RESEARCH REPORT

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Professor Ian Ramsay
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Clayton Utz

333 Collins St
Melbourne
Victoria
Australia 3000

Phone: + 61 3 9286 6000
Fax: + 61 3 9629 8488
Website: www.claytonutz.com

Centre for Corporate Law and Securities Regulation

Faculty of Law
The University of Melbourne
Victoria
Australia 3010

Phone: + 61 3 8344 5281
Fax: + 61 3 8344 5285
Email: cclsr@law.unimelb.edu.au
Website: http://cclsr.law.unimelb.edu.au

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For more information, please contact:

Paul James | D +61 3 9286 6927 | F +61 3 9629 8488 | pjames@claytonutz.com

or visit our website www.claytonutz.com

Centre for Corporate Law and Securities Regulation - University of Melbourne

The Centre for Corporate Law and Securities Regulation was established in January 1996. Its objectives are to:

- undertake and promote research and teaching on corporate law and securities regulation
- host conferences to disseminate results of research undertaken under the auspices of the Centre or in other programs associated with the Centre
- develop and promote links with academics in other Australian universities and in other countries who specialise in corporate law and securities regulation
- establish and promote links with similar bodies, internationally and nationally, and provide a focal point in Australia for scholars in corporate law and securities regulation
- promote close links with peak organisations involved in corporate law and securities regulation
- promote close links with those members of the legal profession who work in corporate law and securities regulation

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The Centre's contact details are:

Tel: 61 3 8344 5281
Fax: 61 3 8344 5285
Email: cclsr@law.unimelb.edu.au
Website: http://cclsr.law.unimelb.edu.au

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Executive Summary

Overview of research report

This research report documents the findings of an empirical study of judicial findings (of superior courts) relating to the duty to prevent insolvent trading. The duty to prevent insolvent trading is the most controversial of the duties imposed upon company directors. Those who support the duty argue that it provides appropriate protection for the unsecured creditors of companies. Those who oppose the duty argue that it has the effect of making directors unduly risk adverse which can result in directors too quickly putting companies into voluntary administration or liquidation for fear of personal liability (which may have a negative financial impact on unsecured creditors).

The elements of the duty to prevent insolvent trading

The duty to prevent insolvent trading is contained in section 588G of the *Corporations Act*. This section applies to impose liability upon a person if:

- the person is a director of the company when the company incurs a debt;
- the company is insolvent when it incurs the debt or becomes insolvent because it incurs the debt;
- when it incurs the debt there are reasonable grounds for suspecting that the company is insolvent or would become insolvent because it incurs the debt; and
- the director is aware at the time the debt is incurred that there are reasonable grounds for suspecting that the company is insolvent or would so become insolvent (as the case may be) or a reasonable person in a similar position in a company in the company's circumstances would be so aware.

Even if a director has breached section 588G, there might be a defence for the director. Section 588H contains four defences. These are:

- reasonable grounds on which to expect solvency;
- reasonable reliance on information provided by others;
- absence from management; or
- taking reasonable steps to prevent incurring of debt.

Research methodology

The project involves an empirical study of insolvent trading cases based on court judgments. Insolvent trading provisions were first introduced by each of the States and Territories in their *Companies Acts* in 1961. Various searches (both text based and electronic) were undertaken to obtain relevant cases from the introduction of the insolvent trading provisions until February 2004.

The searches undertaken revealed a large number of cases which then needed to be considered for the purposes of determining whether they would be included in the study. This process resulted in 103 cases forming the basis of the study. Each case was read and, for each case, eighteen questions were, to the extent possible, answered.

Key findings of the study

The key findings of the study are as follows:

- There has not been a large number of insolvent trading cases in Australia (our research revealed 103 cases in total). Although the insolvent trading provisions were introduced into companies legislation in

1961, we were unable to find any cases from the 1960s. In the 1970s there were ten cases and in the 1980s there were sixteen cases. There was a rapid increase to 62 cases during the 1990s. However, the number of cases decided has since slowed, with only 15 cases decided since the end of the 1990s.

- In the vast majority of the insolvent trading cases (75%), the defendant is found liable for insolvent trading.

- Where the defendant is found liable for insolvent trading, the amount of compensation the court orders the defendant to pay varies significantly. The largest amount of compensation a director was ordered to pay by a court was $96.7 million. The smallest amount of compensation ordered in a case was $517. The average amount of compensation ordered to be paid by courts was $1.7 million although this amount is skewed by the large judgment referred to above. The median amount of compensation was $110,600.

- In addition to ordering the defendant director to pay compensation where the director has engaged in insolvent trading, the court may also impose other orders including an order banning the director from managing companies for a specified period of time. It is rare for courts to impose such other orders (this was only done in seven cases). There were only two cases in which a management banning order was made. One of those cases involved 3 directors, with the length of the management banning orders against each of the directors involved in this case being 4, 7 and 10 years respectively. The period of the ban was twelve years in the second case.

- It is possible to bring criminal proceedings in relation to insolvent trading. 15% of the cases involved criminal proceedings.

- 91% of the companies alleged to be engaged in insolvent trading are private companies with only about 8% being public companies (and 1% being unknown).

- The type of business that companies alleged to be engaged in insolvent trading undertake varies widely. However, the most common business is construction (22% of all the cases) with the next two most common categories of business being retail trade (17%) and manufacturing (17%). These findings may have implications as to where ASIC should be devoting its remedial and enforcement resources.

- Insolvent trading actions are most commonly brought against executive directors. Excluding those cases where the type of director was unknown, 55% of the cases involved executive directors and 22% involved non-executive directors. A further 6% of cases involved people who were both a director and secretary. 4% of the cases were brought against the chairman of the companies.

- Most cases of insolvent trading against directors (60%) were brought by creditors of the companies. About 17% of the cases were brought by the corporate regulator with another 16% being brought by the liquidators of the companies.

- About 80% of the insolvent trading cases are brought in the state courts with about 20% being brought in the Federal Court. This trend is reversing given that the Federal Court has only had the jurisdiction to hear insolvent trading cases since the 1990s. In the period since 1991, 36% of the insolvent trading cases have been brought in the Federal Court.

- In relation to the cases brought in the state courts, 30% were brought in NSW, 22% in Western Australia, 18% in South Australia, 17% in Victoria and almost 10% in Queensland.

- There are defences available in a case involving insolvent trading. These defences are summarised above. In 63% of the insolvent trading cases, the defendants argued that a defence applied to them. However, in only about 11% of the cases in which a defence was argued was the director held not liable because a defence applied.

- In order for there to be insolvent trading, the company must incur a debt. In about 64% of the cases, the debt related to the purchase of goods or services by the company. In about another 8% of the cases the debt was a loan from a bank or another financier. In a small number of cases the debt related to unpaid taxation.

Insolvent Trading – An empirical study*

1 Introduction

Insolvent trading occurs when a company incurs debts when it is insolvent.[1] Contravention of the duty to prevent insolvent trading can result, inter alia, in directors being held personally liable for the debts which are incurred by the insolvent company.

Insolvent trading has become increasingly topical in recent years due to a number of prominent corporate collapses. Legislative provisions relating to insolvent trading have however been in existence in Australia for over 40 years. The purpose of this study is to examine Australian insolvent trading cases with a view to identifying trends, and providing possible explanations for identified trends.

Part II of this report is an overview of the duty to prevent insolvent trading. Part III is an examination of the policy arguments relevant to this duty. Part IV is the empirical study and analysis of the data.

2 The Duty to Prevent Insolvent Trading: An Overview

The duty to prevent insolvent trading is currently contained in section 588G of the *Corporations Act*. This part of the report provides an overview of the elements of the duty to prevent insolvent trading and then identifies the potential defences available to a director who has breached section 588G.

Section 588G applies to impose liability upon a person if:

- the person is a director of the company when the company incurs a debt;
- the company is insolvent when it incurs the debt or becomes insolvent because it incurs the debt;
- when it incurs the debt there are reasonable grounds for suspecting that the company is insolvent or would become insolvent because it incurs the debt; and
- the director is aware at the time the debt is incurred that there are reasonable grounds for suspecting the company is insolvent or a reasonable person in a similar position in a company in the company's circumstances would be aware.

Duty is imposed on directors

The duty to prevent insolvent trading is imposed on directors.[2] Unlike the other statutory duties,[3] it does not apply to officers other than directors. However, the broad definition of director in section 9 means

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[1] Coburn N, *Coburn's Insolvent Trading: Global Investment Fraud and Corporate Investigations* (Sydney: Lawbook Co., 2003), at 2; See also Ramsay I (ed), *Company Directors' Liability for Insolvent Trading* (CCH, 2000).

[2] Section 588V of the *Corporations Act* imposes a duty to prevent insolvent trading on the parent companies of subsidiaries. This provision was introduced in 1992: *Corporate Law Reform Act 1992* (Cth).

