

# Directors' Duty to Prevent Insolvent Trading

**There is a positive duty placed on directors by the Corporations Act 2001 to make sure their company does not trade while it is insolvent.**

## What does the duty entail?

A director has a duty to prevent insolvent trading by a company: Section 588G. This section of the Corporations Act 2001 will be breached when trading occurs and:

The company is insolvent at the time, or becomes insolvent because of a debt;

There were reasonable grounds for believing/suspecting the company was insolvent, or would be insolvent;

The director was aware of these reasonable grounds, or a reasonable person would have been aware of the likelihood of insolvency.

## When is a company solvent?

A company is solvent when it has the ability to settle all debts when they fall due. If a company cannot do this, it is insolvent.

Insolvency should be expressed by reference to the cash flow position of the trader (company) and not the overall balance between its assets and liabilities. Also, the availability of loan funds and the reliability of a promise to lend are relevant considerations for determining a company's ability to pay.

## Grounds for suspecting solvency

The Corporations Act 2001 considers that a director is able to predict the financial situation of the company, based on a number of contingencies.

An objective criteria is applied when assessing reasonableness as to the state of knowledge. The Court will make a judgment based on the facts of the individual case<sup>1</sup>. The standard the Court sees as appropriate is that of a director of ordinary competence. Liability is not assessed on the personal characteristics of the particular director.

The director does not have to be aware that the company is actually insolvent, the only criteria is that there were reasonable grounds for suspecting that the company could be insolvent.

## Defences

A director can raise the following defences:

- Section 588H(2): There were reasonable grounds to expect solvency

*The director may escape liability where it can be proven that there was a reasonable expectation of solvency.*

- Section 588H(3): There was reliance upon information as to solvency provided by another

*Here the defendant must establish that there were reasonable grounds to believe the advice of another as to the solvency of the company. The person providing the advice must be known as a competent and reliable person in this position.*

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<sup>1</sup> Set out in judgment of Duggan J in *Group Four Industries Pty Ltd v Brosnan* (1991) 56 SASR 234 at 238

- Section 588H(4): The director did not participate in management

*Where a director establishes that, at the time the debt was incurred, he/she did not participate in the management of the company due to illness (or other good reasons precluding participation), liability may not be applicable.*

- Section 588H(5): The director took reasonable steps to prevent the company incurring debt

*The director is exempted from liability where he/she can prove that reasonable steps were taken to prevent insolvent trading. Here the Court looks at whether an administrator was appointed and when the director decided to take this action. A director who promotes voluntary administration, but fails to persuade fellow directors, may escape liability.*

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**Important:** This is not advice. Clients should not act solely on the basis of the material contained in this paper. Our formal advice should be sought before acting on any aspect of the above information.

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