

DUTY TO PREVENT INSOLVENT TRADING, S588G:

! ONLY APPLIES FOR DIRECTORS/HOLDING COMPANY

If found → consider s181(1)(a)/GL duty to act in best interests → might need to consider creditors!!

ROADMAP

1. Person must be a **director** at the time the **debt** was incurred: s 588G(1)(a); (NB: NOT OFFICERS)
2. The company trades while **insolvent**: s 588G(1)(b);
3. There are **reasonable grounds** for suspecting the co is insolvent when the debt was incurred: s 588G(1)(c); and
4. The director was **aware**, OR a **reasonable person** in the position of the director would have been aware, of [3]: s 588G(2)
5. The director **failed to prevent** the co from incurring the debt

DOES THE DUTY APPLY?

[D] was a director of [COMP] at the time the debt was incurred. [P] (an unsecured creditor) may be able to recover from [D] if the elements of s 588G(1) are satisfied.

THRESHOLD: ARE THEY A DIRECTOR?

Directors: s9AC

For s 588G to apply, the person must be a director at the time the company incurs a debt, the company must be insolvent or become insolvent as a result of incurring that debt, and there must be reasonable grounds for suspecting the company's insolvency at that moment.

- The person does not need to be the one who has incurred the debt, as long as they are a director
- Appointed directors
 - o De facto; s9AC(b)(ii)
 - o Shadow; s9AC(b)(iii)
- **IF THERE IS A DE FACTO/SHADOW DIRECTOR → MAKE SURE THAT YOU DO AN ANALYSIS ON THAT!**
- **NB: There is usually more than one director in the hypo.**
 - o Make sure you structure your analysis on **EACH INDIVIDUAL DIRECTOR!**
 - Their knowledge might be diff, etc

HAVE THEY INCURRED A DEBT? S588g(1)(A)

Identify the debt

Issue spotting:

- Company taking out a loan to fund something (ie a construction project, reducing its share capital, providing financial assistance)

The company is considered to have incurred a debt by entering into a contract that imposes an unavoidable obligation to pay a certain amount of money in the future (Hawkins)(S588g(1)(a)).

- To establish a contravention of s 588G, the company must incur 'a debt'.
- **A debt is an obligation on one person to pay a sum of money, or money's worth, to another** (e.g. if the company contracts for goods or services, borrows money, leases a business premises).
- **A 'debt' includes certain share capital transactions, such as:**
 - o Payment of a dividend
 - o Uncommercial transactions
 - o Financial assistance – **which would then mean doing an analysis on this!!!!**
 - o Reduction of share capital – **which would then mean doing an analysis on this!!!!**
 - o Buying back shares
- A 'debt' must be for a certain amount (i.e. can be positively calculated) and therefore does not include an obligation to pay unliquidated damages or equitable compensation.
- **The debt must be 'incurred' – meaning 'by an act, omission or other circumstance which causes the company to owe the debt' (Hawkins (2005)).**
 - o **The debt is typically incurred when they enter into the contract**

Action of company = which equals a debt:		When the debt is incurred:
1	paying a dividend	when the dividend is paid or, if the <u>company</u> has a <u>constitution</u> that <u>provides</u> for the declaration of dividends, when the dividend is declared
2	making a reduction of share capital to which Division 1 of Part 2J.1 applies (other than a reduction that consists only of the cancellation of a share or <u>shares</u> for no consideration)	when the reduction takes effect
3	buying back <u>shares</u> (even if the consideration is not a sum certain in <u>money</u>)	when the buy - back <u>agreement</u> is entered into
4	redeeming <u>redeemable preference shares</u> that are redeemable at its option	when the <u>company</u> exercises the option
5	issuing <u>redeemable preference shares</u> that are redeemable otherwise than at its option	when the <u>shares</u> are <u>issued</u>
6	financially assisting a <u>person</u> to <u>acquire shares</u> (or <u>units of shares</u>) in itself or a <u>holding company</u>	when the <u>agreement</u> to <u>provide</u> the assistance is entered into or, if there is no <u>agreement</u> , when the assistance is <u>provided</u>
7	entering into an <u>uncommercial transaction</u> (within the meaning of <u>section 588FB</u>) other than one that a <u>court orders</u> , or a prescribed <u>agency</u> directs, the <u>company</u> to <u>enter into</u>	when the <u>transaction</u> is entered into

