Bills Committee
on Companies (Corporate Rescue) Bill

Insolvent Trading Provisions and
Experience in Australia and the United Kingdom

This paper sets out the target group of the proposed insolvent trading provisions (the provisions) in the Companies (Corporate Rescue) Bill (the Bill) and the experience of Australia and the United Kingdom in the implementation of similar provisions.

Target Group of the Provisions

2. Where a company goes into liquidation and the liquidator of the company is satisfied that the company engaged in insolvent trading, the liquidator of the company may make an application to the court to declare that a responsible person or former responsible person is liable for insolvent trading.

3. In this context, "insolvent trading" means the company incurs debts or liabilities after the company has become insolvent (i.e. unable to pay its debts as when they become due and owing). "Responsible person" means a director or shadow director of the company; or a manager of the company who is involved to a substantial or material degree in directing the company's business or affairs and who knows, or ought reasonably to know, the company's solvency position.

4. The court shall declare a responsible person or former responsible person liable for insolvent trading if, but only if, it is satisfied that –

(a) the company engaged in the insolvent trading;

(b) the responsible person or former responsible person was a responsible person at the time that the insolvent trading occurred; and

(c) the responsible person has the required knowledge about the insolvency of the company and he failed t o take any steps to prevent the insolvent trading.

5. The court shall not make such a declaration if the responsible person satisfies the court that he took every step with a view to minimizing the potential loss to the company's creditors as h e ought to have taken. Neither shall the court make the declaration if the responsible person was a member of the senior management of the company and satisfies the court that before the insolvent trading occurred, he issued a pre scribed notice to the board of directors of the company stating that the company is engaging in, or is about to engage in, insolvent trading.

6. There is also a provision to the effect that where in any proceedings against a responsible person it is shown to the satisfaction of the court that the company, on any date within the 12 months period immediately preceding the date of commencement of the winding up of the company, was insolvent or failed to keep proper accounts, it shall be presumed in those proceedings, unless the contrary is shown, that the company remained insolvent from the first-mentioned date to and including the second-mentioned date.

7. Where the court makes a declaration in respect of a responsible person or a former responsible person, it may order the person to pay such compensation to the company as the court thinks proper.

Experience in Australia

8. In Australia, the insolvent trading provisions, enacted in 1993, are set out in section 588G of the Australian Corporations Act. This section applies if –

(a) a person is a director of a company at the time when the company incurs a debt; and
(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
(d) that time is at or after the commencement of the Act.

There is also a provision that is similar to the presumption provision in our Bill (see paragraph 6 above).

9. The term "insolvent" is defined with reference to the inability to pay all debts as and when they become due and payable. There are some Australian judicial dec isions on the wording of section 588G, in relation to the definition of 'insolvent' and the meaning of 'incurring a debt', which indicate that the courts are prepared to take different factors into account an d that the ability to pay debts as they fall due is not a simple mechanical test of assets over liabilities. Some of these authorities are set out below –

(a) In Bank of Australasia v Hall (1907) 4 CLR 1514, the question is not whether the debtor would be able, if time were given to him, to pay his debts out of his assets (the balance sheet test) but whether he is presently able to do so with moneys actually available;
(b) In Rees v Bank of New South Wales (1964) 111 CLR 210, solvency was not determined solely to be cash on hand but included

other factors such as the ability to raise finance through the sell ing or mortgaging of assets;

(c) In Sandell v Porter (1966) 115 CLR 210, insolvency did not mean a temporary cash crisis but required a consideration of all of the debtor's circumstances; and

(d) In Dunn v Shapowloff (1978) ACLC 159, the court interpreted the words "ability to pay" by applying a commercia l reality test: "What will constitute ability to pay must be determined in a realistic way by reference to the facts of each case after taking into consideration, inter alia, the company's assets and liabilities and the nature of them and the nature and circumstances of the company's activities."

It is likely that the Hong Kong courts will use these Australian authorities as precedents in determining whether or not a company was insolvent.

10. In the Australian legislation, there are criminal and civil aspects of actions against directors (whereas our Bill provides for civil actions against responsible persons). Where a director allows a compa ny to trade while insolvent, and this is done knowingly, intentionally or recklessly and was either dishonest with a view to gaining advantage or was intended to deceive or defraud someone, then the director is guilty of a criminal offence. A convicted director is prohibited from managing a company for 5 years. The maximum penalty payable is A$200,000 and/or imprisonment for 5 years.

11. Civil penalties are similar to criminal penalties, but do not include an automatic disqualification. A director may also be ordered to pay compensation.

12.

The insolvent trading provisions target directors only. A liquid

ator or, in limited circumstances, a creditor may sue a director for compensation. The Australian Securities and Investments Commission (ASIC) also has the power to take actions for insolvent trading. Australian commentators have noted that the new ASIC Chairman has, in recent times, taken a tough stance on insolvent trading. Creditors may also take proceedings against directors for insolvent trading with the consent of the liquidator or of the court. The amount recoverable is limited to loss and damage suffered by the creditor, which would usually be equal to the debt due.

