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Introduction: [X] may be able to make [Directors] personally liable for [DEBTS] if it can be demonstrated that s/he engaged in insolvent trading contrary to s 588G, or alternatively [*HOLDING COMPANY*] for insolvent trading under s 588V if it can be shown that it is [*SUBSIDIARY*'S] *holding company*. Alternatively, in exceptional circumstances, the court may be willing to pierce the corporate veil as a matter of common law. Although no universal or settled principle has emerged from the case law, courts have produced a variety of grounds for lifting the veil.

1ST **EXCEPTION** TO *SALOMON*'S RULE: THROUGH **STATUTORY PROVISIONS**

The most powerful method to disregard Salomon's principle is through statute.

Preliminary matters to tick off: • We have a **company** that has a **claim** against it • The claim **cannot be paid in full** • Therefore, we have to look beyond the company for this liability → this entails **disregarding the *Salomon*'s principle**

DIRECTOR LIABILITY (S 588G)

Is there a director involved? Then look at s 588G, if holding company, see next part on s 588V

Introduction and the relevant law

S 588G prohibits a director from allowing the company to continue trading during a period in which it is insolvent, and the director should have suspected that the company was or was likely to be insolvent. The elements for the statutory offence are stated in *s 588G(1)*:

- a person is a **director** of a company at the time **when the company incurs a debt**; and
- the company is **insolvent at that time**, or **becomes insolvent by incurring that debt**, or **by incurring at that time debts including that debt**; and
- at that time, there are **reasonable grounds** for **suspecting** that the company is insolvent, or would so become insolvent, as the case may be → *this is linked to s 588G(2)(b) for civil liability*

S 588G(1)(a) - Was this person a director at the time the company incurred a debt?

As per ***s 9***, a *director* of a company or other body means:
(a) a person who:
  i. is appointed to the position of a director; or
  ii. is appointed to the position of an alternate director and is acting in that capacity;
regardless of the name that is given to their position; and
(b) unless the contrary intention appears, a person who is not validly appointed as a director if:
  i. they act in the position of a director; or
  ii. directors of company/body are accustomed to act in accordance with the person's (or company's) instructions or wishes.
Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or company or body.

S 588G(1)(a) - When is a debt incurred?

A debt is incurred when a company **enters into a contract** (*we are not concerned with tort claims*) by which it subjects itself to an unavoidable obligation to pay a sum of money at a future time, even if that obligation is conditional, i.e. a contingent debt (*Hawkins v Bank of China*). *S 588G (1A)* provides for a range of '*deemed debts*': declaration of dividend, reduction of share capital, engaging in share buy-back activity and other share capital transactions.

- Delays by creditors in enforcing repayment do not prevent the amount owed from being counted as a debt (*Southern Cross Interiors v DCT, NSWSC 2001*). This case was overturned on appeal, but this specific issue was not discussed in the appeal.
- Payment plans may be considered when assessing when is the debt due.

S 588G(1)(b) - When is a company insolvent?

The test for insolvency is provided by *s 95A* which states that a company is insolvent where is it unable to pay its debts as and when they become payable, it **is irrelevant** that it might be able to do so in the future, if given time to trade profitably (*Powell*). The court recognise the real question is whether the company is practically able to pay its debts, whether the funds it derived from cash reserves, assets sales or borrowed funds. **Consider** (*Powell*):

- Commercial reality of the company's financial reality;
- Not simply use a temporary lack of liquidity;
- A company is not insolvent merely because it does not have sufficient cash to pay its debts (*Rees v Bank of NSW*)
- Money by realisation by sale or borrowing against the security of its assets.
- Any indulgences extended to a company by its creditors as to trading terms – if no extension, then court will apply normal terms of trading
- **Non-enforcement of repayment by creditors**: irrelevant, the court will take it that the debt is payable at the time stipulated for payment in the contract, unless there is evidence to the court's satisfaction about an agreement (express/implied) regarding an extension; an estoppel (*Southern Cross v DCT*)

It is the inability to pay the debts, as they fall due, despite the above-mentioned resources, which indicates solvency.

A presumption in limited circumstances: When company failed to keep financial records for a period of 7 years as per *s 286*, the company is presumed to be insolvent throughout that period: *s 588E(4)*.

Were there reasonable grounds to suspect the company was insolvent or may become insolvent by incurring the debt?

Objective test: As per ***s 588G(2)***, the director, by failing to prevent incurring the debt, contravenes this section if (a) he or she was aware at that time there are such grounds for so suspecting → *this ties in to s 588G(3) for criminal liability and it is a **subjective test***; **or** (b) a reasonable person in a like position in the company's circumstances would be so aware. It is necessary to have regards to facts that the defendant director ought to have known as well as to facts that were actually known to him or her: *ASIC v Plymin*, affirmed in *ASIC v Elliot*.

