Director liability for uncommercial transactions: Is s 588G(1A) impotent to provide liquidators the means to seek compensation for creditors?

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It more than 10 years since the addition of uncommercial transactions to the table of deemed "debts incurred" in s 588G(1A) of the Corporations Act 2001 (Cth) (the Act). What, if anything, has this sub-section achieved? One could be forgiven for answering: "not a great deal". What follows is a possible explanation of why this has been so, and what needs to be done to enable this aspect of Australia's insolvent trading laws to operate effectively and as originally intended.

The Corporations Law Amendment (Employee Entitlements) Act 2000 (Cth) amended s 588G(1A) in order to "deem that a company incurs a debt for the purposes of the insolvent trading provisions when it enters into an uncommercial transaction, thereby extending the current duty on directors not to engage in insolvent trading."[1]

The 2000 amendment added uncommercial transactions as a seventh item to a table of deemed incurred debts in s 588G(1A). This table of debts incurred for the purposes of s 588G also includes payments of dividends (item 1), reduction of share capital (item 2) share buy-backs (item 3), redemption and issue of redeemable preference shares (items 4 and 5) and financial assistance in the acquisition of shares in the relevant company or its parent (item 6).

As one commentator noted at the time, the addition of uncommercial transactions to s 588G significantly broadened the ambit of a director's statutory duty to prevent insolvent trading.[2] On its face, s 588G(1A) renders directors personally liable for their failure to prevent companies entering into uncommercial transactions within the meaning of s 588FB of the Act. However, there is little or no case law reflecting the application or use of s 588G(1A) by liquidators, nor any substantive judicial consideration of the provision and its remedial consequences. It appears that s 588G(1A) has only received what could best be described as "judicial mention" in a few cases where the provision was not central to the matters in issue (indeed, where no questions of insolvent trading even arose).[3]

Legislative intent of s 588G(1A)

It appears that Parliament envisaged that s 588G(1A) would enable the recovery by a liquidator of compensation for loss or damage attributable to a s 588G(1A) "debt" (eg, an uncommercial transaction) in the same manner as any other ordinary debt. Paragraph 10 of the relevant Explanatory Memorandum states that:[4]

> ***The inclusion of uncommercial transactions in section 588G(1A) has implications for*** the protection of employee entitlements, the prosecution of directors involved in "phoenix" activity and ***recovery actions by liquidators for the benefit of creditors generally***. The amendment has general application to all uncommercial transactions, and is not restricted … (emphasis added).

In 2002, Morrison commented that:[5]

> It seems fairly clear then, that the introduction of uncommercial transactions to s 588G(1A) has the legislative intent of making directors personally liable where they voluntarily cause the company to make such transactions. Therefore in addition to the operation of s 588FB uncommercial transactions provision, directors now have a duty not to engage in uncommercial transactions. Further it seems that this will cover a variety of possible transgressions that go beyond the purely financial payment of a debt.

Seeking compensation for a contravention of s 588G in relation to a s 588G(1A) "debt"

While the purpose of the table of deemed incurred debts in s 588G(1A) is clear, there is a significant problem with the sub-section's interaction with the provisions of Subdiv A of Div 4 of Pt 5.7B of the Act which lay down the proceedings which can be brought against directors who have contravened the s 588G duty to prevent insolvent trading. In terms of civil consequences, if a director contravenes the duty to prevent insolvent trading then that director is exposed to either:

- a proceeding brought by a liquidator under s 588M of the Act for compensation (a creditor may also bring such proceedings against the director under s 588M with the consent of the liquidator: s 588R); or

- an application by the Australian Securities and Investments Commission (ASIC) for a civil penalty order under s 1317E and with it a pecuniary penalty order or disqualification, in which case the court is empowered under s 588J to also order that the director pay compensation.

In both cases, the compensation which may be ordered under ss 588M or 588J to be paid by the transgressing director is equal to the loss or damage that the relevant creditor has suffered in relation to the debt which the director failed to prevent being incurred, thereby constituting a contravention of s 588G. But just who are the creditors for each of the deemed incurred debts enumerated in s 588G(1A)? The failure of s 588G(1A) to deem a respective creditor for each those deemed debts means that ss 588M and 588J are arguably ineffective in providing a compensatory remedy for a director's contravention (insofar as such contravention entails a failure to prevent one of the s 588G(1A) "debts" from being incurred).