[3] These other statutory duties are:

- the duty to exercise reasonable care and diligence: section 180(1);
- the duty to act in good faith in the best interests of the corporation: section 181(1)(a);

that section 588G applies to de facto directors and shadow directors. A de facto director is someone who acts as a director even if they have not been validly appointed to act as a director or even if they are not described as a director. A shadow director is a person in accordance with whose instructions or wishes the directors of the company are accustomed to act.

Although a company cannot itself be appointed a director of another company, it is possible for a company to be a shadow director of another company.[4] This means that where a company is a shadow director of another company, then the first company, because it is a shadow director, is subject to the duty in section 588G not to have the second company trade while it is insolvent.

The consequences of a company being a shadow director and therefore being subject to section 588G can be very significant. Consider the example of a company which has very substantial assets which is the shadow director of a second company which has few assets. The second company is being wound up because it is insolvent and cannot pay its debts. The liquidator of the second company will be keen to increase the funds available to pay the creditors of the second company. If the liquidator can establish that the first company was a shadow director of the second company and breached section 588G, then the substantial assets of the first company can be made available to pay the debts of the second company.

When does a company incur a debt?

In order to decide when a company incurs a debt for the purposes of section 588G, two questions must be asked. These are:

- What types of debts can be incurred?
- When is a debt incurred?

i. Types of debts that can be incurred.

There are two types of debts that can be incurred for the purposes of section 588G. The first are called "deemed debts". When a company takes any of the actions listed in section 588G(1A) then it is automatically deemed to have incurred a debt for the purposes of section 588G. The actions mostly relate to the laws relating to capital maintenance. The following table identifies these deemed debts.

- the duty to act for a proper purpose: section 181(1)(b);
- the duty not to make improper use of position: section 182(1); and
- the duty not to make improper use of information: section 183(1).

[4] *Standard Chartered Bank of Australia Ltd v Antico* (1995) 13 ACLC 1381; 18 ACSR 1. This is the only Australian judgment of which we are aware where a company has been held to be a shadow director of another company.

Table 1: Deemed Debts

Action of company	When debt is incurred
Paying a dividend	When the dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared
Making a reduction of share capital	When the reduction takes effect
Buying back shares	When the buy-back agreement is entered into
Redeeming redeemable preference shares that are redeemable at the option of the company	When the company exercises the option
Issuing redeemable preference shares that are redeemable otherwise than at the option of the company	When the shares are issued
Financially assisting a person to acquire shares in the company or its parent company	When the agreement to provide the assistance is entered into or, if there is no agreement, when the assistance is provided
Entering into an uncommercial transaction (defined below)	When the transaction is entered into

The first six actions which are identified in the table (paying a dividend, reducing share capital, buying back shares, redeeming or issuing redeemable preference shares, and financially assisting a person to acquire shares in the company) relate to specific financial transactions. The final action (entering into an uncommercial transaction) refers to a transaction that a reasonable person in the company's circumstances would not have entered into, having regard to (i) the benefits (if any) and detriment to the company from entering into the transaction; (ii) the benefits other parties gain from the transaction; and (iii) any other relevant matter. This definition of uncommercial transaction is contained in section 588FB.

In addition to deemed debts, courts have had to decide what other types of debt can be incurred for the purposes of section 588G. The courts have developed several principles although there is some uncertainty in this area.[5] First, the debt must be for a specific amount. A company cannot incur a debt for an amount that cannot be specified or calculated. Second, the debt can be contingent and therefore can include a guarantee.[6] Third, courts have generally said that because section 588G refers to a company incurring a debt, the debt must be one which is voluntarily incurred by the company.

ii. When is a debt incurred?

It is important to answer this question because for section 588G to apply, the debt in question must be incurred when the company is insolvent. In relation to deemed debts, Table 1 specifies when these debts are taken to be incurred for the purposes of section 588G. In relation to other debts, the answer is not

[5] See generally on these principles, HAJ Ford, RP Austin and IM Ramsay, *Ford's Principles of Corporations Law*, looseleaf, [20.120].

[6] *Hawkins v Bank of China* (1992) 26 NSWLR 562; 10 ACLC 588; 7 ACSR 349.

always clear. In the case of the guarantee of a debt, the debt can be incurred when the guarantee is first given – not when payment is required.[7] In relation to contracts for the supply of goods to a company in the future, with payment for the goods being required upon delivery or after delivery, some courts have said that the debt is incurred at the time of the order for the goods. Other courts have held that the debt is incurred when the goods are delivered.[8] It depends upon what can be regarded as the substantial act of the company which incurs the debt.[9]

When is a company insolvent?

Under section 588G, a company must be insolvent when it incurs the debt in question or else it must become insolvent by incurring the debt. Section 95A defines insolvency. Under section 95A, a company is insolvent if it is unable to pay all its debts, as and when they become due for payment. It has been said that the court must ascertain "the company's existing debts, its debts within the near future, the date each will be due for payment, the company's present and expected cash resources and the date each item will be received" in order to determine whether the company is able to pay all its debts as they become due for payment.[10] A temporary lack of liquidity will not necessarily mean that the company is insolvent.

There are several presumptions of insolvency which can assist in establishing that a company is insolvent for the purposes of section 588G. These presumptions are contained in section 588E. First, where a company is being wound up and it is proved that the company was insolvent at a particular time during the twelve months ending on the date of the application for winding up, there is a presumption that the company continued to be insolvent through that period: section 588E(3). This presumption can be particularly useful where it is sought to establish that the company incurred a number of debts during the twelve months prior to its winding up and each time a debt was incurred, the company was insolvent. If it is proved that on one occasion during the twelve month period the company was insolvent, then the company is presumed to have been insolvent for the entire twelve months. The presumption is rebuttable.

Another presumption of insolvency is in section 588E(4). Where a company has failed to keep or retain financial records for a specified period as required by section 286, then the company is presumed to have been insolvent for the entire period that it was in contravention of section 286. The reason for this presumption is that section 588G requires proof that, when a debt was incurred, the company was insolvent. It can be difficult for a liquidator to prove that the company was insolvent when the company has not kept proper records.

What are reasonable grounds for suspecting insolvency?

Even if a company is insolvent when it incurs a debt, this does not automatically mean that the directors of the company have breached section 588G. There must be reasonable grounds for suspecting insolvency. Whether there are reasonable grounds for suspecting that the company was insolvent when it incurred the debt in question is to be judged according to a director of ordinary competence who is capable of understanding the company's financial status.[11]

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[7] Ibid.

[8] *Credit Corporation Australia Pty Ltd v Atkin* (1999) 17 ACLC

756; 30 ACSR 727.

[9] *Leigh-Mardon Pty Ltd v Wawn* (1995) 13 ACLC 1244; 17 ACSR 741.

[10] Ford, Austin and Ramsay, supra n4, [20.140].

[11] *Credit Corporation Australia Pty Ltd v Atkins* (1990) 17 ACLC 756; 30 ACSR 727.

What does it mean to say that there must be reasonable grounds for *suspecting* insolvency? The High Court has said that it is more than mere speculation. To say that someone has reason to suspect insolvency means they must have a "positive feeling of actual apprehension" that there is insolvency.[12]

Of what must the director be aware?

The final requirement for section 588G to apply to make a director liable is that:

- the director was aware at the time the debt was incurred that there were reasonable grounds for suspecting that the company was insolvent; or
- a reasonable person in a similar position in a company in the company's circumstances would have been aware that there were grounds for suspecting that the company was insolvent.

The first test is satisfied if the court finds that the director was actually aware that there were reasonable grounds for suspecting insolvency. What is meant by reasonable grounds for suspecting insolvency is discussed above. However, even if the director was not actually aware that there were reasonable grounds for suspecting insolvency, the director can still be liable under section 588G if a reasonable person in a similar position in a company in the circumstances of the company would have been aware. The reasonable person is a director of ordinary competence who has the ability to understand the company's financial status.[13]

Defences

Even if a director has breached section 588G there might be a defence for the director. Section 588H contains four defences. These are:

- reasonable grounds to expect solvency;
- reasonable reliance on information provided by others;
- absence from management; or
- taking reasonable steps to prevent incurring of debt.

i. Reasonable grounds to expect solvency

It is a defence if it is proved that, at the time the debt was incurred, the director had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if it incurred the debt and any other debts incurred at that time: section 588H(2).

An important point to note about this defence is that it requires reasonable grounds to **expect** solvency while a contravention of section 588G requires reasonable grounds to **suspect** insolvency. Is there a difference? In *Metropolitan Fire Systems Pty Ltd v Miller* the Court said:[14]

> "*…To "suspect" something requires a lower threshold of knowledge or awareness than to "expect" it…The expectation must be differentiated from mere hope in order to satisfy this defence…It implies a measure of confidence that the company is insolvent. The directors must*

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[12] *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 303.

[13] *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699; *Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946; 5 ACSR 115.

[14] (1997) 23 ACSR 699 at 711.

