
CREDIT ISSUES

WOODGATE & CO.

Chartered Accountants

SEPTEMBER 2015

RISKS TO DIRECTORS FROM INSOLVENT TRADING

Introduction

Section 588G of *the Corporations Act (Cth)* (“*the Act*”) provides that a director has a positive duty to prevent insolvent trading by a company. Failure to prevent insolvent trading may have civil and/or criminal consequences. Civil proceedings to recover claims for insolvent trading may be commenced by the Liquidator of a company or, in some circumstances, a creditor. The Australian Securities and Investments Commission may also commence proceedings.

A contravention of Section 588G comprises four elements:

- (a) the person is a director of the company; and,
- (b) the company is insolvent at the time; and,
- (c) there are reasonable grounds for suspecting that the company is insolvent or will become insolvent; and,
- (d) the director failed to prevent the company from incurring a debt or debts.

A solvent company is defined in Section 95A of *the Act* as being a

person who is able to pay all the person's debts, as and when they become due and payable. Solvency is determined by a cash flow test, in preference to a balance sheet test.

The recent case of *Smith v Boné* [2015] FCA 319 demonstrates that a director will not be easily excused from insolvent trading, especially if the director fails to seek professional advice when attempting to trade out of financial difficulties.

Background to the case

In December 2011 Petrolink Pty Limited (“Petrolink”) was wound up by Order of the Federal Court of Australia. The petitioning creditor was the Commissioner of Taxation (“ATO”). The Liquidator traded on the business and, with the consent of the Court, appointed himself as Voluntary Administrator. Mr Boné was the sole director of Petrolink and considered proposing a Deed of Company Arrangement. However, the proposal for the Deed of Company Arrangement did not eventuate and the voluntary administration ended. The Court liquidation then proceeded.

DISCLAIMER:

The material contained in this newsletter is merely general commentary and the comments and information do not represent a legal or professional service. Advice should be sought from Woodgate & Co. in relation to the circumstances of each matter before acting in this area.

The Administrator's report to creditors disclosed Petrolink's assets were approximately \$629,000. Its liabilities were \$1.8M, of which the principal creditor was the ATO.

In 2013 the Liquidator commenced legal proceedings against Mr Boné. The Liquidator argued that Petrolink became insolvent on 30 June 2009 and remained insolvent until the company was wound up. The Liquidator's claim against Mr Boné was \$844,491. Mr Boné provided expert evidence stating that the company became insolvent on 7 July 2011 and that the quantum of the claim was \$169,053.

The Court reviewed, in detail, the records of Petrolink as to when particular debts were incurred and when those debts became due and payable. This is typical of insolvent trading cases, which turn on the facts. Her Honour Justice Gleeson had particular regard to the 10 written payment arrangements between Petrolink and the ATO between July 2006 to April 2011. Her Honour noted that:

- Petrolink incurred trading losses in each of the financial years ended 30 June 2009, 2010 and 2011;
- Petrolink had a cash flow shortfall on its immediate obligations as at 30 June 2010 and 2011;
- Petrolink had deficiencies of current assets to meet current liabilities at as 30 June 2009, 2010 and 2011; and,
- Petrolink's indebtedness to the ATO increased from \$356,254 as at 30 June 2009 to \$696,987, when Petrolink was wound up.

Her Honour concluded that Petrolink was insolvent at all times from

12 May 2010.

Effect of payment arrangements

Her Honour considered six payment arrangements between Petrolink and the ATO between June 2009 and April 2011. The evidence was that Petrolink complied with none of the payment arrangements. Further, the ATO had also served director penalty notices on Mr Boné, a garnishee on Petrolink's bank account and a statutory demand on Petrolink in June 2011.

Her Honour determined that the payment arrangements made with the ATO after 30 June 2010 were of such short duration that they failed to materially improve Petrolink's solvency. Further, none of the payment arrangements had the effect that Petrolink was not required to pay its outstanding tax liabilities. The payment arrangements demonstrated that Petrolink was continuing to experience one of the features of insolvency, which is a failure to pay taxes.

The director argued that it could be inferred that the ATO was content with the manner in which Petrolink was discharging its taxation obligations. Her Honour dismissed the suggestion that the time for payment of Petrolink's tax liability had been deferred. Her Honour noted that there was a failure of strict compliance with Section 255-10(2) of Schedule 1 of the *Taxation Administration Act*.