To take the example of an uncommercial transaction prior to the commencement of a liquidation, s 588G(1A) will deem the transaction to be a debt incurred at the time when the transaction was entered into. If a liquidator then sought to bring an action to recover compensation for and on behalf of the company (for the benefit of its creditors) the liquidator will need to negotiate (indeed, rely upon) the relevant terms of s 588M:

> **Section 588M: Recovery of compensation for loss resulting from insolvent trading**
>
> (1) This section applies where:
>
> (a) a person (in this section called the ***director***) has contravened subsection 588G(2) or (3) in relation to the incurring of a debt by a company; and
>
> (b) the ***person*** (in this section called the ***creditor***) ***to whom the debt is owed has suffered loss or damage in relation to the debt*** because of the company's insolvency; and
>
> (c) the debt was wholly or partly unsecured when the loss or damage was suffered; and
>
> (d) the company is being wound up;
>
> whether or not:
>
> (e) the director has been convicted of an offence in relation to the contravention; or
>
> (f) a civil penalty order has been made against the director in relation to the contravention.
>
> (2) ***The company's liquidator may recover*** from the director, as a debt due to the company, ***an amount equal to the amount of the loss or damage***.
>
> (emphasis added)

In the case of an uncommercial transaction (indeed for all s 588G(1A) "debts") it can be seen that it is difficult to specify the identity of the relevant creditor for the purposes of s 588M(1)(b). Similarly, for the purposes of ss 588M(1)(b) and 588M(2), it would be difficult to specify with any precision the loss or damage suffered by an unspecified (indeed non-existent) creditor.

It is settled law that in the event of upholding a contravention of s 588G, the court will examine and determine the loss and damage suffered by the specific creditors whose debts have comprised the contravention. The matters set out in ss 588M(1)(a), (b) and (c) are "prerequisites" to a compensation order.[6] This may even involve deducting from the incurred debts any dividends received by the respective creditors for their provable claims.[7] This loss and damage — sustained by discrete creditors in relation to their discrete debts — will constitute the compensation payable under either s 588M (liquidator action) or 588J (ASIC action). Given this creditor-specific method of assessment, it is somewhat curious that such compensation is recovered by a liquidator as a debt due to the company, usually for the benefit of all unsecured creditors in the winding up generally.[8]

If s 588G(1A) were somehow construed to facilitate recovery actions by liquidators for compensation for the benefit of creditors, presumably it would be on the basis that it is creditors as a whole who suffer loss or damage as a result of, say, an uncommercial transaction (eg, where the company has divested itself of property on uncommercial terms such as inadequate consideration). Insofar as s 588G(1A) deems an uncommercial transaction to be a debt incurred, it might be faintly arguable that ss 588M and 588J should be read in this manner (though for the reasons discussed above this would appear to be something of a stretch).

The statute is also silent as to the manner of assessing such compensation. Is it appropriate to conduct the sort of exercise undertaken by a court in fashioning a s 588FF order to remedy a s 588FB uncommercial transaction — ie, to arrive at an amount which represents the immediate "net benefit" provided by the company under the transaction — or is some broader assessment of loss and damage called for? Under s 588FF (described by one judge as a "remedial smorgasbord"),[9] a court may require a person to pay to the company an amount "that in the court's opinion, fairly represents some or all of the benefits that the person has received because of the transaction".[10] Is this the amount which a director should be ordered to pay under s 588M for a contravention of s 588G in respect of a s 588G(1A) deemed debt, or should such a compensation order be limited to the loss caused to the relevant creditors under s 588M(1)(b) by reason of the transaction? The two approaches may not always yield the same quantum.[11]

The silence and inadequacies of the statute on these issues present real problems for a liquidator seeking to obtain compensation from a director for an insolvent trading contravention relating to a debt deemed to have been incurred under s 588G(1A).

On the other hand, if ASIC (rather than a liquidator) applies for a civil penalty order, then s 1317H provides that a court may order the director to compensate the corporation for damage suffered by the corporation as a result of the relevant contravention. For debts incurred in contravention of s 588G which are not within the categories of deemed debts in s 588G(1A), this section would be unnecessary to invoke in light of ss 588J (referred to above). However, if it is a s 588G(1A) "debt" which is the subject of a director's contravention, s 588J will bear the same difficulties as s 588M (discussed above). In this circumstance, s 1317H may assist ASIC in a manner not available to a liquidator proceeding under s 588M. A contravention of s 588G for a debt incurred under s 588G(1A) would be a case of a s 588G contravention resulting in a loss to the corporation (as opposed to a creditor) and s 1317H will be available to ASIC.

Why an ineffectual s 588G(1A) denies liquidators what would otherwise be a preferable option to pursue directors for uncommercial transactions

Does it really matter if s 588G(1A) has these problems? In the event of an antecedent uncommercial transaction, a liquidator may also have recourse to a general law action for breach of a director's duty to act in good faith and in the interests of the company, or for a breach of the equivalent statutory duty under s 181 of the Act. However, s 588G could provide better prospects to a liquidator to seek redress for an uncommercial transaction if the associated compensation (remedial) provisions do in fact work. The effectiveness of s 588G(1A) therefore matters, because s 588G could reach to instances which will not always be actionable as a breach of a director's fiduciary or other statutory duties. Indeed, this was presumably part of the reasoning behind Parliament seeking to broaden the provision by deeming a variety of incurred debts in s 588G(1A).

