

## Commercial Dispute Resolution & Litigation Newsletter



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**M**arsdens Law Group takes pride in keeping our clients informed of all the latest developments in the law, changes to the law and recent case decisions.

Commercial Dispute Resolution and Litigation covers many areas of the law including corporate, commercial, insolvency and contract disputes.

This update is designed to bring to your attention issues which we believe may be of interest to you.

### TRADING WHILST INSOLVENT

This is a topical issue in the current economic climate. It is crucial that directors monitor the financial position of a company regularly to avoid potential liability for insolvent trading.

Directors have a legal duty to prevent a company from incurring debts whilst it is insolvent under the *Corporations Act 2001* (Cth). A company will be insolvent when it is unable to pay all debts, as and when they become due and payable.

If a director allows a company to trade whilst it is insolvent, a liquidator or creditor may bring proceedings against the director personally. This will apply even if the director did not know that the company was insolvent and where a reasonable person in a like position in the company's circumstances would have known.

If a director is found to have allowed the company to trade whilst insolvent, the Court may order the director to pay compensation to the company. The Court may also order the director to pay a fine or disqualify the director from managing corporations. If the director cannot pay all the compensation that is required of him/her a liquidator may also seek to recover the compensation from a related entity of the insolvent company.

At present, ASIC is looking more closely into insolvent trading and at prosecuting directors who breach the duty. Recent prosecutions have involved criminal offences where a director may be liable for a fine of up to \$220,000 or up to 5 years imprisonment.

*Australian Securities and Investments Commission v Plymin (No 1)* (2003) 46 ACSR 136 is a leading case in this area which highlights some of the common indicators of insolvency. They are:

- continuing trading losses
- liquidity ratios below one
- overdue federal and state taxes
- poor relationship with bank, including inability to borrow further funds
- no access to alternative finance
- inability to raise further capital
- suppliers imposing on the company cash on delivery or otherwise special payments before resuming supply

- creditors unpaid outside of trading terms
- issuing of post dated cheques
- dishonoured cheques
- special arrangements with selected creditors
- solicitors' demands, summonses and the like
- payment to creditors of rounded amounts not reconcilable to specific invoices
- inability to produce timely and accurate financial information to indicate trading performance and financial position, and to make reliable forecasts.

The Court stated that in any particular case one or more of the above factors may exist, while others may not. It confirmed that the absence of one or more of the above factors does not establish solvency.

Please do not hesitate to contact us if you require advice about any issues concerning your directorship of a company.

## CASE STUDY 1 – IS A CO-DIRECTOR LIABLE FOR A PERSONAL LOAN OF ANOTHER DIRECTOR

In the recent case of *Friend v Brooker* [2009] HCA 21 the High Court of Australia examined whether a co-director is liable for the repayment of a personal loan of another director where the other director on-lent the money to the company.

Company director, Mr Brooker, personally borrowed money which he on-lent to the company. The arrangement he made for repayment was that the company would repay him and then he would repay the loan company. When the company ceased trading and was unable to repay the loan, Mr Brooker sought orders against the second company director Mr Friend requiring him to make equal contribution to the loan. Mr Friend objected.

At first instance the matter was dismissed with the Supreme Court finding that there was no agreement between the two directors to compel them to equally contribute to the repayment of any personal loan made to the company.

Mr Brooker appealed to the Court of Appeal where that Court found in favour of Mr Brooker and that the two directors were subject to a fiduciary obligation "to be equally and personally liable to each other for the losses flowing from personal borrowings". The Court declared that Mr Friend was required to contribute to the loan so as to equalise the burden of Mr Brooker.

Mr Friend appealed to the High Court of Australia. The High Court overturned the Court of Appeal and found that while Mr Friend knew of the personal loan arrangement and agreed to it, he did not agree to be personally liable to the personal loan. The High Court held that the rights of the loan company were against Mr Brooker and neither the company nor Mr Friend. Mr Brooker was unable to claim co-contribution and the Court held that in circumstances such as this case, a director will be solely liable for loan repayments.

## CASE STUDY 2 – IN WHAT CIRCUMSTANCES WILL A GUARANTEED LOAN BE DISCHARGED

In the recent case of *Rankin & Anor v Morgan & Anor* [2009] NSWCA 116 the New South Wales Court of Appeal examined in what circumstances, if any, will a guaranteed loan be discharged.

### **First loan agreement**

Two guaranteeing directors of a company obtained an investment loan for the company. All four directors of the company were guarantors to the loan. Clause 7 of the loan agreement provided that the guarantee was a continuing guarantee; the guarantor's liability was joint and several; and that nothing would effect the continuing liability of the guarantor's.

### **Second loan agreement**

About 12 months later, one guaranteeing director approached the lenders and proposed that the lenders invest for an additional twelve months. The lenders advanced the money but did not sign the second loan agreement. The second loan agreement

was signed by all four directors and it did not have a guarantee clause. A few months later, the lenders were granted a mortgage over a property owned by the company as security for the second loan.

Two months after the second loan, the company went into voluntary administration and the administrator expressed the opinion that the company had been trading whilst insolvent.

Interest payments ceased being paid and the second loan was not repaid. The company went into liquidation. The lenders commenced proceedings against two of the guaranteeing directors. The other two guaranteeing directors were bankrupt.

### **Did the second loan agreement take the place of the first loan agreement?**

The guaranteeing directors argued that the second loan agreement replaced the first loan agreement so that they no longer had any liability as guarantors. They submitted that although the guaranteed clause was not renewed, the mortgaged security took its place.

The Court of Appeal held:

- Despite the company being in administration, as evidenced by its actions, the rights against it were not given up;
- Even though the lenders did not sign the second loan agreement, but nevertheless acted upon it, their conduct did not constitute an adoption of that loan agreement;
- There was no variation of the first loan agreement by the “de facto” effect of the discussions resulting in the second loan.

The Court of Appeal found that on the facts the first guaranteed loan had not been discharged.

## **NEW SOLICITOR – KATE GOULD**

We are pleased to introduce a new solicitor, Kate Gould, to the Commercial Dispute Resolution and Litigation Department. Kate commenced studies in Arts/Law at the University of Western Sydney, Campbelltown campus in 2003. She was admitted as a solicitor of the Supreme Court of New South Wales in October 2008, and started at Marsdens in March this year.

Since joining this team, Kate has assisted in the preparation of a number of commercial litigation matters including drafting documents, briefing counsel, reviewing reports and generally offering support where needed. Kate will also be working with Elyse White in the area of Estate litigation and Charles McElroy in Industrial Relations and Employment Law. She has worked on a number of cost assessments and is building expertise in this area of law.



Kate enjoys ocean swimming and tennis. She is a member of North Wollongong Surf Life Saving Club and enjoys being involved in the community atmosphere. Every chance she gets you will find Kate on a paddle board. She is committed to a fitness regime but when she finds time to relax, enjoys reading historical fiction novels and listening to all sorts of music.

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**This newsletter represents a brief summary only of the cases and legislation discussed and is not intended to be a definitive analysis and therefore should not be relied upon as a definitive or complete statement of the relevant law. For more information or detailed legal advice, please contact Grant Butterfield or Elyse White on (02) 4626 5077.**