

Article Information

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Service: Restructuring & Insolvency

Insolvency - the impact of unreconciled accounts and funds available to a director

The Court at first instance held that the Applicants failed to establish that the Company was insolvent. The key findings that informed the Associate Judge's conclusions included the following:

- **the funds that were available to the Company to pay its debts included funds in an offset account in the name of the director (and an account in the name of the director's wife); and**
- **the Applicants' claims were based on unreconciled accounts of the Company.**

The Applicants were granted leave to appeal and appealed the decision of the Court a quo.

Takeaways:

- A party seeking to assert that funds, purportedly available to a company from a third party, should be taken into account in assessing the solvency of that company must discharge the burden of proof;
- A company must have a degree of assurance that the funds of that third party will be made available to pay the debts of a company as and when they became due and payable;
- The test is objective and must be assessed from the perspective of the company on the actual availability of the third party funds to a company; and
- A Liquidator may rely on the unreconciled accounts of a company to prove the insolvency of a company in circumstances where the unreconciled accounts were admissible in evidence.

Background:

The First Applicant (**Liquidator**) was the liquidator of the Second Applicant (**Company**). The Respondent was the sole director and secretary of the Company (**Respondent**). The Company operated a book-selling business and specialised in selling discounted books to students. The Company had physical stores in Melbourne and Adelaide and also had an online store.

The Company held three bank accounts, one for each physical store and one for its online store. The Respondent also held a personal offset account (**Offset Account**) from which he paid some of the Company's debts.

The Company ceased trading in April 2014 and ultimately a Liquidator was appointed to the Company on 27 August 2014.

The Applicants issued proceedings in which they claimed that the Respondent had engaged in insolvent trading and sought compensation orders and furthermore sought declarations that certain payments made by the Company to the Respondent were voidable against the Liquidator because there were either unfair preferences or unreasonable director related transactions.

The Court at first instance dismissed the proceedings on the basis that the Applicants had failed to establish that the Company was insolvent as at 1 January 2014 or any other date. The Applicants appealed.

Decision:

The Court of Appeal (**Court of Appeal**) allowed the appeal and held that the Company was insolvent at 1 January 2014.

The Court of Appeal considered the key findings of the Associate Judge in the Court at first instance and set out relevant factors to consider in respect to third-party funding and in regard to the reliance on unreconciled accounts to prove the insolvency of a Company. The Court of Appeal also provided a careful analysis of the indicators of insolvency, as referred to by Mandie J in *Australian Securities and Investments Commission v Plymin* [2003] VSC 123 (which are not discussed in this paper), and the impact of the admissibility of those unreconciled accounts to prove the insolvency of the Company.

Third party funding

The Associate Judge held that the funds in the Offset Account were funds available to the Company to pay its debts. Although the Court of Appeal considered it was not strictly necessary to decide whether the funds in the Offset Account were available to pay the Company's debts, as the addition of those funds to the other funds available to the Company would not have enabled it to pay its debts which were due and payable as at the relevant date, the Court of Appeal considered the issue and determined that the funds in the Offset Account were not available.

The Court of Appeal discussed earlier cases which had considered whether funds held by a third party may be treated as funds available to pay a company's debts as and when they become due and payable and ultimately determined that:

- the availability of funds must be considered objectively from the perspective of the relevant company rather than the putative third-party funder;
- there must be cogent evidence to enable a court to conclude that there is a degree of commitment from the third-party to fund a company's debts as and when they became due and payable for example, a formal or informal agreement between a company and the third-party funder which established objective criteria from which it could be determined at any given time whether a debt would be paid from third-party funds; and
- in the case of a director, the director should not have "an unfettered discretion" as to when and if any funds in a personal account are to be made available to pay the debts of the company and, if so which debts.

A difficulty that the Respondent encountered was that he conceded that he unilaterally decided which debts would be paid from the Offset Account and the Court of Appeal noted that the Respondent had not accessed the Offset Account to pay statutory liabilities (tax and superannuation).

Unreconciled accounts

In effect, the Respondent contended that the Court of Appeal could not take into account unreconciled accounts of the Company to determine solvency and criticised the Liquidator for failing, amongst other things, to liaise with the former accountants of the Company to reconstruct the Company's 2014 financial accounts. Understandably, the Liquidator contended that the production of one set of reconciled and audited accounts would have been a substantial expense to the administration of the Company.

The Court of Appeal held that the starting point for determining whether unreconciled accounts could be relied upon to determine whether a company is insolvent was section 1305 of the *Corporations Act 2001* (Cth). This provision provides that the tendering of a company's accounts is evidence of the matters recorded in those accounts and will be proven unless other evidence convinces a court to the contrary on a balance of probabilities.

In summary, the Court of Appeal held (contrary to the court of first instance):

- the Offset Account could not be taken into account to determine the solvency of the Company
- the Liquidator could rely on unreconciled accounts to determine the insolvency of the Company