IS THE COMPANY INSOLVENT? S588(1)(B)

The company must've become insolvent at the time of debt being incurred or becomes insolvent due to the debt being incurred (s588G(1)(b)). Insolvency is being unable to pay debts when they become due and payable (s95A(1)-(2)).

ISSUE SPOTTING →

- **ASK → is the company practically able to pay its debts?**
- *You need to make sure that, prior to the debt being incurred (prior to the K or arrangement being entered into), the company has the following factors, suggesting insolvency. If following points are present, the company has entered into an arrangement, when they are insolvent = BAD*

CONSIDER FACTORS

Core question: whether the company is practically able to pay its debts as a matter of commercial reality (Plymin)

- **Insolvent (Plymin)**
 - o Insolvency is a 'cash flow' concept
 - If there is a lack of cash flow, you don't have enough money to keep your business going
 - Ask = is the current/future cash flow of the co sufficient?
 - Look also at any funds which can be obtained – such as selling shares/assets
 - o Ongoing trading losses
 - o Poor relationship with the bank (inability to borrow further funds)
 - o Post-dated cheques being dishonoured
 - o Overdue taxes
 - o Inability to produce timely/accurate financial information (Plymin)
 - o **Inability to raise money: (Plymin)**
 - Borrow money
 - Sell assets
 - Raise money/further equity
 - Difficulty obtaining bank finance or raise equity capital
 - Is the co asking for financial assistance from their friends/fam/creditors and they're not successful???
 - o **Enforcement actions (Plymin)**
 - **USUALLY ON EXAM** → Suppliers demanding payment on delivery (Plymin)
 - **If suppliers are requiring cash on delivery** → suggests that there has been a lack of timely payments in the past, and that payment is required immediately due to a lack of consistent payments in the past

- Suppliers paid outside terms of trade despite complaints
- Threatened legal proceedings over unpaid debts

- **Not insolvent**

- If a company negotiates a payment extension, then they will not be considered insolvent (*Heide*)
 - A company is considered insolvent = when they cannot pay their debts when they are due
 - Therefore, if you are able to make a payment extension = co is NOT insolvent!!
- Consider express/implied agreements for extensions w creditors
- If a company has a TEMPORARY LACK OF LIQUIDITY (6 months is probs too long) (*Hymix*)
 - Must be an endemic shortage of liquid capital in order to be insolvent *Hymix*

- **Presumptions of insolvency: s588E**

- If co fails to keep financial records for seven years unless the fault is minor (*s588E(4)*)
 - Meaning → if a co fails for 7 years to keep financial records for 7 years = presumption of insolvency
- Presumed if proven that company was insolvent at any point in the last 12 months (*s588E(3)*)
 - Meaning → if you can prove that a co was insolvent for 1 month, you can presume that they were insolvent for the past 12 months

ARE THERE REASONABLE GROUNDS TO SUSPECT INSOLVENCY? S588G(1)(C)

When the debt is incurred, there must be reasonable grounds to suspect insolvency under s 588G(1)(c). This requirement is assessed objectively, based on what a director of ordinary competence would be expected to know (Miller).

- **ASK:** Would a reasonably competent director suspect insolvency? **OBJECTIVE!!!**
- It is not necessary to prove that a director actually suspected insolvency (i.e. not a subjective test here).

