

Good company law case study example

[Business](#), [Company](#)



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Introduction

This paper contains two parts. Part of this paper offers a brief explanation regarding the role of the directors in a company. This part specifically discusses the reason behind the existence of the directors of a company's duty to prevent insolvent trading. It also discusses the circumstances and the results after the court lifting the veil of incorporation for the wrong of insolvent trading upon a director of a company.

Discussion

Directors of companies are under a duty under the Corporation Act provisions and the common law to prevent companies from incurring debts while they are insolvent. At common law, the director's duty to prevent a company's insolvent trading falls under the category of the director's duties of care and diligence. The company's directors have a direct influence on the decisions arrived at by the company. As a result, they are undoubtedly responsible for the corporation's development. Specifically, even though directors have significant power on the decisions about running a company, they have borne strict duties for the company's financial situation and

ordinary business trading.

Under the company law, companies have either limited or unlimited liability. This is the principle of separate legal entity. A company is held to be a separate legal entity from its directors and employees. In the company limited by shares, shareholders are only liable for unpaid amounts on their shares, if any. The principle of the veil of incorporation flows logically from the principle of separate legal entity of the company. This principle, established in Salomon's Case in 1897, protects the directors and employees of the company from its debts and losses.

There are circumstances where the veil can be lifted and thus subject the company's directors to actions for acts of the company. It can be done on grounds established under the common law or a statute. Under common law, where the company is formed with the reason of advancing a fraudulent purpose, the court will be forced to lift the veil of incorporation. This was the decision of the court in the case of Gilford v Horne where the court, after piercing the veil, the court found that the defendant secretly controlled a rival company formed by his wife in order to defeat a non-solicitation clause from his employment contract. Under the statute, the veil can be lifted according to the provisions of the Corporations Act 2001 making the directors and non-executive directors personally liable for obligations and losses for the following reasons: pre-incorporation contracts (ss 131-133); paying dividends when there are insufficient profits (s 588G), and insolvent trading (s 588G-588Z). In both instances, the test used for determining liability of a director for preventing insolvent trading is an objective test. Several elements, however, have to be fulfilled before a director is held liable

for preventing fraudulent trading. First, the person must at the time be a director of a company who is formally appointed irrespective of whether they are managing director, finance director, alternate director, 'shadow director' or 'de facto' director. This excludes executive officers who are not appointed as directors and, therefore, do not have the stated obligations. Secondly, it must be established that the company is insolvent or became insolvent when the debts occurred. Furthermore, at that time the directors of the company must have had reasonable grounds to suspect that the company is insolvent. It must be deduced from the position of an ordinary person, that there is reasonable expectation that the company is not solvent or will become insolvent if more business trading is taken (Philip, 2012).

Therefore, if a person is a director when the debt is incurred, or becomes insolvent by taking that debt, and there are reasonable grounds for suspecting that it is or will be insolvent, and then under s 588G of company law the director is liable for failing to prevent or not preventing the company from incurring the debt.

Directors of a company can only avoid liability for insolvent trading under s588 if they can establish that the director reasonably believed that the company was solvent or; a reasonable and competent person provided them with adequate information that the company was solvent; illness prevented them from carrying out their duties; or, they have done everything possible to prevent the company from incurring the debt.

Several reasons exist for the existence of this duty on directors to prevent insolvent trading. First this duty is imposed to prevent fraud by companies. It would be harmful to public policy to allow the company to trade even where

it is not capable of fulfilling its financial obligations as and when they fall due. Therefore, as a means of curbing this vice, the duty is imposed on the directors who are the alter egos of the company. This measure, therefore, provides a mechanism through which the law can hold an individual liable for actions of the company involved in insolvent trading. In addition, insolvent trading by the company may result to losses to other innocent parties involved in transactions with the insolvent company. This duty is, therefore, imposed as a protective measure for innocent traders with the company. The results of allowing an insolvent company to continue trading may also have a profound economic effect where such a company has a huge national coverage. Therefore, this duty is imposed as an economic protection measure (Ciro, 2008).

Part B

Introduction

This is the second part of this paper. This part will discuss whether OHS Solutions Pty. Ltd directors is likely to breach or have already breached their duty of preventing insolvent trading as provided by the statute and the common law. In evaluating the breach or potential breach of this duty by the directors of OHS Solutions Pty. Ltd, sections of the Corporations Act and previously decided cases will be highlighted.

Discussion

In light of the specific positions held by the different directors of OHS Solutions Pty. Ltd, an overview of the liabilities and duties of company directors under Australian law will be provided. A company, under Australian company law, must have at least one director. Company directors perform

the main role of management of the company. They are of different types including managing director, finance director, executive and non-executive director. The word director refers to any person who occupies the director's position by whatever name so called. This definition captures both acting directors as well as interim directors. On the other hand, there are non-executive directors. These directors do not deal with the financial problem of the company and may not be involved in the day-to-day official work directly. This task is the preserve of the managing director and executive director who are the 'de facto' directors who handle the corporation's affairs directly. Another category of directors is the shadow directors. These are people who have actual power to advise and influence company decisions and whose advice is sometimes acted upon by the managing directors. Sometimes, the shadow directors are person who has the particular business relationship with the company (Karen, 2011).

