CORPORATE COLLAPSE - Pitfalls for Directors, Auditors and Bankers

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My task is to comment in relation to the issue from the position of directors and auditors. I have chosen not to make any comments on bankers - I leave it to others to delve into that area. Indeed, in commenting on directors and auditors and the pitfalls that they face in the context of corporate collapse, I am doing so in New Zealand from the position of a person who has been involved mainly in other areas of the law than corporate law in the last three or four years.

I want to start off my comments by suggesting to you that the courts in Australia, and perhaps the same is true for New Zealand - I really have not had the opportunity to read New Zealand cases in as much detail as Australian cases - have been increasingly concerned about the business environment and the way in which corporate directors have conducted themselves. Sir Daryl Dawson, who is a member of our High Court, spoke at a conference in 1989 to the Business Law Section of the Law Council of Australia. In my synopsis I refer to the fact that he made certain comments about the huge salaries that were being paid to directors without appropriate authorisation from shareholders. He also made certain other comments about the general standard being shown by directors. He was also influenced by some remarks made by Mr Justice Brooking in the case of ***Knightswood Nominees v Sherwin Pastoral Company*** ((1989) 15 ACLR 151; 7 ACLC 536) where the judge said that there were far too many cases which came before him where he saw breaches of duties being committed by directors of listed public companies which were never pursued either in civil litigation or in any prosecution (see references in synopsis).

In that particular case, Mr Justice Brooking allowed the National Companies and Securities Commission to "receive" the benefit of the investigation that was going to be conducted by lawyers and auditors appointed under the provisions of what is now s319 of the Corporations Law. Under that section members can get lawyers and auditors appointed to obtain information about relevant companies. And I think that the remarks made by Mr Justice Brooking, and those by Mr Justice Kirby and there are a number of others in the courts, have shown that the judges sitting in many of these cases are becoming increasingly concerned about the standard that is being shown by company directors in a number of areas. And yet we see in a sense very few cases where these particular matters are being challenged.

Now that is all changing, of course. Tony Hartnell has embarked on a very significant programme, both, he says, in the civil area and in the criminal area as well. No doubt we will see the courts being given an opportunity to look at some of these matters. But that concern, expressed by those judges, led in turn to the appointment of the Cooney Committee and then the Lavarch Committee, in Australia. The Cooney Committee has made some very strong recommendations about changes to the law in relation to directors' duties and not simply in the area of their so-called social and fiduciary duties, but looking beyond that. It will be interesting to see what the Lavarch Committee has to say in due course.

It is on that background that it is not surprising that one finds that the courts have tended to be a lot tougher in terms of dealing with the problems that arise when companies are in insolvent positions and the situation that face directors and others advising or working with those companies.

The almost throw-away lines, by Mr Justice Mason as he then was in ***Walker v Wimborne*** ((1975-1976) 137 CLR 1) that directors were at risk in not taking into account the interest of creditors in conducting their affairs whilst denying the obligation on the part of the directors to look at the group as an entity, (which Mr Justice Street had said was a duty owed by the directors) has led of course to the very famous line of cases culminating in New Zealand in the decision of ***Nicholson v Permakraft (NZ) Ltd*** ((1985) 3 ACLC 453), and in Australia to the important decision of ***Jeffree v National Companies and Securities Commission*** ((1989) 7 ACLC 556). In these cases the courts have said that in certain circumstances directors do owe duties to creditors or at least should take into account the interests of creditors so that a duty may well be said to arise in that particular context, especially where insolvency is present. However, if you read the ***Kinsela*** case in the New South Wales Court of Appeal, and in particular the judgment of Sir Laurence Street, then Chief Justice, one wonders just where the line is to be drawn. This "development" was resisted by a number of people including Mr Justice McPherson of the Queensland Supreme Court.

I spoke at a conference in New Zealand with Bruce McPherson a couple of years ago where he was still critical of the line of reasoning in ***Walker v Wimborne*** and the later cases. But I note that in the most recent decision in Queensland in which that particular issue has been addressed, the case of ***ANZ Executors and Trustee Co Ltd v Qintex Australia Ltd (Receivers and Managers Appointed)*** ((1990) 2 ACSR 676; see also 8 ACLC 989), Mr Justice McPherson writing the judgment on behalf of the court clearly recognises that that line of authority is now set.

It will be interesting to see whether that line of authority will be extended beyond the situation of where insolvency is in fact present, or likely to be present, to situations where it may not be present, but where unless action is taken, insolvency may well arise.

In my synopsis I refer to s1324 of the Australian Corporations Law which has been there in a slightly different form for ten years. It surprises me that that section has never been used, except in two cases, one a minor case in Western Australia in looking at questions of standing and the second, of course, is the ***BHP v Bell Resources*** case ((1984) 2 ACLC 157). Although it has been referred to now on one or two other occasions as a section that could provide a very useful basis for litigation to proceed if shareholders wanted to get some relief, it has not been used.