> *have reasonable grounds for regarding it as likely that the company would at the relevant date have been able to pay its debts as and when they fall due*."

ii. Reasonable reliance on information provided by others

It is a defence if it is proved that, at the time the debt was incurred, the director:

- had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing to the director adequate information about whether the company was solvent;

- had reasonable grounds to believe, and did believe, that that person was fulfilling that responsibility; and

- expected, on the basis of information provided to the director by that person, that the company was solvent at the time the debt was incurred and would remain solvent even if it incurred the debt and any other debts incurred at that time: section 588H(3).

iii. Absence from management

It is a defence if it is proved that, at the time the debt was incurred, the director did not take part in the management of the company because of illness or for some other good reason: section 588H(4).

iv. Reasonable steps to prevent incurring of debt

It is a defence if it is proved that the director took all reasonable steps to prevent the company from incurring the debt: section 588H(5). One matter which the court can consider is any action the director took with a view to appointing an administrator of the company: section 588H(6).

Consequences of contravention

There are several consequences which can result from a breach of section 588G. The director may be ordered to pay compensation. In addition, a breach of section 588G can result in an order banning the director from managing companies or even criminal consequences such as a fine or imprisonment if the director's failure to prevent the company incurring the debt was dishonest.

i. Payment of compensation

Where a company is being wound up and a director of the company has breached section 588G, then the liquidator of the company may sue the director for compensation: section 588M. The compensation that may be obtained from the director is an amount equal to the loss or damage suffered by one or more creditors whose debts were incurred by the company when it was insolvent. The debts must be wholly or partly unsecured. This means that the compensation is mostly for the benefit of unsecured creditors.

Although most claims for compensation are currently brought by liquidators of companies being wound up, in some circumstances, an individual creditor may sue a director for compensation for breach of section 588G. The creditor can only do so if the company is being wound up and the creditor must obtain the written consent of the company's liquidator: section 588R. It is possible for the creditor to sue a director even without the liquidator's consent where the creditor obtains the permission of the court: section 588T. However, the creditor cannot sue if the company's liquidator has already sued the director: section 588U.

ii. Consequences of breach of a civil penalty provision

Section 588G is a civil penalty provision. Civil penalty provisions such as section 588G are enforced by the Australian Securities and Investments Commission ("**ASIC**"). Where a director breaches section 588G, the court can make the following orders:

- an order disqualifying the director from managing companies for a specified period of time;
- an order to pay a pecuniary penalty of up to $200,000; and/or
- an order to pay compensation to the company for any loss or damage it has incurred because of the breach of section 588G.

The amount of compensation is the loss or damage suffered by the creditor whose debt was incurred when the company was insolvent: section 588J.

iii. Criminal penalties

Where a director breaches section 588G and the director's failure to prevent the company incurring the debt was dishonest, ASIC can seek to have a criminal penalty imposed on the director: section 588G(3). The criminal penalty will be a fine of up to $220,000, or imprisonment for up to five years, or both.

3 The Duty to Prevent Insolvent Trading: Policy Arguments

Having provided an overview of the elements of the duty to prevent insolvent trading, we now explore a number of the policy arguments relevant to the duty.

It has been argued that the insolvent trading provisions in the United Kingdom offer limited assistance to creditors, and it therefore seems unlikely that creditors would contract for analogous legal protection if the provisions were not part of the United Kingdom Companies Act.[15] On the other hand, it has been argued that the United Kingdom provisions (i) preserve and maximise the pool of assets in the context of insolvency which is a primary goal of insolvency law and, (ii) encourage directors to operate with regard for the company's unsecured creditors.[16]

There are a number of criticisms that have been made of the insolvent trading provisions. We have already seen that one commentator argues that, at least in relation to the United Kingdom, such provisions appear to be of little practical assistance to creditors.[17] One criticism that is often made is that the insolvent trading provisions have the effect of making directors unduly risk averse. This has two consequences. First, it may be that provisions such as section 588G have the effect that directors will too quickly put companies into voluntary administration or liquidation for fear of personal liability, even in circumstances where it may be possible for a company to trade out of its financial difficulties. This is an important empirical question. Second, provisions such as section 588G may be deterring qualified people from becoming company directors and the provisions may be having this effect precisely in relation to those companies in financial difficulties which require the best possible expert assistance from directors. Again, this is an empirical question.

Of course, the major argument used to support the insolvent trading provisions is that they are necessary to protect the interests of creditors. This argument is elaborated in the next section.

However, the question then becomes "how are creditors' interests best protected?" As stated above, insolvent trading provisions have generally ensured a conservative approach by directors when the

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15 BR Cheffins, *Company Law: Theory, Structure and Operation* (1997), 547. Professor Cheffins argues that there are a number of reasons why the insolvent trading provisions may offer limited assistance to creditors.

These include (i) a defendant director may have few personal assets in order to pay compensation to creditors, (ii) there are few reported cases in the United Kingdom involving director liability for insolvent trading and this may dissipate the deterrent effect which these provisions should have, and (iii) procedural constraints in the law.

16 RJ Mokal, "An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain" (2000) 59 *Cambridge Law Journal* 335.

17 Cheffins, supra n14.

company is experiencing financial difficulties (ie. early appointment of administrator). Of course, the potential alternative effects of such a decision are:

1. to preclude the company from trading out of its temporary insolvency, thus resulting in creditors not being fully paid in respect of their debt; and

2. to avoid the company dwindling away assets and further reducing any return to creditors.

Based on the results of this Report, generally creditors do obtain a financial benefit from insolvent trading proceedings against directors (it should be noted that the Report does not take account of settlements of such claims, cases in which directors plead guilty to insolvent trading charges, and decisions of lower courts). However, while most insolvent trading proceedings have resulted in a judgment against the "director(s)" to compensate the company, the Report also reveals that since the introduction of insolvent trading provisions in Australia, there have been only 35 cases giving rise to judgments in excess of $100,000 and only 24 cases giving rise to judgments in excess of $200,000. It is also arguable that the presence of insolvent trading provisions provides some incentive for directors (especially if associated with a significant shareholder) to propose a deed of company arrangement (in a voluntary administration) that provides a greater return to creditors than a liquidation. Such incentive may have been slightly weakened following the decision in *ASIC v Plymin, Elliott & Harrison* as the directors in that case were held liable for being in breach of the insolvent trading provisions even though the creditors had previously accepted a deed of company arrangement proposed by the directors.[18]

Creditor protection: the rationale for section 588G

Because section 588G is designed specifically to protect creditors, a critical question that must be addressed is whether creditors require protection or whether they should be expected to contract to protect themselves. The starting point is a recognition of the conflicts of interest that exist between a company's shareholders and its creditors. Smith and Warner[19] identify four major sources of conflict:

- the payment of excessive dividends;
- claim dilution (through taking on debt with similar or higher priority);
- asset substitution (for example, substituting saleable for non-saleable assets); and
- excessive risk taking.

Although the first three conflicts are straight forward, the fourth warrants elaboration. A conflict arises because payment to a creditor may be jeopardised where the company engages in high-risk investments. Shareholders in a leveraged company have incentives to invest the company's resources in risky projects: if a project is successful, the excess returns will be distributed among the shareholders as dividends but will not be shared with the creditors who are only entitled to a fixed return on their investment. Company losses, however, are shared among both creditors and shareholders (albeit that creditors are paid in priority to shareholders).

Creditors can generally be expected to contract to protect themselves against actions that reduce the prospect of them being paid. This contracting has two parts to it. First, the interest rate on the loan that is negotiated between the creditor and the company can be expected to reflect the risks that the creditor faces. Second, the contract may contain restrictions on activities of the company. For example, there may be restrictions on the amount that the company can pay out as dividends. There may also be

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18 [2003] VSC 123 & [2003] VSC 230.

19 CW Smith and JB Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979) 7 *Journal of Financial Economics* 177.

restrictions on the company incurring debt of a similar or higher priority. These types of restrictions are common in debenture trust deeds.[20]

However, this type of contracting may not always be possible. The theory that creditors charge different interest rates for different levels of risk does not work where the costs of the creditor acquiring adequate information about the level of risk are disproportionate to the amount of the transaction.[21] The theory also does not work in the case of involuntary creditors (such as tort claimants).[22] Moreover, dispersed creditors face a collective action problem and may therefore lack the appropriate incentives to undertake joint action to prevent opportunistic behaviour by the company that threatens payment to creditors.[23] Finally, even sophisticated creditors cannot foresee all contingencies and contract for protection against them. Significant corporate restructurings, such as leveraged buyouts, have sometimes seen transfers of wealth from sophisticated creditors (namely some bondholders) to shareholders.[24] The result has been a vigorous debate concerning whether directors should owe fiduciary duties to bondholders as a means of protection.[25]

In addition to contractual protections, there are constraints upon companies which operate to protect the interests of creditors. First, there is the maintenance of share capital doctrine. This doctrine states that while creditors accept the risk that a company whose members enjoy limited liability may lose money in the ordinary course of its business, they are entitled to protection against reduction of the company's net assets in other ways not specifically authorised by law.[26] However, the effectiveness of the legal rules underpinning the maintenance of share capital doctrine has been questioned by a number of commentators.[27]

A second constraint which operates to protect the interests of creditors is the reputations of the shareholders and the directors of the company with which the creditors are contracting. Shareholders and directors will be reluctant to undertake actions which harm their reputations and which may make it

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20 R Sappideen, "Protecting Debenture Holder Interests: A Delicate Art" (1991) 4 *Corporate and Business Law Journal* 36. For an empirical study of the restrictive covenants contained in Australian trust deeds, see G Whittred and I Zimmer, "Accounting Information in the Market for Debt" (1986) 26 *Accounting and Finance* 19. See also I Ramsay and B Sidhu, “Accounting and Non-Accounting Based Information in the Market for Debt: Evidence from Australian Private Debt Contracts” (1998) 38 *Accounting and Finance* 197.

