

concerns about the report. Directors can rely on others to assist them, but in case of financial accounts, a director has a responsibility to read and understand (no matter how lengthy or complex the documents are) and make sure the statements are correct.

The court found that each director in this case had failed to:

- To properly read, understand and give sufficient attention to the content of the financial statement.
- To make or raise inquiries about the efficiency of the report.
- To have these apparent failures corrected.

Decision: The directors have failed to exercise the request degree of care and diligence, and failed to take all reasonable steps to make sure the financial statements were correct.

Week 10: Related Party Transactions

Overview of the elements of duty to prevent insolvency

Part 5.7B Division 3 imposes a positive duty upon directors to ensure that their company does not trade while it is insolvent. Part 5.3A provides for an administrator to take over who is appointed by resolution if directors think the company is insolvent or likely to be insolvent. If they do not appoint an administrator then directors face personal liability.

The duty to prevent insolvent trading contains five distinct elements (s 588G):

1. The duty applies only to a person who was a director at the time the company incurred the debt.
2. The company must have been insolvent at that time (i.e. cant pay your debts), or became insolvent by incurring that debt, or would become insolvent (i.e. small business taking out a 1 billion dollar debt will likely lead it to be become insolvent).
3. The debt must have occurred after 1993 (unlikely it would be before).
4. At that time there were reasonable grounds for suspecting that the company was insolvent.
 - a. Reasonable grounds is determined by an objective test of suspicion, which is determined by more than a mere idle wandering, but a positive feeling of mistrust.
5. Director must be aware that there are grounds for suspecting insolvency at that time or a reasonable person would suspect.
 - a. The test is subjective regarding awareness. It must either be proved that the director has actual knowledge of facts concerning the financial position of the company, or that a reasonable person in a similar position would have. What would a reasonable person in the position of a director be expected to do:

- i. Should be able to read and understand financial information such as a balance sheet.
- ii. The board ensures skilled people are hired to carry out company's accounting functions.
- iii. The board should monitor the entering into of contracts with financiers or the signing of checks or bills.
- iv. Where the risk is high, the director should take extra care and precautions.

The director against whom the five elements are proven bears the burden of establishing a defence on the balance of probabilities.

What is the definition of a debt and insolvency?

The term 'debt' signifies an obligation sounding in the payment of a sum of money or moneys worth.

A company is deemed to be insolvent if it is not able to pay all its debts as and when they become due (s 95). To determine insolvency you look at the financial position as a whole. You look at commercial realities such as that creditors normally have some leniency with payment debts and may not necessarily want it exactly by the due date. This is determined by looking at express or implied conduct, such as a creditor letting a person constantly pay late.

Defences to liability for insolvent trading (s 588H)

*Reasonable grounds to **expect** insolvency*

Expectation of solvency requires an actual expectation that the company was and would continue to be solvent, and the grounds for expecting this are reasonable.

Reliance upon information as to solvency provided by another

The director under section 588H if he had reasonable grounds to believe when the debt incurred that:

- A competent and realisable person was responsible for providing the director with information; and
- The other person was fulfilling that responsibility; and
- The director expected, on the basis of information that the company was solvent and would remain solvent if it incurred that debt.

There are two limbs here. The first is that the director relates to the director have actual belief that compliance was occurring. The second limb is an expectation rather than a belief that solvency will continue on the grounds of information provided by the delegate.

Non-participation in management due to illness or other good reason

A further defence is at the time the debt occurred the director did not take part in the management of the company because of illness or other good reason.

Reasonable steps to prevent the incurring of the debt

A further defence is conceded if a director establishes that they took all the steps to prevent the company from incurring the debt, examples include:

- Appointing an administrator;
- When the action was taken; and
- The results of that action.

Liability of a holding company for insolvent trading by a subsidiary company

Under Part 5.7B Division 5 an action for compensation may be brought against a holding company where it allows a subsidiary company to trade while insolvent. There needs to be four elements satisfied (s 588V):

1. The company must be the holding company of a company at the time the subsidiary incurs the debt.
2. The subsidiary must be insolvent at that time or became insolvent by incurring that debt.
3. At the time the subsidiary company incurs the debt there must be reasonable grounds that they would be insolvent.
4. The fourth may be satisfied by one of two ways. Either the holding company or its directors are aware when the debt is incurred that insolvency would occur. Secondly, having regard to the holding companies control over the subsidiary affairs it is reasonable to expect the holding company is aware of insolvency.

There are also several defences (s 588X). The first is that each director who was aware that there were grounds for insolvency of the subsidiary had reasonable grounds to expect that the subsidiary was solvent and would remain solvent if it incurred that debt. Secondly, if there is a decent system for example of accounting in place you may rely on that defence. Thirdly, if the director of the holding company was ill or for another good reason was not there at the time the subsidiary incurred the debt will not be held liable. Fourthly, if a holding company took all reasonable steps to prevent insolvency of a subsidiary.

Hall v Poolman 2007 NSW (Liquidity)

Decision: Case revolved around liquidity. It is not appropriate to base an expectation of solvency upon the prospect that the company might trade profitable in the future. The critical question of solvency is: how soon will the proceeds be available if liquefied? The case gives a rough estimate of selling assets within 90 days. The question is how sure are we that this asset can be