



## NEWS FLASH

March 2010

### Insolvent Trading - The Importance of Professional Advice

In a recent decision<sup>1</sup> in the Federal Court of Australia (“**the Court**”), the Court has exercised discretion under s1317S of the Corporations Act 2001 (“**the Act**”) to excuse a director from liability for a contravention of insolvent trading provisions. Whether the judgment represents an isolated decision or the formation of a wider precedent, especially in light of the proposed business judgment defence, remains uncertain.

#### The Implications

It is difficult to predict the future application and interpretation of this first instance judgment, however if the judgment is broadly applied, the implications may be significant in terms of a Director’s liability for insolvent trading. To arrive at this decision to exonerate, Justice Goldberg cited specific behaviours of the director that he found directly mitigated against any wrongdoing. Those behaviours include:

- Actively seeking external expert advice as to the solvency of the business. This advice was not confined to information routinely sought during the normal operation of a business, but was sought and provided in specific reference to the solvency of the business;
- Once provided by the external advisor, actually acting on the advice. It is one thing to be advised, but the Court had regard to what actions could be shown to have been taken from the advice;
- Clear demonstration that the Director at all times acted in the best interests of all stakeholders, particularly not obtaining or seeking personal gains; and
- A demonstrable pattern of behaviour that establishes that the issues were dealt with consistently, not commencing only when the liquidator was knocking on the door.

It should be stressed that the above should not be seen as a checklist. The behaviours listed above may indeed be persuasive for a Court, but it is important to remember that this is the first time that such a judgment has been delivered, based very much on the individual circumstances of the case. The Director was found to have been trading while insolvent and was, prima facie, liable for the \$426,469.37 in debts incurred during the relevant period. The

#### More information

For more information please contact:

#### SYDNEY

Quentin Olde  
Partner  
(02) 8247 8000  
[quentin.olde@twcs.com.au](mailto:quentin.olde@twcs.com.au)

Matt Adams  
Partner  
(02) 8247 8000  
[matt.adams@twcs.com.au](mailto:matt.adams@twcs.com.au)

#### MELBOURNE

Ross Blakeley  
Partner  
(03) 9604 0600  
[ross.blakeley@twcs.com.au](mailto:ross.blakeley@twcs.com.au)

Andrew Schwarz  
Partner  
(03) 9604 0600  
[andrew.schwarz@twcs.com.au](mailto:andrew.schwarz@twcs.com.au)

#### PERTH

Michael Ryan  
Partner  
(08) 9321 8533  
[michael.ryan@twcs.com.au](mailto:michael.ryan@twcs.com.au)

Ian Francis  
Partner  
(08) 9321 8533  
[ian.francis@twcs.com.au](mailto:ian.francis@twcs.com.au)

Mark Englebert  
Partner  
(08) 9321 8533  
[mark.engagebert@twcs.com.au](mailto:mark.engagebert@twcs.com.au)

<sup>1</sup> *McLellan, in the matter of The Stake Man Pty Ltd v Carroll* [2009] FCA 1415.



Court's discretion was only in terms of exoneration from liability, and costs were still awarded against the Director.

A full description of the case and the relevant facts are detailed below.

## Background

The liquidator of The Stake Man Pty Ltd (In Liquidation) ("the Company"), commenced insolvent trading proceedings against the Company's sole director. If proven, the liquidator would be able to improve the return to creditors by accessing the personal assets of the Director.

Until 2004, the Company was a profitable raw timber processing and wholesaling business. The Company saw an opportunity to expand its operations by increasing production capacity through the purchase of plant and equipment to kiln dry and machine its own timber.

With significant problems and delays being experienced with its kiln installation, in March 2005 the Director engaged an accountant to provide business advice with regard to the Company's cashflow, costs and expenses and complete an analysis of the business model and its profits and losses.

In June 2005, based on his analysis of the Company and its rate of cash usage, the Company's business advisor, advised the Director, that the Company was close to being insolvent and that a significant capital injection was required. At this point in time, the Director together with an investor were able to advance further funds to the Company.

However, the Company's cashflow situation remained poor with all funds injected completely exhausted by February 2006. Critically, in the context of the Court case, at this time the Director sought the advice from an insolvency specialist noting that the Company was experiencing cashflow difficulties.

Unable to raise additional capital the Company was placed in Voluntary Administration in May 2006 and thereafter Liquidation.

Following an investigation by the Liquidator proceedings were commenced against the Director for insolvent trading.