21 JM Landers, "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" (1976) 43 *University of Chicago Law Review* 527, 529. However, creditors are expected to "price protect" in this situation. In other words, they will require a higher interest rate as compensation for risk which they are unable to ascertain.

22 Ibid.

23 V Brudney, "Corporate Bondholders and Debtor Opportunism: In Bad Times and Good" (1992) 105 *Harvard Law Review* 1821.

24 This has mainly occurred in the United States: WW Bratton, "Corporate Debt Relationships: Legal Theory in a Time of Restructuring" [1989] *Duke Law Journal* 92. A leveraged buyout occurs where existing shareholders of a company transfer control of the company to an outsider. A high level of debt is used to fund the acquisition. Because this debt will be serviced by the acquired company (by cash flows of the business or by disposal of assets) this increases the risk of existing creditors of the company not being paid.

25 See, for example, MW McDaniel, "Bondholders and Stockholders" (1988) 13 *Journal of Corporation Law* 205 (arguing that directors should have a fiduciary duty to deal fairly with all investors in a company - bondholders as well as shareholders because "leveraged takeovers, buyouts and recapitalizations are having a devastating impact on existing bondholders. Stockholders are getting rich in part at bondholder expense"); LE Mitchell, "The Fairness Rights of Corporate Bondholders" (1990) 65 *New York University Law Review* 1165 (supporting fiduciary duties to bondholders on the basis that this would enhance corporate social responsibility); K Lehn and A Poulson, "The Economics of Event Risk: The Case of Bondholders in Leveraged Buyouts" (1990) 15 *Journal of Corporation Law* 199 (arguing against fiduciary duties to bondholders for two reasons. First, such duties would induce additional litigation and more resources would be expended in redistributing wealth among holders of different securities, thereby reducing the documented wealth gains created by leveraged buyouts. Second, market forces compensate bondholders for the risk of leveraged buyouts. If leveraged buyouts increase the riskiness of bonds, then this is reflected in a higher interest rate for the bondholders. In addition, investors can mitigate risk by diversifying and holding both bonds and stocks in their portfolios); TR Hurst and LJ McGuinness, "The Corporation, the Bondholder and Fiduciary Duties" (1991) 10 *Journal of Law and Commerce* 187 (arguing against fiduciary duties on the basis that directors would have the difficulty of serving two masters - bondholders and shareholders - which would undercut their existing fiduciary duty to maximise shareholder returns).

26 Ford, Austin and Ramsay, supra n4, [20.198].

27 See, for example, Ford, Austin and Ramsay, ibid; JA Farrar and BM Hannigan, *Farrar's Company Law* (4th ed, 1998), 171-181.

difficult to raise capital in the future. However, as one commentator observes, this constraint applies only when the present value of maintaining the company as a going concern exceeds the value of the benefits derived from taking action that adversely affects creditors (for example, the payment of excessive dividends).[28]

A final constraint is that, although shareholders may want to take actions which adversely effect creditors, the shareholders may lack effective control over the management of the company because of a separation of ownership and control.[29] However, whether the separation of ownership and control adequately protects creditors is open to question. First, as directors increase the percentage of shares that they own in the company, their incentive to act in the interests of shareholders increases. Second, there is evidence that Australian companies have high ownership concentration. A study of 100 Australian companies listed on the stock exchange found that the five largest shareholders held, on average, 54 percent of the issued shares of these companies.[30] Consequently, the degree to which the separation of ownership and control in Australian companies operates to protect creditors of these companies is an open issue.[31]

It can therefore be seen that the debate on creditor protection is largely unresolved. However, it does not need to be resolved in order to evaluate the merits of section 588G. This is because section 588G does not provide unqualified protection to creditors. It operates only where the company is insolvent. Consequently, the question of creditor protection can be phrased in a more precise way for our purposes. Is creditor protection warranted where the company with which the creditor has contracted is insolvent?

The courts have long recognized that insolvency presents special problems for creditors. While the vexed issue of directors' duties to creditors continues to be debated,[32] there is consensus that the onset of insolvency imposes special obligations upon directors with respect to the interests of creditors. This is best articulated in the judgment of Street CJ in *Kinsela v Russell Kinsela Pty Ltd*:

> "*In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise... But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency or the imposition of some alternative administration.*"[33]

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28 W Frost, "Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups" (1993) 44 *Hastings Law Journal* 449, 483.

29 "This separation of ownership from control redounds to the benefit of creditors. Because managers are heavily invested in the firm and are unable to diversify their firm-specific skills, they are likely to be risk-averse. Thus, while shareholders may desire to increase enterprise risk after the interest rate of debt is fixed, managers may be reluctant to do so. The shareholders' inability to have complete control over the management of the corporate group reduces their opportunity to engage in misappropriations." Frost, ibid, 484-485.

30 I M Ramsay and M Blair, "Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies" (1993) 19 *Melbourne University Law Review* 153. See also G Stapledon, "Australian Sharemarket Ownership" in G Walker, B Fisse and I Ramsay (eds), *Securities Regulation in Australia and New Zealand* (2nd ed, 1998).

31 Increasing ownership concentration of Australian companies may not result in a reduction of the separation of ownership and control if these few shareholders who have the potential to control the companies in which they invest do not actually exercise this control. These large shareholders are typically institutional investors and there are many reasons why such investors do not exercise control over the management of companies in which they invest: Ramsay and Blair, ibid, 179-180. See also G Stapledon, "Disincentives to Activism by Institutional Investors in Listed Australian Companies" (1996) 18 *Sydney Law Review* 152.

32 The cases and issues are evaluated in DA Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand Universities Law Review* 323 and V Finch, "Directors' Duties: Insolvency and the Unsecured Creditor" in A Clark (ed), *Current Issues in Insolvency Law* (1991). See *Spies v The Queen* (2000) 18 ACLC 727 at 731, where the High Court of Australia stated that to the extent that previous cases suggest that directors owe an independent duty to, and enforceable by, creditors, the cases are contrary to principle and do not correctly state the law.

33 (1986) 4 NSWLR 722 at 730. This does not mean that directors owe an independent duty to creditors: *Spies v The Queen*

The reasoning in *Kinsela* provides justification for creditor protection upon corporate insolvency. Shareholders' funds have been dissipated and it is now the creditors' funds which are at risk. However, there is a further justification for creditor protection. We have already observed that one of the problems confronting creditors is excessive risk taking by shareholders.[34] As insolvency approaches, this problem is exacerbated. This is because the shareholders now have an even more powerful incentive to engage in risky investments given that most of their funds have been dissipated yet there is the possibility of a "bonanza payoff that will prevent insolvency".[35]

4 Empirical study and analysis of data

Methodology

Research was undertaken with a view to finding as many Australian insolvent trading cases as possible.

The research was conducted using various text-based and electronic case search engines.[36] The search strings used consisted of relevant phrases, and the relevant section numbers in which the insolvent trading provisions have been contained throughout the various legislative regimes.[37]

The searches referred to above revealed a large number of cases which then needed to be considered for the purposes of determining whether they would be reviewed and form part of this study. The cases selected to form part of the study were those cases in which a final determination was made by the court as to whether insolvent trading had occurred. Common examples of the types of cases that were excluded from the study were interlocutory proceedings in relation to insolvent trading actions (for example, the separate determination of legal questions) and proceedings based on other causes of action but the judgments of which, for one reason or another, contained references to insolvent trading.[38] This process left us with 103 cases forming the basis of the study. As referred to above, it should be noted that the study does not include instances where insolvent trading proceedings were settled, or where directors pleaded guilty to insolvent trading charges.[39] Further, as a result of the methodology and resources used, it is possible that insolvent trading decisions of lower courts may not have been detected.

Each case was read and, for each case, the following 18 questions were, to the extent possible, answered:

1. What section of the legislation was the legal action brought under?

2. Is it a civil or criminal action?

3. Is the judgment by a state court or federal court?

4. If it is a judgment of one of the state Supreme Courts, which state court?

5. Is it a judgment of a court at first instance or a judgment of an appeal court?

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34 See note 17 and accompanying text.

35 R Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] *Journal of Business Law* 1, 3, quoting J Coffee (1986) 85 *Michigan Law Review* 1, 61.

36 Full details of the research methodology are available. Proximity searches were carried out using the following search strings: "Uniform Companies 303" (repeated using 304, 374C and 374D); "Companies Code 556" (repeated using 557), "Corporations Law 592" (repeated using 588G, 588H, 588M, 588V and 588W); "Corporations Act 588G" (repeated using 588H, 588M, 588V and 588W); "insolvent trading"; "trading while insolvent" and "trad* insolv*" (truncated search terms).