A director's duty under s 588G extends responsibility for inaction and is therefore a more stringent or onerous duty than that owed by a director at general law or under s 181. The s 588G duty is breached by a director failing to prevent the company entering into the uncommercial transaction. On the other hand, a breach of s 181 of the Act (or the general law) would appear to require some level of involvement on the part of the director in the company's decision to enter into the transaction or its implementation. There is authority for the proposition that s 181 is only contravened where there is deliberate engagement in conduct with knowledge that it is not in the company's interest.[12] In many cases an uncommercial transaction may entail a clear contravention of both duties. However, in some circumstances a director could successfully defend an alleged breach of his/her s181 duty but be still vulnerable (under s 588G) to an alleged failure to prevent the uncommercial transaction having been entered into at a time when the company was insolvent. There may also be circumstances (though probably rare) where a transaction may be characterised as uncommercial for the purposes of s 588FB, but not sufficiently devoid of corporate benefit to constitute a breach of s 181. In *Tosich Constructions Pty Ltd v Tosich*,[13] Lehane J stated (in obiter) that it may not stand as a truism to say that a transaction for value can never be an uncommercial transaction within the meaning of s 588FB.[14]

Further, it stands to reason that a director of an insolvent company will carry a heavier burden in making out a "reasonable grounds" (to suspect solvency) defence under s 588H(2) than will a counterparty to an uncommercial transaction seeking to mount a "no reasonable grounds to suspect insolvency" defence under s 588FG(2). (Section 588FG(2) comes into play if a liquidator sues under ss 588FE and 588FF of the Act.) It stands to reason that a counterparty to an uncommercial transaction may be less "infected" with knowledge or grounds for suspicion of the company's circumstances when compared with the corporate knowledge of the subject company's director. While the beneficiary of an uncommercial transaction may in any event struggle to show valuable consideration (another necessary element of the s 588FG(2) defence), it could argue a change of position in support of the defence.

This analysis of Parliament's original rationale for adding uncommercial transactions to the table of deemed incurred debts in s 588G(1A) is reinforced by the Explanatory Memorandum to the Corporations Law Amendment (Employee Entitlements) Act 2000 (Cth). Paragraphs 6 to 9 of the Explanatory Memorandum noted the recourse of liquidators to the ordinary uncommercial transaction provisions in Pt 5.7B of the Act and that:

> ... such claims by liquidators [against persons who receive the benefit of the uncommercial transaction] are subject to a number of defences; for example, where a person entered into the transaction in good faith and had reasonable grounds to expect that the company was solvent.[15]

The Explanatory Memorandum also noted that there was:

> ... no duty on directors not to engage in a non-debt uncommercial transaction where the company is or becomes insolvent, and no penalty for doing so...

and that this would be addressed by:

> ... deeming that a company incurs a debt when it enters into an uncommercial transaction (as defined under the voidable transaction provisions) for the purposes of the insolvent trading provisions.[16]

By failing to address the inadequacies of the remedial provision for liquidators, the 2000 amendments may not have strengthened the insolvent trading laws in the far-reaching manner Parliament apparently intended.

Conclusion

If the relevant statutory framework does enable a liquidator to seek compensation from a director under s 588M for an uncommercial transaction of an insolvent company, the director may often be the preferred target of a liquidator's claim rather than the counterparty actually advantaged by the transaction. That is to say, liquidator action under s 588M could be preferable to the customary s 588FF proceeding. However, it is doubtful whether ss 588G(1A) and 588M can effectively operate together in this manner. The best that can be said for the compensatory consequences of s 588G(1A) "deemed debts" is that if ASIC initiates proceedings against a director for insolvent trading (a rare event) then there will be a compensatory remedy for the company's loss in the form of s 1317H of the Act.

Given the apparent objectives of the legislature in introducing and extending s 588G(1A) to broaden the consequences for directors who are responsible for insolvent trading, some statutory refinement is required to ensure that the provision achieves its intended effect. Section 588G(1A) could be amended to deem a company's creditors as a whole to be "the creditor" for the purposes of s 588M(1)(b). Alternatively, a remedial provision along the lines of s 1317H could be introduced to enable a liquidator to recover compensation from a director for loss or damage suffered by the company by reason of the incurring of s 588G(1A) "debts".

If liquidators are unable to wield a right of action with a plain and uncontroversial compensatory remedy, s 588G(1A) may continue to remain little more than ineffectual window-dressing for Australia's insolvent trading laws. That said, in light of the ongoing debate about these laws — already viewed by some as too strict — it may be that a good number of stakeholders will be content to let sleeping dogs lie.