13. On defences, they are provided for in section 588H of the Australian Corporations Act, which include –

(a) reasonable grounds to expect the company was solvent;

(b) information as to solvency from another person;

(c) the director did not take part in the management of the company; and

(d) reasonable steps were taken to prevent the incurring of a debt.

The Australian courts seem to have taken different approaches to these issues. In some cases, the court adopted a more liberal approach while in some others, it adopted a more restrictive one[1].

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[1] There appears to be three approaches. The so-called liberal approach which takes the view that the words "reasonable grounds to expect the company was solvent " required a blending of subjective and objective considerations. A director would need to show that "he had no cause or reasonably grounded belief in the whole of the circumstances then existing as he knew them to expect that the company would not be able to pay all its debts as and when they became due or that if the company incurred that debt it would not be able to pay all its debts as and when they fell due". [Carruthers J in *Pioneer Concrete Pty v Ellston* 10 ACLR 289] A second and narrower approach adopted is whether or not there were reasonable grounds to expect that the company would not be able to pay all its debts depended on the director's knowledge at the relevant time and the grounds of expectation were considered objectively. [Hodgson J in *3M Australia Pty Ltd v Kemish* (1986) 4 ACLC 192-3] The third approach is that a defence would only be made out

14. Since the introduction of the insolvent trading provisions in 1993, there have not been many cases and the first court decision was handed down in 1997. Australian commentary has noted that the provisions are not often invoked by liquidators because there are often insufficient funds available within the company to fund and sustain proceedings or to ensure that a liquidator's fees and costs are covered. It is, however, noted that there has been a rise in the number of insolvent trading actions in the past few years as a result of actions by the ASIC and litigation funding.

Experience in the United Kingdom

15. In the United Kingdom (UK), the wrongful trading provisions are contained in section 214 of the Insolvency Act 1986. In brief, wrongful trading occurs when the directors of a company continue to trade when they should have realised that there was no prospect of avoiding insolvent liquidation and do not act to minimise losses and the company then goes into liquidation.

16. Only the liquidator of a company in a winding-up may take action in respect of wrongful trading, which is limited to civil action against directors. The operation of section 214 is triggered where a liquidator can establish that at some time before the commencement of the winding-up, a director knew or ought reasonably to have concluded that there was no reasonable prospect t hat the company would avoid going into insolvent liquidation. For the purposes of the section, a compan y goes into insolvent liquidation if it goes into liquidation at a time when

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if the director were able to prove that he had no reasonable cause to believe that the company was insolven t. [Ormiston J in *Statewide Tobacco Services Ltd v Morley* (1990) 8 ACLC 371]

its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding-up. Because of this approach, the UK legislation does not need to include a presumption provision similar to the one in our Bill (see paragraph 6 above).

17. This approach is different from our approach as set out in paragraph 4 above (which relates to whether the company incurs debts after the company has become insolvent and the responsible person has the required knowledge about the insolvency of the company and failed to take any steps to prevent the insolvent trading).

18. If the company continues to trade after the point where the court considers that the director should have concluded insolvent trading was inevitable, then the court must be satisfied that the director took every step thereafter with a view to minimising the potential loss to the company's creditors that he ought to have taken, otherwise wrongful trading will be established and the director may be ordered to contribute to the assets of the company for the benefit of the creditors.

19. On defences, a director will escape liability if he can show that he took every step with a view to minimising loss to creditors after he concluded, or should have concluded, that the company could not have avoided insolvent liquidation.

20. The UK legislation does not specify what "every step" would include but put down the standard against which the director's conduct has to be measured as that of a "reasonably diligent person" having both -

(a) the minimum level of competence which every reasonably diligent director will be presumed to possess; and

(b) the level of competence that that director has.

A similar approach is adopted in our Bill.

21. The first reported case in the UK was Re Produce Marketing Consortium Ltd. [1989] 5 BCC 569, followed by Re DKG Contractors Ltd. [1990] BCC 903 and Re Purpoint Ltd. [1991] BCC 121. In each case, the directors were required to make a contribution to the assets of the company and there was no evidence of dishonesty. These decisions were e ncouraging for liquidators and creditors.

22. A number of cases in the 1990s saw a change in judgements handed down by the court. The two cases Re M C Bacon Ltd. (No. 2) [1990] BCC 430 and Re Oasis Merchandising Services Ltd. [1997] 1 All ER 1009 in particular had made the funding of pursuing a wrongful trading claim difficult unless the creditors of the company were willing to provide financial support. The court in the said two cases basically decided that the liquidator could not seek repayment of costs incurred by him or ordered against him from the company's assets as liquidation expenses if the wrongful trading claim was unsuccessful; he could not assig n the right to take wrongful trading action to another person and that the pro vision of fund by a third party to enable a claim to be made was unlawful. In this r egard, the law is still developing.

Financial Services Bureau

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