37 Proximity searches and truncation were also used where appropriate.

38 Full details of all cases which were uncovered by our research, and subsequently excluded from the study, are available.

39 For example, see ASIC Media Releases 02/208 and 02/188 in relation to the directors of Farmer Furniture Pty Ltd, and ASIC Media Release 02/407 in relation to the director of Twintara Pty Ltd. Both of these cases involved criminal prosecutions.

6. Was the defendant director found liable for insolvent trading?

7. If the defendant director was found liable for insolvent trading, what was the amount of compensation ordered by the Court?

8. Were there any other orders made by the Court?

9. What year was the judgment decided?

10. What type of company does the allegation of insolvent trading apply to?

11. Is it possible to identify the number of shareholders in the company?

12. What sort of business is the company involved in?

13. Who is the plaintiff?

14. What are the key characteristics of the defendant director (i.e. type of director)?

15. Are there any characteristics of the defendant director worth noting, such as age, gender, etc.?

16. What specific action is alleged to be the "incurring of the debt"?

17. Did the defendant director argue any of the defences in section 588H or its predecessors?

18. If any of the defences were argued by the defendant director, was the defence successful?

The results were then collated and are presented below.

Our research is current to 19 February 2004.

Results

The results of the study will be considered by reference to each of the questions/issues listed above. We note the following general comments in relation to the limitations of the results:

(a) it was not possible to answer all of the relevant questions for all of the cases; and

(b) there is some "duplication" in the sense that first instance and appeal decisions in respect of the same case may form part of the study.

Further limitations of the study which are specific to each of the issues considered will be dealt with in the relevant part of the report.

What section of the legislation was the legal action brought under?

The legislative provisions relating to insolvent trading have changed over the years.

Insolvent trading provisions were first introduced by each of the States and Territories in section 303(3) of the uniform *Companies Act* 1961.[40] Section 303(3) only introduced a criminal offence for insolvent trading. The elements of the offence required the person to knowingly be a part of the contracting of a

[40] Coburn, supra n1 at 11.

debt, and that when the debt was contracted there was "*no reasonable or probable ground of expectation*" that the company would be able to pay the debt.[41]

The provision did not initially however provide for a director's personal liability for the debt (except where there was intention to defraud creditors), and the criminal nature of the liability meant that a conviction was of no benefit to unsecured creditors.[42] The subsequent amendments to the regime imposed personal liability on directors if they acted in a manner that resulted in the company incurring a debt without reasonable grounds for believing the debt would be paid (section 304(1A)).[43] However, civil liability could only be established following conviction for the criminal offence. In this regard, creditors were reliant upon the Director of Public Prosecutions ("**DPP**") to prosecute and establish the criminal offence before there was any prospect of civil recovery.[44] Sections 374C and 374D replaced section 303(3), and commenced operation in Victoria in 1966, in New South Wales in 1972, and later in other States. There were only minor differences between these sections, and the focus remained the criminal offence.[45]

Section 556 of the *Companies Code* (introduced by the *Companies Act* 1981) commenced operation in 1982 and was part of a push for a national companies scheme.[46] Section 556(1) made directors and managers personally liable for incurring debts where there were "*reasonable grounds to expect that the company would not be able to pay all its debts when they become due*." The provision allowed proceedings to be brought by a creditor, irrespective of whether the director was previously convicted. Section 556 also introduced the defences to insolvent trading (discussed below).

In a further move towards a national scheme, section 592 of the *Corporations Law* commenced operation in 1991. The provision was drafted in almost identical terms to section 556.[47]

In response to the recommendations of the Australian Law Reform Commission, *General Insolvency Inquiry*, Report No. 45 ("**the Harmer Report**"), significant changes were introduced in a new insolvent trading regime which became operative in 1993.[48] The new provisions became section 588G and related sections of the *Corporations Law*, as introduced by the *Corporate Law Reform Act* 1992 (Cth). Some of the main features of this regime included:[49]

(a) the imposition on directors of a duty to prevent insolvent trading;

(b) new statutory defences;

(c) decriminalisation of the insolvent trading provisions and the introduction of civil penalty orders for the contravention of section 588G in the absence of dishonest intent;

(d) new criminal proceedings (further amendments to which took effect in 2000);

(e) giving liquidators standing to initiate proceedings; and

(f) giving power to the court to make compensation orders in favour of liquidators and creditors.

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41 Ibid, at 12.

42 Ibid.

43 Ibid, at 13.

44 Ibid.

45 Ibid, at 14.

46 Ibid, at 16.

47 Ibid, at 19.

48 Ibid, at 20.

49 Ibid.

The *Corporations Act* came into force in 2001 and contains identical provisions in relation to insolvent trading as those contained in the *Corporations Law*.

Table 2 below represents the number and percentage of cases forming part of the study which were brought under each of the various legislative regimes referred to above.

Table 2: Distribution of cases according to various regimes

Section/Regime	Number of Cases	Percentage
303(3) and related sections of the *Companies Act*	5	4.9%
374C and related sections of the *Companies Act*	15	14.6%
556 and related sections of the *Companies Code*	35	34%
592 and related sections of the *Corporations Law*	25	24.3%
588G and related sections of the *Corporations Law*	17	16.5%
588G and related sections of the *Corporations Act*	2	1.9%
Section 592 of the *Corporations Law* and Section 588G of the *Corporations Law*	3	2.9%
Section 556 of the *Companies Code* and section 592 of the *Corporations Law*	1	1%
Total	103	100%

Table 2 shows that the highest number of insolvent trading actions were brought under section 556 and related sections of the *Companies Code*. The second most commonly used provisions were section 592 and related sections of the *Corporations Law*. The next most commonly used provisions were section 588G and related sections of the *Corporations Law* and a similar number of cases were based on section 374C and related sections of the *Companies Act*. The least commonly used provisions were section 303(3) of the *Companies Act*, and section 588G of the *Corporations Act*. There were also a small number of cases which, because of the various dates on which the relevant debts were incurred and the periods of time in which each of the regimes applied, were based on 2 different insolvent trading regimes.

It is interesting to note that, in the time during which section 556 and section 592 applied (being a total of about 11 years) there were a total of 61 insolvent trading actions. In 1993, in response to the Harmer Report, section 588G and related sections were introduced (along with other reforms to Australia's insolvency laws). In the 11 or so years since the implementation of section 588G, there have only been 19 insolvent trading actions. While we note that there would still be cases relating to section 588G which have yet to be decided, this difference appears significant.

Is it a civil or criminal action?

As discussed above, the initial focus of the insolvent trading provisions was criminal liability. Whilst provisions relating to civil contraventions were subsequently introduced, criminal provisions have continued to exist and have been developed further over the years.

Table 3 below details the number and percentage of cases forming part of the study which involved either civil or criminal proceedings.

Table 3: Distribution of cases according to type of proceeding

Type of Proceeding	Number	Percentage
Civil	88	85.4%
Criminal	15	14.6%
Total	103	100%

Table 3 shows that 85% of the cases forming part of the study were civil proceedings and 15% were criminal proceedings.

However, it should be noted that 11 of the 88 civil cases were cases in which there were previous criminal cases the result of which was a conviction, and the civil proceedings merely involved an application to the court for a declaration that the defendant was liable to pay the amount of the relevant debt to the Plaintiff.

The results contained in Table 3 may be explained by the development of the insolvent trading provisions over the years. All of the criminal proceedings referred to in Table 3 were brought under one of section 303(3), section 374C or section 556, with most of them being based on sections 303(3) and 374C. Indeed, under these provisions, the authorities had little choice other than to bring criminal proceedings, and civil liability could only be established after a conviction was obtained.

The study did not reveal any criminal proceedings under section 592 or section 588G. Whilst section 588G provides for both civil and criminal proceedings, considerations such as the higher burden of proof in relation to criminal prosecutions, and the greater range of relief available in relation to civil proceedings, may prompt authorities to pursue civil proceedings rather than criminal prosecutions.[50]

Is it a judgment of a state court or a federal court?

The Federal Court of Australia was only given jurisdiction in relation to insolvent trading with the introduction of the national *Corporations Law*. Whilst the *Companies Act* and the *Companies Code* were uniform, they were State legislation and the Federal Court of Australia had no jurisdiction under these Acts.

Table 4 below details the distribution of insolvent trading cases between state and federal courts.

Table 4: Distribution of cases between state and federal courts

Jurisdiction	No. of Cases	Percentage
State courts	83	80.6%
Federal courts	20	19.4%
Total	103	100%

[50] Ibid, at 181.

Table 4 shows that about 81% of the cases forming part of the study were heard in state courts, with 19% being heard in federal courts. We note that one of the 20 matters heard in the federal courts was an appeal from a state court which was heard in the High Court of Australia.[51]

When only the post-*Corporations Law* matters are considered, the difference between the number of cases in the different jurisdictions is reduced. Of the 47 cases brought under the *Corporations Law* and the *Corporations Act*, 36% (17 cases) were heard in the federal courts.