The test for determining the liability of directors for breach of the duty for preventing insolvent trading requires the fulfillment of the following. A director must be properly appointed irrespective of the name assigned to them. Second, it must be established that the firm is insolvent or became insolvent after incurring the debt. Thirdly, at that time the directors of the company must have had reasonable grounds to suspect that the company is insolvent or will become insolvent after the debts incurred. A director can, however, evade liability by pleading the following defenses. They are contained in s558H of the Corporations Act. First, that the director had no reasonable grounds to suspect that the company was insolvent or would be insolvent after incurring a debt. Secondly, the director relied on advice

provided to him by a competent and reasonable person of the company. The director may also allege that he was absent from management due to illness or another cause. Lastly, the director may plead that he took all measures to prevent insolvent trading.

Applying the provisions of the Corporations Act, OHS Solutions Pty. Ltd is a proprietary company formed by three friends who have different skills namely accounting, IT and health. On whether the corporate veil will be lifted under the described circumstances, this will be determined basing on whether it is being lifted on grounds of common law and statutory provisions. Under common law, the veil will not be lifted. This is because there is no information to show that the company was formed for a fraudulent purpose. Therefore, the lifting of the veil of incorporation can only be done on the basis under statute law. In particular, as the above scenario does not have information about pre-incorporation contracts or paying dividends when there are insufficient profits. The only ground to be invoked under this circumstance is insolvent trading

OHS Solutions Pty. Ltd has four directors. Satish is the company's executive director. Des is the company's managing director. The company also has two non-executive directors Emma and Ying. The Corporations Act regulations impose a direct duty on a company's directors to prevent the company from insolvent trading regardless of they are executive or non-executive directors. The courts have adopted a very strict construction of the liability of directors, and non-executive directors. These cases included cases such as ASIC v Plymin & Ors, Statewide Tobacco Ltd v Morley and DFC of T v Clark. In the above cases, 'sleeping directors' and non-executive directors alike were

found to be personally liable although they were not actively involved in running the company and only indirectly approved insolvent trading, or relied on the advice of others (Patrick, 2010).

In the above scenario, Ying, who is a non-executive director, cannot escape the liability for breaching his duty of preventing insolvent trading even though she is not directly involved. To begin with, Ying is a director of Support Pty. Ltd. a company that has guaranteed a \$50, 000 loan from the Business Bank Ltd. to OHS Solutions. Therefore, Ying has a fundamental knowledge that OHS Solutions' financial situation is not that solid and strong. The \$50 000 loan is a big sum of money that is likely to impede future operations of the company. With that amount of debt, Ying must have had a reasonable basis to believe that incurring the debt would make the company liable. This knowledge, therefore, makes him liable. Her reservations that the company were poorly managed also serves as a constructive notice to Ying on the financial situation of the company. Her failure to prevent the firm from continuing to trade while it is under insolvency makes her liable for breaching the duty for preventing insolvent trading. Having no reasonable defense under the statute, she will be held liable.

On the part of Emma, the decision in the case of ASIC v Healey where the court held that “ if the director has the knowledge of the financial affairs, then the liability is inescapable” is applicable. Emma was the executive director who realized that the company had a debt to another company that had not been settled. Her failure to take actions to prevent the company from trading while insolvent makes her liable. On the part of Satish, she is also liable for breaching the duty of preventing insolvent trading of the

company. This is because she is an executive director who is privy with the financial statements of the company. Having incurred a debt of 50, 000 USD, she should have noticed that the company was insolvent and, therefore, not competent to continue incurring additional debts. Additionally, as an executive director, she should have remained privy with the financial situation of the company. The case of *Woodgate v Davies* becomes applicable. In this case, the court stated that “ when a debt is incurred, the directors have breached their duty if they still keep trading.”

On the other hand, Des is managing director of the company and an expert in the affairs of OHS Solutions Pty Ltd. As managing director, Des is directly involved in the daily running of the business of the company. It is Des, according to the above scenario that reported the disturbing news of the overdue payment owed by the company. Therefore, before the news from Emma, he did not realize that the company had some financial problems. Neither did he have any means of obtaining such knowledge. Des can, therefore, rely on the defense established under S588G to avoid liability. In particular, Des would allege that he was told by Satish who is the executive director and IT expert that all the IT problems have been fixed. To Des, Satish is a competent and reliable person whose advices can be trusted in the company. Thus, even though Des signed \$10 000 advertising contract while the company was insolvent, he may use one of the defenses established under the Act. In particular, Des would allege that a reasonable and competent person provided her with adequate information that the company was solvent before contacting the additional debt.

On the above basis, all the directors of the company of OHS Solutions Pty.

Ltd is liable for breaching their duty to prevent insolvent trading by a company with the exception of Des. Des has a defense established under a statute that he can rely on to evade liability.

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