
CREDIT ISSUES

WOODGATE & CO.

Chartered Accountant

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INSOLVENCY UPDATE

Director's double jeopardy

Directors of a company in financial difficulty are often described as being in a position of double jeopardy in relation to the Australian Taxation Office ("ATO").

If directors do not ensure that the company pays its tax debts then Part VI, Division 9 of the *Income Tax Assessment Act 1936 (Cth)*, the directors' penalty notice regime can impose personal liability on them.

If the directors cause the company to make payments which are later found by the Court to be unfair preferences, then Section 588FGA of the *Corporations Act* can impose a personal liability on them to reimburse the ATO. In *Gibbons & Anor v Deputy Commissioner Taxation* the Supreme Court of New South Wales was asked to adjudicate on such a situation.

The Liquidators of a company identified transactions totalling more than \$821,000 which they claimed were insolvent transactions pursuant to Section 588FC of the *Corporations Act*.

The ATO admitted receiving the payments but argued that the company

was not insolvent at the time the payments were made. Further, the ATO argued that the Liquidators should not be able to rely on statutory presumptions to prove insolvency. The ATO joined one of the directors to the action, so that if it was unsuccessful, it could seek an indemnification order under Section 588FGA against the director.

The director argued that the company was solvent when the payments were made and that he was entitled to various statutory defences, pursuant to Section 588FGB of the *Corporations Act* namely that he had reasonable grounds to believe that the company was in fact solvent, that he had reasonable grounds to rely on another person which led him to believe that the company was solvent and that there were no reasonable steps that he could have taken to prevent the company from making the payment.

The Court ruled that:

- a report prepared by the Liquidators as to the date of insolvency should be regarded as having proved the company's insolvency;
- criticisms that the Liquidator had erred by treating \$3.1 million of loans

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to related entities as irrecoverable, should be disregarded. The Court stated it was difficult to understand why the loans to related parties had not already been called up if the loans were in fact recoverable;

- the Liquidators' inability to locate a wide range of financial information led them to the conclusion that adequate books and records had not been maintained by the company and the Liquidators should be entitled to the benefit of the statutory presumption of insolvency, due to inadequate books and records;
- the director's assertion that he believed the company to be sound and thriving was implausible. The director had clear reason to be concerned about the financial position of the company;
- the director had not established that there were no reasonable steps that he could have taken;
- the director had a clear responsibility to put himself in a position to guide and monitor the management of matters relevant to solvency and once aware of the problem, it would have been reasonable to seek professional advice; and,
- the director failed to inform himself about the choices lawfully available to him, such as persuading his fellow directors that the company should not make the payments.

The Liquidator was successful in obtaining an order for the recovery of the insolvent transactions. The ATO was successful in obtaining an indemnification order. Accordingly, the director was personally liable.

Can Family Court proceedings

displace directors' duties?

In *McVeigh & Anor v Merlo* the Supreme Court of Victoria was asked to consider the impact of orders made by the Family Court of Australia ("Family Court") on the duties of directors.

The company in question was the trustee of a family trust which conducted a franchised haircare products business. The trust also operated a tobacco farm.

Anticipating prosecution for excise duty offences, one director transferred his shares to his sister and then resigned as a director. His wife then became the sole director of the company.

Some months later, the husband and wife separated. The wife continued to run the haircare business whilst the husband maintained the tobacco farm.

The wife began Family Court proceedings. The Family Court made consent orders which controlled the disposal of the stock of the haircare business, which had ceased trading, as well as setting out a detailed framework intended to maintain the value of the tobacco farm business.

Around five months later the wife determined that the company was insolvent. The company appointed Voluntary Administrators.

The Administrators attempts to perform their duties were met by resistance from the husband who argued that the appointment was a breach of the Family Court orders and an abuse of process. In due course the Administrators asked the Court to settle a number of contentious issues.

The Supreme Court of Victoria determined that:

- based on advice from her father's accountant, the sole director was genuinely concerned about the solvency of the company and the implications for her if she allowed it trade whilst insolvent;
- based on advice from the company's accountant, the director had believed that the company was a properly constituted sole director company and she had the power to appoint Administrators;
- based on advice from the sole director the Administrators had similarly believed that the company was a sole director company and that the director was able to resolve that the company appoint Administrators;
- the Administrators could not be expected to conduct a detailed due diligence as to whether their appointment was proper or not. Likewise, it was inappropriate for the sole director to defer acting in recognition of insolvency in order for articles of association to be produced; and,
- the sole director would have been foolhardy to the point of recklessness if she failed to address the insolvency of the company, in the mistaken belief that somehow the Family Court could indemnify her from the consequences of insolvency.

The Court concluded that the existence of Family Court orders should not disturb the general rule that directors should address insolvency as soon as practical.

The appointment of Administrators was ratified.

Are arbitration proceedings affected by the Voluntary Administration moratorium?

Section 440D of the *Corporations Act* imposes a moratorium on legal proceedings whilst a company is under administration. Proceedings in a Court cannot be commenced or proceeded with unless the Administrator gives written consent or a Court order is obtained.

In *Auburn Council v Austin Australia Pty Ltd (Administrators Appointed)* the Court had to consider whether arbitration proceedings commenced by agreement between the parties prior to the appointment of Administrators could be considered as proceedings in a Court and, if not, whether it should order security for costs.

The Supreme Court of New South Wales held that:

- the Court should not distinguish between Court ordered arbitration and arbitration commenced by agreement by the parties;
- it was not fantastic or absurd to exclude arbitration from the general definition of Court. Further, if the legislature wished the moratorium to extend to arbitration it would have done so in a direct manner;
- the Court had discretion to order security for costs in an arbitration; and,
- it could not be argued that continuation of the arbitration would distract the Administrators, as they had written to the arbitrator and

advised that they were of the view that arbitration should proceed and without delay.

for security for costs.

In the absence of any evidence that such an order would stifle the arbitration, the Court was prepared to make an order

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