If it is a judgment of one of the state courts, which state court?

Table 5 below details the distribution of insolvent trading cases between the various states.

Table 5: Distribution of cases between the States

State	No. of Cases	Percentage
New South Wales	25	30.1%
Western Australia	18	21.7%
South Australia	15	18.1%
Victoria	14	16.9%
Queensland	8	9.6%
Tasmania	3	3.6%
Total	83	100%

The cases represented in Table 5 were each heard in the Supreme Court of each jurisdiction, except for 2 cases in each of New South Wales, Western Australia and Queensland, which were heard in inferior courts in those jurisdictions.

Table 5 shows that 30% of the insolvent trading actions brought in state courts were heard in New South Wales with 22% being heard in Western Australia. South Australia and Victoria had a similar number of actions with 18% and 17% respectively. About 10% of actions were heard in Queensland and 4% in Tasmania. The study did not reveal any insolvent trading actions in the Northern Territory or the Australian Capital Territory.

Is it a judgment of a court at first instance or a judgment of an appeal court?

Table 6 below details the proportion of cases forming part of the study which were trials at first instance, and those which were appeals.

[51] *Shapowloff v Dunn* (1980) 148 CLR 72.

Table 6: Distribution of cases between first instance and appeal

Nature of Case	No. of Cases	Percentage
First instance	67	65%
Appeal	36	35%
Total	103	100%

Table 6 shows that 65% of the cases forming part of the study were first instance trials, and 35% were appeals. It should be noted that one of the cases included in the "first instance" field above was a retrial ordered by an appeal court.[52] Further, the results are also affected by the 11 cases in which declarations were sought to hold directors previously found guilty of insolvent trading liable for the debts involved. Of these 11 cases, 10 were trials at first instance, and 1 was an appeal.

Was the defendant found liable for insolvent trading?

Table 7 below details the number of cases in which the defendant director/s was/were found liable or not liable for insolvent trading.

Table 7: Distribution of cases according to finding

Finding of Court	No. of Cases	Percentage
Liable	77	74.8%
Not liable	25	25.2%
Total	103	100%

In respect of cases where more than one defendant director was involved:

(a) the results in Table 7 do not deal separately with the findings made in relation to each individual director; and

(b) to the extent that there were different findings made against individual directors, if one defendant director was found liable, then that case appears in the "liable" part of the results.

Further, in respect of cases in which the plaintiff/s was/were seeking a declaration that the defendant director/s were liable for the payment of the relevant debts (in relation to which the director/s were previously found guilty of insolvent trading), a finding that the director/s was/were "liable" means that the director/s were ordered to pay the amount of the relevant debt. There were 11 instances of such cases. Similarly, in civil and criminal cases, "liable" means a finding by the court that the elements of the relevant offence or contravention were held to have been satisfied.

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[52] *Southern Star Group Pty Ltd v Byron* (1995) 123 FLR 368.

Table 7 shows that in 75% of the cases forming part of the study, there was a finding that at least one of the defendant directors were liable. In 25% of the cases, none of the defendant directors were found to be liable.

If the defendant director(s) was/were found liable for insolvent trading, what was the amount of compensation ordered by the court?

A fundamental part of the insolvent trading provisions is that the court may order compensation against a director where the debt was wholly unsecured and the person to whom the debt was owed suffered loss or damage as a result of the company's insolvency.[53] The formulation of the provisions means that the amount of compensation ordered to be paid by the defendant directors often equates (if liability is established in relation to each debt) to the amount of the debts incurred.

The cases forming part of the study were examined to determine the amount of compensation, if any, that was ordered in cases in which there was a finding of liability. The qualifications/limitations placed on this part of our enquiry are that:

(a) the amount of compensation ordered by the court in the event that the defendant/s were found liable was not always apparent from the judgment. Where it was possible to provide an estimate of the amount ordered by the courts (for example, by reference to the amount of the debts involved in the case), these figures were used. Where it was not possible to provide an estimate of the amount of the liability, those cases were omitted from the results for this part of the study; and

(b) the cases in which the defendant directors were found guilty of insolvent trading offences were also omitted from this part of the study, as no compensation was awarded in these cases.

Whilst it was common for cases to involve more than one defendant director, and for compensation orders to be made against those directors either jointly or severally, or in separate amounts, the results have been collated with respect to the amount of compensation ordered by the court in the proceeding, rather than against each individual defendant director.

In the cases where the defendant director/s were found liable for insolvent trading, and compensation was ordered, the mean amount of compensation ordered was $1,702,152.32. However, this figure has been skewed by one particularly large judgment of $96,704,998.[54] The minimum amount of compensation ordered in a case was $517.39.[55] The median amount of compensation ordered was $110,597.62.

Compensation was ordered in 66 cases. Table 8 below represents the range of compensation that was payable in the cases.

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53 Sections 588J and 588K.

54 *Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946.

55 *Androvin Pty Ltd v Figliomeni* (1994) 14 WAR 11.

Table 8: Distribution of Cases according to amount of compensation ordered

Range of Compensation	No. of cases	Percentage
$1 - $20,000	11	16.7%
$20,001 - $50,000	8	12.1%
$50,001 - $100,000	12	18.2%
$100,001 - $200,000	11	16.7%
$200,001 - $500,000	17	25.8%
$500,001 - $1,000,000	3	4.6%
$1,000,001 -	4	6.1%
Total	66	100%

Table 8 shows that in 16.7% of the cases in which compensation was awarded, the amount was less than $20,000. Further, in over 64% of the cases, the amount was less than $200,000. Under 11% of the compensation orders made were over $500,000.

Were there any other orders made by the court?

The two main types of other orders which may be made by a court in relation to insolvent trading are:

(a) disqualification orders; and

(b) pecuniary penalties or fines.

The provisions relating to the making of such orders have, like the other insolvent trading provisions, developed over the years. Under the current civil penalty provisions, if the court makes a declaration of contravention,[56] it has the power to:

(a) disqualify a person from managing a corporation;[57] and/or

(b) make pecuniary penalty orders that require a person to pay to the Commonwealth an amount up to $200,000.[58]

Under the earlier insolvent trading provisions (the focus of which was criminal), fines were imposed for offences. Table 9 below shows the number of cases in which other orders were made by the courts.

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[56] Section 1317E.

[57] There are various provisions under which disqualification orders may be made: sections 206C, 206D and 206E.

[58] Section 1317G.

Table 9: Distribution of cases according to the making of other orders by the courts

Were other orders made by the Court?	No. of Cases	Percentage
Yes	7	6.8%
No	96	93.2%
Total	103	100%

For the purposes of this enquiry, awards of legal costs and interest were disregarded.

Table 9 shows that in only 7% of cases forming part of the study were orders other than compensation orders made by the Court. In the 7 cases in which "other orders" were made, those orders consisted of management banning orders and pecuniary penalties or fines. Specifically, 2 of the 7 cases were based on section 588G. In one of those cases, both disqualification orders and pecuniary penalties were imposed,[59] and a disqualification order was imposed in the other.[60] These were the only 2 cases in which management banning orders were made, with the shortest ban being for 4 years[61] and the longest ban being for 12 years.[62]

The other 5 cases in which other orders were made were based on either section 303(3) or section 556, and involved the imposition of fines on the defendant directors. Of those 5 cases, 3 involved the same facts, the decisions in which were appealed several times.[63]

When was the judgment decided?

Table 10 shows the distribution of the years in which courts handed down judgments in relation to insolvent trading.

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[59] *ASIC v Plymin, Elliott & Harrison* [2003] VSC 123 & [2003] VSC 230.

[60] *ASC v Forem-Freeway Enterprises Pty Ltd* (1997) 17 ACLC 511.

[61] *ASIC v Plymin, Elliott & Harrison* [2003] VSC 123 & [2003] VSC 230. One of the defendants in this case was banned from managing a corporation for 4 years while the other two defendants were banned for 7 and 10 years respectively.

[62] *ASC v Forem-Freeway Enterprises Pty Ltd* (1997) 17 ACLC 511.

[63] *Corporate Affairs Commission v Shapowloff* (1974) CLC 40-134 (Sydney Court of Petty Sessions); *Dunn v Shapowloff* (1977-1978) CLC 40-451(NSW South Wales Court of Appeal); *Shapowloff v Dunn* (1980) 148 CLR 72 (High Court). There was one further cases in which the defendant director was acquitted: *Shapowloff v Dunn* (1977-1978) CLC 40-351 (New South Wales Supreme Court).

Table 10: Distribution of insolvent trading judgments across the years

Year of Judgment	No. of Decisions	Percentage
1970-79	10	9.7%
1980-89	16	15.5%
1990-99	62	60.2%
2000-	15	14.6%
Total	103	100%

Table 10 shows that about 61% of insolvent trading cases forming part of the study were decided between 1990 and 1999. The next highest proportion, being about 16%, were decided in 1980-89. The lesser proportion of cases decided since 2000 (about 15%) may be attributable to the fact that a little over 4 years had elapsed to early 2004. The lowest proportion of cases (10%) were decided between 1970 and 1979. Whilst the insolvent trading provisions were introduced in the 1960s, the study did not reveal any cases decided in the 1960s.

