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Directors of an insolvent company face a strict duty not to allow their company to trade whilst insolvent. Whilst there are exceptions and defences available for directors, the recent case of *Smith v Bone* [2015] FCA 319 demonstrates that:

a director will not easily be excused, especially where they fail to seek advice on the company's solvency in circumstances which would warrant such an enquiry; and that directors should not assume that simply entering into certain arrangements with creditors is enough to prevent them being liable for insolvent trading.

BACKGROUND

This case involved two plaintiffs: Petrolink Pty Ltd (**Petrolink**) and its liquidator, Mr Smith. Mr Smith was appointed as liquidator in December 2011. The defendant, Mr Boné was the sole director of Petrolink at all relevant times. The liquidator sought compensation from Mr Boné for insolvent trading.

The liquidator claimed Petrolink became insolvent on 30 June 2009. Mr Boné claimed Petrolink was insolvent from 7 July 2011.

The judge spent a significant amount of time sorting through the books and records of Petrolink, its arrangements with creditors, its tax debt, its arrangements for instalment plans with the ATO to fulfil tax debts, and its debts owing, reaching the conclusion that Petrolink was insolvent at all times from no later than 12 May 2010. It was acknowledged that it was possible, and even likely, that Petrolink was insolvent before this date but the Court was not satisfied for any particular date or the whole period from 30 June 2009.

The Court was satisfied that all debts incurred by Petrolink from 12 May 2010 were incurred when the company was insolvent. Having established this, the Court then considered Mr Boné's personal liability.

DIRECTOR'S LIABILITY

In deciding whether Mr Boné was liable for insolvent trading the Court considered whether he had reasonable grounds for suspecting Petrolink's insolvency.

'Reasonable' means the standard of reasonableness appropriate to a director of reasonable competence and diligence.

The Court had to ascertain:

- what facts concerning the ability of Petrolink to pay its debts as they fell due were, or should have been, known to Mr Boné as a competent director of Petrolink; and
- whether those facts constituted reasonable grounds for suspicion of insolvency.

Mr Boné submitted a reasonable person of ordinary competence would not have suspected Petrolink insolvent prior to 7 July 2011 because:

- the GFC was a 'once in a lifetime' event which affected all business;
- very few of the usual indicia of insolvency existed as Petrolink's creditors were content to trade with Petrolink and did not take action to recover their debts; and
- the tax debt was being managed through an instalment plan with the ATO.

The Court rejected this argument, concluding Mr Boné did have reasonable grounds to suspect Petrolink insolvent due to factors including:

- the level of Petrolink's tax debt;
- its inability to pay the tax debt at all times;
- the terms of the arrangements negotiated with the ATO;
- the fact Petrolink never had access to resources which could have given Mr Boné reason to believe Petrolink could comply with the arrangements; and
- Petrolink's progressive inability to pay trade creditors in a timely way.

It was concluded these facts constituted reasonable grounds for suspecting insolvency. A director of ordinary competence, viewing objectively the whole of Petrolink's circumstances at the time of incurring the debts, would have had no real

idea where the necessary money to pay those debts would be found.

DEFENCES AND EXEMPTIONS

A reasonable expectation of solvency acts as a defence against insolvent trading. Mr Boné tried to rely on the payment arrangements with the ATO as reasonable grounds for expecting Petrolink was solvent. This was rejected as the payment arrangements did not cause Petrolink's tax debts not to be due and payable. The systems in place to manage Petrolink's financial situation did not support a conclusion that Mr Boné had a reasonable expectation as to Petrolink's solvency.

Mr Boné also sought relief from liability for insolvent trading on the basis that he had acted honestly and having regard to all the circumstances of the case, ought fairly to be excused.

The Court stated that in causing Petrolink to incur debts for a substantial period whilst it was insolvent, Mr Boné failed to respond to clear signs the company was insolvent, however, the Court was satisfied that Mr Boné had not conducted himself dishonestly.

The next consideration was whether Mr Boné 'ought fairly to be excused' from liability for his breaches. The key question in this respect was whether he acted honourably, fairly, in good faith and in a common sense manner as judged by the standards of others of a similar background.

Mr Boné submitted that he relied on information from various employees and advisors had was never told during the relevant period that Petrolink was insolvent. The Court was not satisfied that this demonstrated Mr Boné's conduct was of the kind that warranted him being excused from liability. This conclusion was based on the absence of evidence that Mr Boné sought advice as to the company's solvency or that Mr Boné received credible advice that the company was solvent. In such circumstances, Mr Boné could not have been said to have been permitting Petrolink to continue to trade on the basis of expert advice that the company was solvent.

Further, after May 2010 Petrolink made four payment arrangements with the ATO in circumstances where it had no clear plan as to how it would meet payments under the arrangements. There was no evidence that a reasonable, commercially experienced director would have made payment arrangements of the relevant kind in the circumstances. The Court did not accept that Mr Boné's conduct in dealing with its creditors was fair in the circumstances.

The Court commented that the conduct strongly suggested an attitude on Mr Boné's part that he was entitled to decide what was in the best interests of the creditors and that he should be able to negotiate and renegotiate payment plans with them until Petrolink's debt was fully paid, even if that would take years. It was concluded that Mr Boné's should not be excused from liability for insolvent trading and he was ordered to pay compensation to Mr Smith.[1]

A lack of advice that the company is insolvent will not be enough to excuse a director from liability for insolvent trading. In 'suspicious' circumstances the director should actively seek advice as to the company's solvency. Further the director should not assume they know best regarding how to deal with creditors. Simply because a creditor is not actively trying to recover a debt does not mean that it is not 'due and payable' or that the company should continue to trade.

[1] Corporations Act 2001 (Cth) s 588M.

The author wishes to acknowledge Law Clerk Ann-Marie Coleman for her contribution to this article.

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