The existence of reasonable grounds/facts, NOT the individual director's belief in them

- Objectively judged by the standard appropriate to a director of ordinary competence (*Metro fire station*)
- **Do circumstances exist, which would give grounds for a reasonable director to suspect insolvency???** (*Plymin*)

Sufficient for suspicion:

- **More than mere 'idle wondering'** *QLD Bacon*
- A 'positive feeling of actual apprehension or mistrust' *QLD Bacon (Kitto J)*
- If there's **actual knowledge** of why there is a reasonable ground to suspect insolvency, can't evade this (*Standard Chartered Bank*)
 - **NOT: supplying a supplier late**
- Doesn't require: an 'actual expectation', 'actual belief'
 - Not based on hindsight: *Powell v Fryer*
- The fact that the company **IS** insolvent **does not equate** to having **reasonable grounds to suspect it**

Interim conclusion: *Further, the time is after the commencement of the CA. Therefore, the duty does/does not apply (s588G(1)).*

IS THERE A BREACH?

A director breaches this duty if they are aware, at the relevant time, of grounds for suspecting insolvency (s 588G(2)(a)), or if a reasonable person in their position and under similar circumstances would also be aware and they failed to stop the company from incurring the debt (s588G(2)(b)),

CHOOSE 1. OR 2. → You only need to show one of these two options!!!!

Remember to do this for EVERY DIRECTOR!!!! (if there are multiples in the hypo)

- **Choose option 1 if we know the director was aware.**
- **Choose option 2 if it wasn't super clear, but it would be pretty obvious to a reasonable person.**
- **Then go on to step 3.**

NB: You are likely referring to a lot of the same facts you have previously mentioned regarding insolvency and reasonable grounds. However, here we are focusing on whether the director personally knew/should have known these facts/was aware of the facts:

1. Was the director aware of the grounds for suspecting insolvency? S588G(2)(A)?

Though specific knowledge of the debt is not required, [D] has actual knowledge/awareness of the grounds [....]

- **Subjective awareness test:** did the director have ACTUAL knowledge of the grounds
- **Actual knowledge:**
 - o Correspondence or evidence showing the director knew (*Plymin*)
 - Check if the director has been to the retail store and seen that their sales are going down, or they have been in negotiations with banks/financers and failed to get \$\$\$
 - o Sufficient if a director is aware of facts that would cause a reasonably competent director to suspect that the company was insolvent when it incurred the debt (*Plymin*)
- **Such grounds for suspecting insolvency** = the reasonable grounds for suspecting insolvency per s588G(1)(C)

2. A reasonable person in a like position in a company in the company's circumstances would be so aware: s588G(2)(B):

Though [D] did not have subjective knowledge of the ground, a reasonable person in [D's] position and the co's circumstances, acting with reasonable competence and diligence as a director, would be aware of these grounds (s 588G(2)(b))

- Place the reasonable person, in the position of the director, with all the facts you are given. **Would a reasonable person in their position have suspected insolvency?**
- **Constructive awareness:** did they fail to learn key facts that a reasonable person would/should have?
- **Consider:**
 - o Size & type of company
 - *Smaller co → maybe should expect more knowledge?*
 - *If it's a small, PPTY company, they are more likely to be across everything going on as opposed to a large public company*
 - o Director's position
 - If they are also the CFO, they are assumed to be more across the finances of the company
- **The standard:** A director of reasonable competence and diligence seeking to properly perform their duties and can form a well-informed opinion on the company's financial health (*Plymin*)

3. Did they fail to prevent the company from incurring debt? S588G(2)?

[D] arguably failed to/didn't fail to prevent the company from incurring the debt (s588G(2)) as...

- **Are they subjectively aware of this?**
- A director doesn't need sole power themselves to prevent the debt (*Plymin*)
- Taking **all reasonable steps** in their power to prevent the debt: (*ASIC Guide 217*)
 - o **Obtaining advice:** Directors should seek advice from a qualified and reliable person if they suspect financial difficulties.
 - o **Maintaining proper financial records**
 - o **Investigating and staying informed** about the company's financial affairs.
 - o Act **in a timely manner** to be aware of the company's financial viability and risks of incurring further debts
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