What type of company does the allegation of insolvent trading apply to?

Table 11 below shows the type of companies involved in the cases forming part of the study.

Table 11: Distribution of cases according to company type

Type of Company	No. of Cases	Percentage
Private	94	91.3%
Public	8	7.8%
Unknown	1	1%
Total	103	100%

Table 11 shows that about 91% of the companies involved in insolvent trading are private companies, with only about 8% being public companies.

Of the 8 cases involving public companies:

(a) four of the cases involved the same facts scenario, and the appeals process; [64]

(b) one of the cases involved 1 public and 1 private company; [65]

(c) another of the cases involved a non-profit company limited by guarantee; [66] and

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[64] Ibid.

[65] *ASIC v Plymin, Elliott & Harrison* [2003] VSC 123 & [2003] VSC 230.

(d) the other two cases each involved one public company. [67]

Is it possible to identify the number of shareholders in the company?

It was possible to identify the number of shareholders in 16 of the 102 cases (as opposed to 103, as there was one case of a company limited guarantee). In all of those 16 cases, there were 3 or less shareholders, with the average number of shareholders being 1.81. It should be noted that some of those shareholders were themselves companies. There was one further case in which, whilst the exact number of shareholders was not apparent, there were at least 3 shareholders.

What sort of business is the company involved in?

The type of businesses that the companies involved in the insolvent trading cases engaged in were classified according to the Australian and New Zealand Standard Industrial Classification ("**ANZSIC**") used by the Australian Bureau of Statistics. The ANZSIC contains the following 17 divisions:

(a) Agriculture, Forestry & Fishing;

(b) Mining;

(c) Manufacturing;

(d) Electricity, Gas and Water Supply;

(e) Construction;

(f) Wholesale Trade;

(g) Retail Trade;

(h) Accommodation, Cafes and Restaurants;

(i) Transport and Storage;

(j) Communication Services;

(k) Finance and Insurance;

(l) Property and Business Services;

(m) Government Administration and Defence;

(n) Education;

(o) Health and Community Services;

(p) Cultural and Recreational Services; and

(q) Personal and Other Services.

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[66] *Commonwealth Bank of Australia v Friedrich* (1991) 9 ACLC 946.

[67] *Standard Chartered Bank of Australia v Antico* [Nos 1 and 2] (1995) 38 NSWLR 290; *State Government Insurance Corp v Pollock* (1993) 11 ACLC 839.

Table 12 below details the Divisions to which each of the companies involved in the insolvent trading cases belonged. The companies have been allocated to Divisions based on their predominant activities, as apparent from the judgments. In this regard, we note that:

(a) in four of the cases, the judgments have not made it clear what the nature of the company's business was. These cases are accounted for in the "Unclear" field in Table 12; and

(b) in another four of the cases, the judgments indicated that the nature of the relevant company's business fell within more than one of the ANZSIC Divisions, because of a range of business activities, but did not indicate which of the activities were the predominant activities of the company. These cases are accounted for in the following categories, which are combinations of the ANZSIC Divisions:

    (i) Retail Trade and Construction;

    (ii) Manufacturing, Wholesale Trade and Retail Trade;

    (iii) Property and Business Services, and Construction; and

    (iv) Finance and Insurance, and Transport and Storage.

Table 12: Distribution of cases according to ANZSIC Division

Industry Division/s	No. of Cases	Percentage
Agriculture, Forestry & Fishing	2	1.9%
Mining	2	1.9%
Manufacturing	17	16.5%
Construction	23	22.3%
Wholesale Trade	11	10.7%
Retail Trade	17	16.5%
Accommodation, Cafes & Restaurants	2	1.9%
Transport and Storage	5	4.9%
Finance and Insurance	4	3.9%
Property and Business Services	5	4.9%
Education	1	1%
Cultural and Recreational Services	5	4.9%
Personal and Other Services	1	1%
Manufacturing, Wholesale and Retail	1	1%
Retail and Construction	1	1%
Property and Business Services and Construction	1	1%
Finance and Insurance and Transport and Storage	1	1%
Unclear	4	3.9%
Total	103	100%

Table 12 shows that in the cases forming part of the study, the companies which were involved in the insolvent trading were most commonly involved in the business of construction. The next most common type of businesses engaged in were, jointly, retail trade and manufacturing, followed by wholesale trade.

What are the key characteristics of the defendant director? (type of director)

Each of the cases forming part of the study were examined to determine the type of directors/officers involved in the cases by reference to the types of directors/officers recognised by law and commercial practice, both now and historically. Those categories, and brief descriptions/definitions of each, are as follows:

(a) chairmen, who are appointed by the board of directors and have the duty of chairing meetings of directors;[68]

(b) executive directors, who are directors engaged by a company under a contract of employment to perform functions additional to those involved in being a member of the board of directors; [69]

(c) non-executive directors, who are directors who do not take part in the day-to-day management of the company;[70]

(d) de-facto directors, who are acting in the position of director, although not validly appointed to that position. This category includes persons who, under the previous regimes, took part in the management of a company, or was a "manager";[71]

(e) shadow directors, who are persons who have not been appointed to the board, but are directors because the duly appointed directors follow their instructions;[72]

(f) secretaries, who are an officer of the company, appointed by the company's directors, that usually have responsibility for record-keeping within the company;[73] and

(g) alternate directors, who are persons appointed by directors to act for or on behalf of a director when that director is absent or unable to act.[74]

Table 13 below details the frequency with which the various types of directors/officers were involved in insolvent trading cases.

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68 *Butterworth's Encyclopaedic Australian Legal Dictionary*.

69 Ibid.

70 Ibid.

71 Ibid.

72 Ibid.

73 Ibid.

74 Ibid.

Table 13: Distribution of types of directors/officers involved in cases

Type of Director/Officer	No. of Directors/Officers	Percentage
Chairman	5	2.9%
Executive director	71	41.5%
Non-executive director	28	16.4%
De facto director	5	2.9%
Shadow director	1	0.6%
Director & secretary	8	4.7%
Alternate director	1	0.6%
Held not to be a director	10	5.8%
Unclear	42[75]	24.6%
Total	171	100%

Table 13 clearly shows that insolvent trading actions are most commonly brought against executive directors. However, non-executive directors (which were the second most common type of defendants) and other officers of corporations are not immune from such actions.

If the 42 instances where it is not clear what type of director was involved are excluded, then 55% of the remaining 129 directors involved in the cases were executive directors, 21.7% were non-executive directors, 6.2% were both a director and secretary and 3.9% were chairmen.

We note the following in relation to Table 13:

(a) the total number of directors (171) is greater than the total number of cases involved in the study (103), as many cases involved multiple defendants;

(b) to the extent that the nature of the director was explicitly stated, the directors were appropriately allocated. In cases where the matter was not expressly dealt with in the judgment, the judgments were examined to determine what type of director/s was/were involved in the case;

(c) the cases in which the nature of the director's position was not apparent were allocated to the "unclear" category;

(d) there were 8 instances where the defendant was both a director and secretary of the company. There was one case[76] in which one of the defendants was the secretary of the company, but not a director.

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[75] One of these cases in this category involved multiple defendants but it was not apparent how many there were. We have allocated 2 directors to this case.

[76] *New World Alliance Pty Ltd* (receiver and manager appointed); *Re Sycotex Pty Ltd v Baseler* (1994) 122 ALR 531.

That case is accounted for in the "held not to be a director" as the secretary was held not to have participated in the management of the company; and

(e) the only defendant which was held to be a shadow director was a company which held a 42% shareholding in the company.[77]

Are there any characteristics of the defendant director worth noting?

The other characteristics of defendant directors involved in each case were also considered. In particular, the following two matters were examined:

- the gender of the directors; and
- the frequency of cases where the directors of the company were (or included) a husband and wife.

(a) Table 14 below shows the frequency of male and female directors. The total number of directors is considered rather than the total number of cases.

Table 14: Distribution of directors between genders

Gender	No. of Directors/Officers	Percentage
Male	134	78.4%
Female	26	15.2%
Company	5	2.9%
Unclear	6	3.5%
Total	171	100%

Table 14 shows that the clear majority of directors involved in insolvent trading actions are males.

(b) In 14 of the 103 cases, the directors involved in the insolvent trading actions (or some of those directors) were husband and wife. This high rate may be explained by:

(i) the previous legislative requirement that proprietary companies have a minimum of 2 directors, and/or a misapprehension that such a requirement continues to apply; and

(ii) the fact that husbands and wives wish to structure their affairs so that they are both directors of a company that they are involved with.

What specific action is alleged to be the "incurring of the debt"?

The current provisions require (and its predecessors required some variation of) a "debt" to be "incurred".[78] The concept of incurring a debt is fundamental to insolvent trading. However, it is not an

[77] *Standard Chartered Bank of Australia Ltd v Antico* [Nos 1 & 2] (1995) 38 NSWLR 290.