- **Threshold for '*reasonable*':** imports the standard of reasonableness appropriate to a director of reasonable competence and diligence, seeking properly to perform his or her duties as imposed by the law and capable of reaching a reasonably informed opinion as to the company's financial capacity *(Smith v Bone)*.
- **'*Model reasonable person*':** would be one who would be able to understand, in general terms at least, what the company's accounts and the auditor's report show (*CBA v Friedrich*)
- **Not contingent on elements personal** to the defendant director [like his aptitude; experience or education are irrelevant] (*3M Australia v Kemish*), rather refers to facts external to the director and peculiar to the particular company (*MFS v Miller*).
- **Proper performance of directors' duties:** Depends on type of company, nature & size of its enterprise, provisions of its articles of association, the composition of its board & distribution of work between the board & other officers: *CBA v Friedrich*.
- "***Special skills***" v "***ordinary skills***": Possession of special expertise could attract liability but lack of what might be called 'ordinary skills' would not take a person outside of *s 588G(2)*.

Factors to consider (*ASIC v Plymin*):	- **Creditors unpaid outside trading terms**

• **Continuing losses** • **Overdue taxes** • **Poor relationship with the bank** • **No access to alternative finance** • **Liquidity ratios below 1** • **Inability to raise further equity capital** • **Solicitors' letters issued against company** • **Payment to creditors of rounded sums that are not reconcilable to specific invoices**	• **Suppliers placing company on COD, or otherwise demanding special payments before resuming supply** • **Inability to produce timely & accurate financial information to display the company's trading performance & financial position, and make reliable forecasts** • **Issuing post-dated cheques; dishonoured cheques**

- **Non-executive directors are not spared**: s 588G imposes a **positive obligation on all directors** to stop the company's insolvent trading, including non-executive directors. Where the directors cannot prevent insolvent trading, they have an **obligation to resign immediately** (*ASIC v Plymin*).

Can the director rely on any defence available to him?

- **Safe harbour defence: S 588GA (introduced in 2017)**

A director can avoid contravening *s 588G(2)* if at a particular time after the director starts to suspect that company may become or be insolvent, he/she starts developing one or more courses of action that are reasonably likely to lead to a **better outcome for the company**: *s 588GA(1)(a);* and the debt is incurred directly or indirectly in connection with any such course of action during the period starting at that time, and ending at the earliest of any of the following times (i.e. the end of the safe harbour): *s 588GA(1)(b)*

- if the person fails to take any such course of action within a reasonable period after that time--the end of that reasonable period;
- when the person ceases to take any such course of action;
- when any such course of action ceases to be reasonably likely to lead to a better outcome for the company;
- the appointment of an administrator, or liquidator, of the company.

****Better outcome for the company*** *(s 588(GA)(7)):* means an outcome that is better for the company, than the immediate appointment of an administrator, or liquidator, of the company.

Onus of proof: Director bears the evidential burden of identifying the steps he/she took that made up the course of action that was reasonably likely to lead to a better outcome for the company: *s 588GA(3)*

Factors court will consider in working out whether a course of action is reasonably likely to lead to a better outcome for the company (*s 588GA(2)*):

- is **properly informing** himself or herself of the company's financial position; or
- is taking **appropriate steps to prevent any misconduct** by officers or employees of the company that could adversely affect the company's ability to pay all its debts; or
- is taking appropriate steps to ensure that the company is keeping **appropriate financial records** consistent with the size and nature of the company; or
- is **obtaining advice** from an appropriately qualified entity who was given sufficient information to give appropriate advice; or
- is **developing/implementing plan for restructuring** the company to improve its financial position.

Outcome of course of action: It does not have to be successful, because the aim of this provision is to boost the director's confidence.

ASIC v ADLER [2002, NSWSC] → **FACTS**

HIH (an insurer**)**
The holding company of HIHC (100%)

- **A** = director + member of investment committee
- **W** = director + CEO
- **F** = ED + FC

Company A
Substantial shares in HIH

- **A** = Control the company

*Entitled to 10% income from **AEUT**

PEE (15/06/00)
All shares owned by Company A

- **A** = Director

*Bought shares in **HIH (T2)**
*Bought at cost

HIHC
Wholly owned subsidiary of HIH

- **W** = Director
- **F** = ED + FC

*Investments overseen, directed & controlled by **HIH** – especially by **A**

***A** instigated payment to **PEE** of $10m on 15/06/00 for unit in AEUT (**T1**)

*Entitled to 90% of **AEUT**'s distributable income

AEUT (07/00)
A unit trust

- **PEE** = Trustee
- **Company A** & 2 others = Control

Funding: 98.2 % (**HIHC**) + 1.2% (**Company A**)

***PEE** as trustee of AEUT made unsecured loans from $10m to A/Company A (**T4**)

T1	15/06/00 HIHC paid PEE $10 million for a unit in AEUT. • A instigated this payment. • W and F knew about it • F drew the cheque for T1 by-passing the relevant responsible officer – no documentation for this. • W and F knew that T1 was for a related party funding • No approval was sought from HIH's board or investment committee. • Investment committee did not know, approve or ratify this transaction. • Other directors did not know about it until September 2000. • A and W were aware of impropriety of this transaction.
T2	PEE used part of the $10 million to buy shares in HIH. • A bought shares in HIH to boost HIH's share price which would benefit Company A. • W and F knew about it. • Other directors did not know about it until September 2000. • A and W were aware of impropriety of this transaction
T3	From late August 2000, part of the $10 million was used by PEE to buy at cost from Company A various capital unlisted investments made by it in technology stocks. • There was no independent appraisal. • No disclosure to HIH directors other than W and F. • No approval from investment committee

DUTY TO ACT IN GOOD FAITH – S 181(1)(A)

S 181(1)(a): A <u>director/officer</u> must exercise their powers and discharge their duties in <u>good faith</u> in the <u>best interests of the corporation</u>.