Mr Boné made considerable efforts to pay Petrolink's creditors as best he could, with the resources available to Petrolink. However, the evidence showed that those efforts did not cause the ATO to defer Petrolink's payment obligations. As a consequence, those

efforts did not have a material effect on Petrolink's solvency.

Defences

Section 588H of *the Act* provides a number of defences to claims for insolvent trading, including:

- at the time when the debt was incurred, the person had reasonable grounds to expect that the company was solvent at that time; or,
- that the person took all reasonable steps to prevent the company from incurring the debt.

Relief for a contravention of Section 588G is also available under Section 1317S and 1318 of *the Act*.

Her Honour determined that Mr Boné had reasonable grounds to suspect that Petrolink was insolvent from 12 May 2010 because:

- Petrolink's tax debts were at all times due and payable;
- Petrolink was unable to pay its tax debts at all times;
- from at least the fourth written payment arrangement, the ATO required Petrolink to pay its tax debt, in full, in a very short space of time;
- Petrolink never had access to financial resources which could have given Mr Boné reason to believe that Petrolink could fully comply with the ATO's written payment arrangement after 12 May 2010;
- Petrolink was unable to pay its PAYG withholdings for March 2010 and April 2010, which resulted in the ATO's subsequent threats of legal action; and,

- from July 2009 Petrolink had a progressive inability to pay trade creditors in a timely manner.

Her Honour determined that the overall situation was one in which Petrolink was managing its relationship with its trade creditors, by non-compliance with its tax obligations.

Her Honour determined that whilst a director of reasonable competence and diligence would take some comfort from his or her ability to negotiate successive payment plans with the ATO, they would also recognise those plans did not affect the due and payable status of the tax debts. Further, in the circumstances, a director of ordinary competence would have had no real idea at all as to where the necessary money to pay those debts would be found. Accordingly, Her Honour found that Mr Boné had no reasonable expectation as to Petrolink's solvency.

Mr Boné's evidence regarding his efforts to reduce staff numbers and restructure the business were not accepted by Her Honour as evidence of steps taken to prevent the company from incurring debts.

Relief

Mr Boné also sought relief from the Court under Section 1317S of *the Act*.

Her Honour determined that Mr Boné had failed to respond to clear signs that Petrolink was insolvent. However, there was no suggestion that Mr Boné acted dishonestly. The Court had particular regard to a meeting held on 23 June 2010 between Mr Boné and his financial advisors, which discussed Petrolink's financial position and the possibility of

appointing a Voluntary Administrator or a Liquidator. Her Honour concluded that one or more of Mr Boné's advisors had previously advised that Petrolink had engaged in insolvent trading.

There was no evidence that Mr Boné sought advice as to the company's solvency or that Mr Boné received credible advice that the company was solvent after 12 May 2010. In those circumstances Mr Boné could not be said to have been permitting Petrolink to continue to trade on the basis of expert advice that the company was solvent. Further, after May 2010 Petrolink made four payment arrangements with the ATO, in circumstances where there was no clear plan as to how it would meet all the payments. Her Honour concluded that a reasonable, commercially experienced director would not have made such payment arrangements.

Her Honour determined that Mr Boné's conduct was unfair in the circumstances. His conduct strongly suggested an attitude that he was entitled to decide what was in the best interest for creditors and that he would be able to negotiate and renegotiate

payment plans with the ATO until Petrolink's tax debt was fully paid, even if that would take years. Accordingly, Her Honour held that Mr Boné ought not to be excused from his contraventions of Section 588G.

After taking into account certain counter claims, the court Ordered that Mr Boné was to pay Petrolink the sum of \$669,583.

The judgment of *Smith v Boné* is now the subject of an Appeal.

Other cases

A 2004 research report into insolvent trading prepared by Clayton Utz noted that between 1961 and early 2004 there were, on average, two judgments a year concerning insolvent trading in Australia. An analysis performed by Woodgate & Co. of the insolvent trading judgments a year between 2004 and mid-2015, revealed 32 reported judgments, which equates to an average of three cases a year. Therefore, despite Section 588G, enforcement of the prohibition on insolvent trading is the exception rather than the rule.

WOODGATE & CO.

Chartered Accountants

**Business Recovery Services
Official Liquidators & Trustee in Bankruptcy**

Level 8, 6 - 10 O'Connell Street, Sydney, NSW, 2000

GPO Box 882, Sydney, NSW, 2001

Telephone: (02) 9233 6088 Facsimile: (02) 9233 1616

www.woodgateco.com.au

Associated Offices: **Melbourne · Brisbane · Adelaide · Perth**