[78] Section 588G(1)(a).

issue between the parties in all insolvent trading cases as there is often no doubt that debts have been incurred.

In the cases where the question of whether a debt has been incurred is in issue, it is often in issue because of the time of incurring the debt (ie. it may have been incurred just prior to the date of insolvency, in which case the defendant directors will not be held liable for it). The specific point or time at which the debt was "incurred" will depend on the nature of the contractual arrangements involved in each case and will, like contractual arrangements, vary between cases. Some examples of points of time at which courts have found debts to have been incurred are:

(a) upon delivery of the goods;[79]

(b) at the time of entry into a lease agreement in relation to unpaid rent, and at the time of default in payment of rent in relation to interest on unpaid rent; [80]

(c) in relation to group tax liability, it was held that it was incurred at the time it fell due, despite the fact that agreement had been reached with the Australian Taxation Office for repayment; [81] and

(d) in relation to amendment to, and a rollover of, a facility agreement, it was held that the debt in relation to the principal was incurred when the original facility was entered into. However, liability for interest was amended subsequently, and it was held that another debt was incurred at the time of the amendment.[82]

As part of our enquiry, we have considered the "type" of debt incurred (ie. purchasing goods), irrespective of whether there was argument in relation to the "incurring" of the debt.

Table 15 below contains details of the "type" of debt incurred in each case. In cases where more than one type of debt was incurred in the case, each type of debt has been accounted for separately below.

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[79] *ASC v Chugg*, 15 April 1994, Supreme Court of Tasmania; *Hussein v Good* (1990) 8 ACLC 390.

[80] *Bans Pty Ltd v Ling* (1995) 13 ACLC 524.

[81] *Milner v Ali* [2000] QDC 107.

[82] *Standard Chartered Bank of Australia Ltd v Antico* [Nos 1 & 2] (1995) 38 NSWLR 290.

Table 15: Distribution of cases according to type of debt incurred

Type of Debt	No. of cases	Percentage
Debts relating to the purchase of goods and/or services by the company	73	63.5%
Debts to a bank or financier	9	7.8%
Property-related debts	4	3.5%
Debts relating to the purchase of shares by the company	6	5.2%
Debts relating to taxation and workers' compensation insurance	5	4.3%
Unclear	18	15.7%
Total	115	100%

Table 15 shows that the debts the subject of the clear majority of insolvent trading cases were debts relating to the supply of goods and/or services to the company. There were a lesser number of cases where the debts involved were debts to banks/financiers, property-related debts, debts relating to investments, and debts relating to taxation and workers' compensation liabilities, with each of those types of debts being involved in a similar number of cases. We note that 2 of the cases in the category of debts relating to the supply of goods and/or services to the company related to the provision of services by sub-contractors.

These results may be explained by:

(a) the frequency with which the various categories occur in the ordinary course of business (ie. a greater number of suppliers of goods and service-providers are necessary for a business to function, as opposed to financiers); or

(b) the structure of transactions in which suppliers of goods or service-providers participate as opposed to that of banks/financiers and taxation authorities. For example, banks, financiers and taxation authorities would often have the status of secured or priority creditors and are more likely to have their debts satisfied in the event of an insolvency of a borrower than a supplier who is often an unsecured creditor.

Did the defendant director argue any of the defences in section 588H or its predecessors?

Similarly to the insolvent trading provisions, the provisions containing the defences to insolvent trading have also developed over the years.

The current defences are contained in section 588H of the *Corporations Act*. The four defences which currently exist are:

(a) that the director had reasonable grounds to expect solvency;[83]

(b) that the director had reasonable grounds to believe that a competent and reliable person was responsible for providing the defendant with information about solvency, and expected solvency on the basis of information provided by that person;[84]

(c) that the director, at the time the debt was incurred, did not take part in the management of the company because of illness or for some other good reason;[85] and

(d) that the director took all reasonable steps to prevent the company incurring the debt.[86]

Table 16 below indicates the number of cases in which the defences were argued.

We note that whilst many of the insolvent trading cases involved arguments as to whether the elements of insolvent trading were satisfied, a "yes" response is only given here in relation to cases in which one or more of the actual statutory defences contained in section 588H or one of its predecessors were argued.

Table 16: Distribution of cases according to whether a statutory defence was argued

Defence Argued?	No. of Cases	Percentage
Yes	65	63.1%
No	38	36.9%
Total	103	100%

Table 16 shows that defences were argued in about 63% (65 cases) of the cases forming part of the study.

10 of the 38 cases in which defences were not argued were cases in which the defendant directors had previously been found guilty of an offence, but where a declaration as to liability was sought. Whilst the defences may have been argued in the criminal case, they were not argued in the cases in which declarations were sought. However, a defence was argued in one such case,[87] with the defendant arguing that, at the time the debt was incurred, the company had reasonable prospects that all of its debts would be repaid. Debelle J stated that such a defence was "*incompetent*", as it sought, "*in effect, to re-litigate the issues under s. 556(1)...*".

If any of the defences were argued, was the defence successful?

Table 17 below details the rate of success in cases in which the defences were argued.

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83 Section 588H(2).

84 Section 588H(3).

85 Section 588H(4).

86 Section 588H(5).

87 *ASC v Snellgrove* (1992) 10 ACLC 1, 542.

Table 17: Distribution of cases according to whether the defence was successful

Defence Successful?	No. of Cases	Percentage
Yes	7	10.8%
No	49	75.4%
Other	9	13.8%
Total	65	100%

Table 17 shows that approximately 75% of defences argued in insolvent trading cases were unsuccessful. Further, we note that the 9 "other" cases consist of the following:

(a) 2 cases in which the defence was successful for one defendant director but unsuccessful for the other defendant director;

(b) 2 cases in which the defence was partly successful in terms of reducing the liability of the defendant director;

(c) 4 cases in which, whilst pleaded, the defence was ultimately unnecessary as the elements of insolvent trading were not made out; and

(d) one case in which the defence was unsuccessful for one defendant director, and unnecessary for the other, as the elements of insolvent trading were not made out in relation to that director.

Who is the plaintiff?

With the development of the insolvent trading provisions, standing to bring insolvent trading proceedings expanded over the years. Under the initial criminal provisions, only the Crown or the DPP and the corporate regulator of the day had standing to bring proceedings. The standing of the corporate regulator also expanded over the years with the development of the various types of insolvent trading proceedings. The standing initially given to creditors was restricted in the sense that creditors had to rely on the DPP to first obtain a conviction before creditors could bring civil recovery proceedings. Liquidators were given standing to initiate proceedings in 1993.

Table 18 below details the frequency with which each of the possible "plaintiffs" featured in the cases forming part of the study.

Table 18: Distribution of cases according to plaintiff

Plaintiff	No. of Cases	Percentage
Creditor/s	62	60.2%
Corporate Regulator	17	16.5%
Crown / DPP	7	6.8%
Liquidator / Company	16	15.5%
Other	1	1.0%
Total	103	100%

Table 18 shows that in about 60% of cases forming part of the study, a creditor/s was/were the plaintiff/s. The next most common plaintiff was the relevant corporate regulator of the day, which were involved in about 17% of cases (17 cases). Of those 17 cases:

(a) the Australian Securities Commission was the plaintiff in 3 cases;

(b) the Australian Securities and Investments Commission was the plaintiff in 1 case;[88]

(c) the National Companies and Securities Commission was the plaintiff in 1 case;[89] and

(d) the plaintiffs in the other 12 cases were the relevant state Corporate Affairs Commissions, which operated under the *Companies Acts* regime. Of those 12 cases, 7 cases were brought by the New South Wales regulator, 3 cases by the Western Australian regulator and 2 cases by the South Australian regulator.

The liquidator or the company was the plaintiff in almost 16% of cases, and the Crown/DPP was the least active plaintiff.

One of the 62 cases in which a creditor was the plaintiff was a case where one of the defendant directors was cross-claiming for contribution from other directors in a case where the plaintiff was a creditor. The plaintiff in the "other" case was a trust established under legislation to compensate consumers suffering loss where money had been prepaid to travel agents.

Interestingly:

(a) 92% of the actions initiated by creditors related to legislation existing prior to the implementation of the Harmer Report's recommendations (i.e. prior to section 588G).[90] Conversely, only 8% of the actions initiated by creditors related to post-Harmer Report legislation; and

[88] *ASIC v Plymin, Elliott & Harrison* [2003] VSC 123 & [2003] VSC 230.

[89] *Williams v National Companies & Securities Commission*; *Lockyer v National Companies & Securities Commission* (1990) 2 ACSR 131.

[90] Cases initiated by creditors and relating to debts incurred under both pre- and post-Harmer Report recommendations have been ignored for the purposes of this statistic. There were 2 such cases.

(b) 25% of the actions initiated by liquidators related to legislation existing prior to the implementation of the Harmer Report's recommendations.[91] Conversely, 75% of the actions initiated by liquidators related to post-Harmer Report legislation.

[91] All of these cases were cases seeking declarations that directors were personally liable in respect of debts previously the subject of guilty findings in criminal proceedings.