X may have contravened his general law duty to act in good faith in the best interests of *[insert company's name*] codified in s 181(1)(a). This duty reflects the general law duty imposed on directors as the fiduciary of the company. As the fiduciary of the company, the director has to comply by the no-profit and no-conflict fiduciary law obligations

Step 1: Is X a director or officer? → See above.

Step 2: What does '*good faith*' require?
There are <u>2 competing interpretations of s 181</u> under the general law.

- *ASIC v Maxwell*
  - **<u>Subjective standard</u>**
    a) **Rule:** *Maxwell*'s view invites consideration of whether s/he 'honestly' thought [*ISSUING SHARE CAPITAL*] was in the best interests of the company
      ♥ S 181 is only breached if the person *consciously* disregards the interests of his shareholders.
      ♥ Thus, 181 imposes a prohibition on <u>dishonesty</u>.
    b) **<u>EXAM FACTS</u>:** Look for a deliberate conduct with knowledge that what the person is doing is not in the best interests of the company
    c) Subjectively, [*X*] appears to have [*ACTED*] for [*THIS PURPOSE*] [*and this purpose*].
- *ASIC v Adler* (preferred approach – stricter, less director-friendly)
  - **<u>Subjective and Objective standard</u>**
    a) Rule: Under *Adler's* view, a director can breach 181(1)(a) even when acting in a subjectively honest manner. The imposition by 181(1)(a) of both a subjective and an objective standard is supported by the statutory framework (***Adler***)
      ♥ Would a reasonable person in the director or officer's position acting in good faith believe the act to be in the best interests of the company?
      ♥ 181(1)(a) <u>must</u> require more than subjective honesty, otherwise an honest belief no matter how ill-founded or absurd would mean a person has acted in the interests of the company.
      ♥ 181(1)(a) is a <u>positive obligation</u> to act in the interests of the company, requiring directors to do certain things.
    b) **S 184:** A director or officer commits a criminal offence if they are <u>reckless</u> or <u>intentionally dishonest</u> → Criminal liability (s 1311 and Schedule 3, item 30)
    c) S 181(1)(a): A director/officer must:
      ♥ Consciously act in the interests of the company (<u>subjective</u>); and
      ♥ The director/officer's conduct must be consistent with what a reasonable director/officer think is in the interests of the company (<u>objective</u>)
    d) **Conclusion:** Majority position in Australia today seems to be *Adler*'s view.

<u>Step 3: What are the '*interests of the corporation*'?</u>
Quick overview:

<u>Step 1: Is the company insolvent or at risk of insolvency?</u>
- **YES** → *s 181(1)(a)*: interests of company include interests of creditors (Westpac); also, *s 588G*
- **NO** → **Step 2**

<u>Step 2: Is the company part of a corporate group?</u>
- **YES** → **Step 3**

- **NO** → Default position: interests of the company = interests of shareholders [Note: CSR; company as a distinct entity]

Step 3: Does the company have outside shareholders?

- **YES** → *Maronis Holdings*
- **NO** → Does *s 187* apply? (Wholly owned subsidiary)
  - **YES** → Apply *s 187*
  - **NO** → *Equiticorp & Lewis*

Detailed Analysis

Introduction

The **general principle** is that duties are owed to the '*company as a whole*'. Interests of the company at any point in time will depend on the context, type of the company and nature of the impugned activity. It also depends on whether the company is: solvent; on the cusp of insolvency; or insolvent already (*Bell Group*).

Is the company insolvent or at risk of become insolvent?

YES → Interests of creditors (also see s 588G)

Test: Insolvency in the context of a duty to consider the interests of creditors can be either an excess of liabilities over assets or lack of liquidity. Alternatively, the test as per **s 95A** can be applied to determine whether the company is in financial difficulty.

Rule: The duty on directors should consider the interests of creditors when the company is insolvent or approaching insolvency (*Westpac*). This duty cannot be removed or released by shareholders (*Kinsela*). And also, this duty is not a separate duty owed to creditors, it is an expansion of the duty under s 181(1)(a) which requires to take into account creditors' interest, together with shareholders' interest.

- Cannot prejudice the interests of creditors in being paid.
- Cannot prioritise the interests of shareholders over the interest of creditors

NOTE however that creditors do not have standing to sue under s 181.

Is the company part of a corporate group?