## Decision

The Court found that the Director had breached Section 588G by permitting the Company to incur debts whilst insolvent, between 31 December 2005 and 10 May 2006. However, Justice Goldberg was satisfied that the Director had acted honestly and, having regard to all the circumstances of the case, ought to be excused for contravention of insolvent trading provisions pursuant to s1317S.

In application of the facts specific to this case, the Court concluded that although the Director allowed the Company to incur debts and in turn contravened the insolvent trading provisions, he did so against the background of various matters being:

- The advice provided to the Director by the business adviser was reasonable for the Director to rely upon notwithstanding suspicions as to the Company's solvency;
- Active steps were employed by the Director to expand sales and continued efforts to get the kilns operational;
- Stock sales were increasing period;
- Advice was sought from an insolvency practitioner, whose advice the Director acted upon;

### More information

For more information please contact:

#### SYDNEY

Quentin Olde  
Partner  
(02) 8247 8000  
[quentin.olde@twcs.com.au](mailto:quentin.olde@twcs.com.au)

Matt Adams  
Partner  
(02) 8247 8000  
[matt.adams@twcs.com.au](mailto:matt.adams@twcs.com.au)

#### MELBOURNE

Ross Blakeley  
Partner  
(03) 9604 0600  
[ross.blakeley@twcs.com.au](mailto:ross.blakeley@twcs.com.au)

Andrew Schwarz  
Partner  
(03) 9604 0600  
[andrew.schwarz@twcs.com.au](mailto:andrew.schwarz@twcs.com.au)

#### PERTH

Michael Ryan  
Partner  
(08) 9321 8533  
[michael.ryan@twcs.com.au](mailto:michael.ryan@twcs.com.au)

Ian Francis  
Partner  
(08) 9321 8533  
[ian.francis@twcs.com.au](mailto:ian.francis@twcs.com.au)

Mark Englebert  
Partner  
(08) 9321 8533  
[mark.Englebert@twcs.com.au](mailto:mark.Englebert@twcs.com.au)



- Active steps were taken to seek out investors who could provide further working capital; and
- The Director met with the Voluntary Administrator, now Liquidator, soon after receiving notification from the ATO of outstanding liabilities.

The Director did not profit personally from allowing the Company to trade, did not disregard the advice received and actively sought advice from professionals including an insolvency practitioner.

## Commentary

Recently, there has been much commentary in regard to proposed insolvency reforms. Australia has often been criticised for having an insolvency regime that takes a far too black and white view of insolvency, severely reducing a company's ability to trade out of difficulty. Faced with a claim of insolvent trading and the personal liability this attracts, it is clear that many Directors opt to place their company under external administrators to avoid placing their individual assets in jeopardy.

This decision highlights the importance for directors to actively seek professional advice, and to act in the best interests of the company, when solvency is potentially an issue.

## How Taylor Woodings Can Assist

Taylor Woodings has extensive experience working with organisations seeking independent restructuring and workout advice, particularly when questions of solvency are prominent. We have worked with organisations in a wide range of industries across Australia and know what can or cannot be done to allow a business to continue trading.

Across all appointments, we work hard to find practical solutions to the challenging financial difficulties that are faced by companies, with the desired aim of maximising returns for all stakeholders.

## Confidential Discussion

If you wish have a confidential discussion about any aspect of external administrations, please contact one of our Taylor Woodings partners in Sydney, Perth or Melbourne.

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### More information

For more information please contact:

#### SYDNEY

Quentin Olde  
Partner  
(02) 8247 8000  
[quentin.olde@twcs.com.au](mailto:quentin.olde@twcs.com.au)

Matt Adams  
Partner  
(02) 8247 8000  
[matt.adams@twcs.com.au](mailto:matt.adams@twcs.com.au)

#### MELBOURNE

Ross Blakeley  
Partner  
(03) 9604 0600  
[ross.blakeley@twcs.com.au](mailto:ross.blakeley@twcs.com.au)

Andrew Schwarz  
Partner  
(03) 9604 0600  
[andrew.schwarz@twcs.com.au](mailto:andrew.schwarz@twcs.com.au)

#### PERTH

Michael Ryan  
Partner  
(08) 9321 8533  
[michael.ryan@twcs.com.au](mailto:michael.ryan@twcs.com.au)

Ian Francis  
Partner  
(08) 9321 8533  
[ian.francis@twcs.com.au](mailto:ian.francis@twcs.com.au)

Mark Englebert  
Partner  
(08) 9321 8533  
[mark.engagebert@twcs.com.au](mailto:mark.engagebert@twcs.com.au)