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Footnotes

1. Corporations Law Amendment (Employee Entitlements) Bill 2000, Explanatory Memorandum, (Outline) p 2.
2. Morrison D, "The addition of uncommercial transactions to s 588G and its implications for phoenix activities", (2002) 10 *Insolvency Law Journal* 229.
3. *Heesh v Baker* (2008) 67 ACSR 192; [2008] NSWSC 711; BC200806511, *Bluebottle UK Ltd v DCT* (2007) 232 CLR 598; 240 ALR 597; [2007] HCA 54; BC200710515 and *Re George Raymond Pty Ltd; Gilbertson v Salter* (2000) 36 ACSR 381; 19 ACLC 553; [2000] VSC 531; BC200007909. In *Heesh v Baker*, Barrett J noted that s 588G(1A) "deems particular actions to be the incurring of a debt by a company" and that "[t]he deeming is solely for the purpose of s 588G", but then stated that the provision was "irrelevant to the present inquiry."
4. Explanatory Memorandum, Corporations Law Amendment (Employee Entitlements) Bill 2000, para 10; Morrison, above note 2, 232.
5. Morrison, above note 2, 233.
6. *ASIC v Plymin (No 2)* (2003) 21 ACLC 1237; [2003] VSC 230; BC200303372 at [18]. Mandie J described ss 588J(1)(a)–(c) as "prerequisites" to a compensation order in respect of what was an ASIC-initiated proceeding and the same naturally holds true for the four matters required by ss 588M(1)(a)–(d). Section 588M mirrors much of s 588J but for the fact that s 588J(1) does not require that the company is being wound up.
7. *Australian Securities and Investments Commission (ASIC) v Plymin (No 2)* (2003) 21 ACLC 1237; [2003] VSC 230; BC200303372 at [104]–[105] (the compensation order was not disturbed on appeal: *Plymin v ASIC* (2004) 10 VR 369; 205 ALR 594; [2004] VSCA 54; BC200401688).
8. Section 588M(2) provides that compensation is recovered from the director "as a debt due to the company". Subject to s 556 priority claims, this compensation will be used to pay provable debts proportionately unless the court disturbs this position by making an order under either s 564 (order in favour of certain creditors) or s 588Y (subordinating the debt of a creditor who knew the company was insolvent when the company incurred a debt for which compensation is ordered). For a recent example of a s 564 order in favour of creditors who funded the liquidator's recovery action against directors for various breaches of duties, see *Lombe, in the matter of Babcock & Brown Ltd (In Liq)* [2012] FCA 107.
9. *McDonald v Hanselmann* (1998) 144 FLR 463; 28 ACSR 49 at 57; [1998] NSWSC 171; BC9801772 (Young J).
10. Corporations Act 2001 (Cth), s 588FF(1)(c).
11. *In New Cap Reinsurance Corporation Ltd v Grant* (2009) 257 ALR 740; 72 ACSR 638; [2009] NSWSC 662; BC200906003 at [66] Barrett J considered the appropriate interest award under s 588FF(1)(c) and stated: "Such a sum will not be, in concept, compensation to [the company] for having been kept out of its money. It will represent, rather, re-allocation of a benefit of the kind with which s 588FF(1)(c) is concerned." His Honour later stated (at [72]) that "[b]ecause the interest element will be awarded under s 588FF(1)(c), it is not

appropriate to approach quantification on the basis of deprivation suffered by [the company]" and that "the focus must be on the "benefits" that the defendants received".

12. See *Australian Securities & Investments Commission (ASIC) v Maxwell* (2006) 59 ACSR 373; 24 ACLC 1308; [2006] NSWSC 1052; BC200608176 at [109] (Brereton J). Brereton J held that "[i]n this context, absence of good faith requires much more than negligence."
13. *Tosich Constructions Pty Ltd v Tosich* (1997) 23 ACSR 466; 15 ACLC 637; BC9701310.
14. Above, 474 (Lehane J). Noting paragraph (d) of s 588FB(1), His Honour stated that a question in the case "which was not explored, but which could conceivably, in a case such as this, give rise to other relevant matters is the relationship between insolvency, or perhaps the view of its solvency or otherwise which a reasonable person would have taken in the company's circumstances at the time, and what a reasonable person might be expected to have done." His Honour stated that he mentioned these matters only to demonstrate why he rejected the submission "that a transaction for which value is given (including by way of the reduction of a debt) cannot be an uncommercial transaction." His Honour considered that "[i]t is by no means impossible, I think, to conceive of circumstances in which it could be one."
15. Explanatory Memorandum, Corporations Law Amendment (Employee Entitlements) Bill 2000, para 7.
16. Above, para 8.