HEARSAY
The legal podcast

Episode 42: Summary

Episode name: Chronicles of Insolvency Law: Unreasonable director-related transactions
Guest(s): David Armstrong

What area(s) of law does this episode consider?

Insolvency Law

David Armstrong joins us in this episode to talk about unreasonable director-related transaction claims brought by liquidators, and the defences available to company directors.

Why is this topic relevant?

The simultaneous demand side and supply side shocks caused by the coronavirus pandemic have placed many Australian small and medium sized businesses under unprecedented financial stress, and for some caused them to become insolvent. Before a company tips over the edge into formal insolvency, it's not uncommon to see company assets transferred by business owners out of the hands of the company and into the pockets of the company's directors and their relatives in an effort to preserve some of the assets of the company before they're divided amongst creditors. This is addressed in the law through the operation of section 5.7B of the Corporations Act 2001, however, what the courts decide constitutes unreasonable director-related transactions and the way they come to these decisions continues to evolve and change.

What legislation is considered in this episode?

Corporations Act 2001 (Cth), particularly section 588FDA 'unreasonable director-related transactions'

Insolvency Law Reform Act 2016 (Cth) (ILRA)

What cases are considered in this episode?

Crowe-Maxwell v Frost [2016] NSWCA 46

- In this case, a company director, who treated the company's bank account as his own, never took a paycheck from the business, instead using the company's account to make personal purchases. When the company went into liquidation, the liquidators attempted to claw-back these personal purchases as unreasonable director-related transactions, however the NSW Court of Appeal ultimately ruled in favour of the business owner, finding the reimbursement of personal expenses was paid in lieu of a reasonable wage for the director's labour. The case provides a useful summary of the elements required to satisfy an unreasonable director-related transaction claim.

Smith v Starke, in the matter of Action Paintball Games Pty Ltd (In Liquidation) (No 2) (2015) FCA 1119

- The directors of a paintball company had purchased a plot of land using a loan secured over the family home of one of the directors, after being unable to raise the finance to purchase it through the company. It was the common intention of the directors that they would move their business to the new plot once the new site had gone through the relevant development processes and checks.

The company went into liquidation before the business' relocation and the liquidators subsequently attempted to bring an unreasonable director-related transaction case against the directors for $500,000 of home loan repayments made by the company. Her Honour Justice Gleeson, as she then was, ultimately found that the transactions were not unreasonable up until a point where the directors should have then taken steps to sell the property due to a decline in the business' performance.

Vasudevan v Becon Constructions (Australia) Pty Ltd [2014] VSCA 14

- A company agreed to assume a joint liability for the obligations owed by a director to a third party and to grant a mortgage securing performance of that liability. The unsecured obligations of the directors became secured obligations of the company and the director received a benefit in terms of a covenant not to sue him. This case is authority for the fact that *indirect* benefits to directors and close associates also fall within the ambit of section 588FDA.

Weaver v Harburn [2014] WASCA 227

- Weaver was a successful business owner who purchased a boat in his wife's name, years before deciding he wanted to start winding down his company as he reached retirement. Although at the time the company was in a good financial position to make that purchase, the liquidators were subsequently able to claw it back as an unreasonable director-related transaction on the basis that Weaver ought to have known that the company may not be in such a financial position in the future due to the company's tax obligations.

What are the main points?

- Unreasonable director-related transactions are a tool available to liquidators under part 5.7B of the Corporations Act in insolvency matters. It is an anti-avoidance provision designed to empower liquidators to claw-back unreasonable transactions that have occurred in the period of time prior to liquidation (up to four years before), when the company was still in the hands of the directors. Unreasonable director-related transactions are an attractive tool for liquidators as they do not have to prove that the business was insolvent at the time of the transaction.

- The ruling in *Vasudevan v Becon Constructions (Australia) Pty Ltd* expanded the types of transactions that are considered in regards to unreasonable director-related transactions, including transactions such as assignments of debts, forgiving debts, granting mortgages, granting securities, issuing shares, relinquishing rights, granting encumbrances and the transfer of real or personal company property.

- One of the key elements for a liquidator to succeed in an action for an unreasonable director related transaction against a company, is that a reasonable person in the circumstances of the company would not have entered into the transaction having regard to the benefits and detriments to the company, or close associates, or other parties to the transaction, that arise from entering into it.

- An unreasonable director related transaction can occur even if that conduct arose out of an obligation to perform imposed on by a party by another court under section 588FDA(3)(b).

What are the practical takeaways?

- When adjudicating an unreasonable director-related transaction matter, the court has wide discretion in considering “any other relevant matter” under section 588FDA(1)(c)(iv), which can lead to an unexpected result if you are not aware of all the relevant circumstances of the case. When acting for a liquidator, make sure to get the whole picture of the company in liquidation, their business history, background and the factual content behind the transaction. Avoid being misled by documents and records.

- In order to prevent a claim arising under s588FDA in the future, it is vital that business owners correctly characterise transactions, whether that is with the help of an accountant or not. Also, if entering into a transaction with a close associate, it is best to obtain an independent valuation from a reputable company so that the commerciality of the decision is not questioned later.

Show notes

NSW State Government’s website for businesses

Federal Government's website for businesses