintiff was a Trustee, with the Plaintiff's duty as Trustee to administer the Trust's property. The First Defendant was required to ensure the availability of means for the Plaintiff to determine how the proceeds were applied and whether the manner of application was proper.

In regard to the cheque for \$383,469, there was an absence of records and information about the manner of its disposition, except that it was deposited into a bank account maintained by the First Defendant and that she then withdrew the whole sum to pay debts that were allegedly owing to her. His Honour held that the First Defendant caused money of the Plaintiff to be applied in ways that could, on an

objective basis, be seen to be inconsistent with the Plaintiff's interests.

In regard to the cheque of \$251,489 paid to Citibank, the First Defendant denied during the public examinations that the Plaintiff had ever borrowed or guaranteed borrowings from Citibank. Therefore, his Honour concluded that the monies which were paid to Citibank did not discharge any direct indebtedness of the Plaintiff to Citibank. In the transcript of the public examinations, the Second Defendant confirmed that she had received approximately \$250,000 from the First Defendant. The Second Defendant stated that the payment was a loan to her by the First Defendant. Further, she confirmed that the monies were used to discharge a debt owed to Citibank. His Honour concluded from the evidence that the Second Defendant knew that the Plaintiff owned the Menangle Park property. His Honour also concluded that the Second Defendant knew that the Plaintiff's ownership of the Menangle Park property had been subject of the legal proceedings during the First Defendant's bankruptcy.

As a former director of the Plaintiff, the Second Defendant was aware that the First Defendant did not own the

Menangle Park property. Although the Second Defendant did not know the finer details, she must have been aware that the Plaintiff had an ownership interest. Accordingly, her receipt of the cheque of \$251,489 was a knowing receipt in respect of the First Defendant's misallocation of funds belonging to the Plaintiff. Therefore, the Second Defendant incurred liability under the first limb of *Barnes v Addy* for the First Defendant's breach of fiduciary duty in respect of that payment.

The First Defendant was Ordered to pay the Plaintiff the sum of \$634,956. The Second Defendant was Ordered to pay the Plaintiff the sum of \$251,489. The Second Defendant's property was charged by Order of the Court to secure repayment of the debt to the Plaintiff. The Defendants were also Ordered to pay interest to the Plaintiff from December 2003, plus costs.

The case demonstrates that a director's failure to maintain proper financial records may lead a Court to conclude that the purpose of the transaction itself was improper.

The Defendants have filed a Notice of Intention to Appeal.

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