It seems to me on reading that particular section and the way in which the law is developing in relation to this alleged duty to creditors that it may be possible, and I put it no higher than that, that creditors may be able to use that section to challenge actions on the parts of directors where the company is not insolvent, but by the very nature of the particular conduct that is being challenged, may well become insolvent and thus trigger the potential liability.

That section is useful for a number of other reasons, it seems to me. The most important in my view is that it creates a form of class action in the Australian context which again has never been used - again I wonder why. I notice that the section was discussed by the Companies and Securities Law Reform Committee chaired by Harold Ford recently in recommending the abolition of the rule in ***Foss v Harbottle*** with the creation of a statutory derivative action. But no explanation was given as to why the section has not been used or why it cannot be used in the context of its broad statement that is contained in the statute.

It is true that it relates to contraventions of the Act; but nevertheless it has not been used, to my knowledge, in any litigation in which it would appear that it may well have been the basis of litigation.

The other section, of course, that has caused perhaps more controversy, difficulty and debate in Australia is s592 of the Corporations Law (formerly s556). Now I do not believe there is either a provision in New Zealand or England that is on all fours with that section. There are sections which deal with wrongful trading, fraudulent trading, but s592 seems to me to be more strongly worded in favour of the creditors. In the most recent decision in Australia involving that section, the case of ***Statewide Tobacco Services Ltd v Morley*** ((1990) 2 ACSR 405; 8 ACLC 827), we have a very powerful judgment in my view, of Mr Justice Ormiston, which has been the subject of some criticism, but also has been strongly endorsed. It lays down some of the bases upon which the director who sits on his or her hands and does nothing to as it were challenge or question the activities of other directors where a company may be trading in insolvent circumstances, may well be at risk. That case has gone on appeal and it will be interesting to see what happens. But there have been a number of more recent cases since ***Morley*** case in which a similar approach has been adopted by judges in both Victoria and in other States.

One can suggest that all of that reflects the fact that we are in recession and that perhaps there is a tendency to look more closely at some of these issues than perhaps has been the case in the past. I wonder whether that is correct. I suggest that you study in that context the report of the Cooney Committee and the remarks that it had to make about some of the matters relating to the nature of directors' duties and the need for directors to give continuous, or at least more regular, attention to the affairs of the company than perhaps has been the tradition in the past. Section 592 does contain important defences which should be studied.

I now move on to talk about auditors. While Sir Robin is constrained about the need to perhaps not comment on ***Caparo***, I, for one, found the decision quite amazing and I believe unsupportable in the context of the judgments in the ***Scott Group v McFarlane*** case, the philosophy of corporate law, and indeed in the context of the Australian position, I think unsustainable in the light of provisions such as s52 of our Trade Practices Act. This enables an action to be brought for misleading and deceptive conduct being generously interpreted by the courts and now we have parallel provisions in the Fair Trading Acts In any event I think that the way in which the Australian law has built up the responsibilities and duties of auditors may well lead to our courts reading ***Caparo*** and the way in which it has been structured in its analysis, as though we are dealing with a different statutory background to that in the UK. Therefore it can be distinguished. And already it has been distinguished - or if you like not given much attention to, it is true on a set of facts that are quite different to that case - in a Victorian decision, where Mr Justice Vincent chose not to even discuss that case but to rely on more traditional Australian law in dealing with the question of liability to third parties and liability generally in the case noted in my outline. It may well be a sign of the unwillingness of our courts to deal with those issues.

But there are more important questions it seems to me that face the auditing profession, especially in Australia, and I am not sure what the position is in New Zealand and in England, than perhaps the ***Caparo*** decision might signal.

Under the Australian statute there is a provision, s332(10), that requires auditors who in the course of their audit, if they are satisfied that there has been a contravention of the Act and the circumstances surrounding that contravention and the way in which the audit opinion is prepared leads them to believe that that particular matter will not be adequately dealt with by the directors, the auditor is required to report that matter to the Australian Securities Commission.

The NCSC late last year issued a "ruling", which suggested that that particular section has not been utilised by the auditing profession enough in bringing to the attention of the Securities Commission details of potential breaches or breaches of the law. I wonder about the onus that is being placed on auditors by that statute. The auditor has got to be satisfied that there is a contravention of the Act and bring that to the attention of the Commission. Now it is difficult enough, it seems to me, for the auditors to do their job in terms of the traditional auditing duties that they face. One wonders just how onerous this will be if that particular statutory provision is put to the test in bringing to the attention of the Commission contraventions of the Act. Auditors are not lawyers. Should they then call in lawyers to advise on whether the particular set of conduct is in fact a contravention of the Act? It has been suggested by some auditors that I have spoken to at a recent congress that they must "lift their game"; they believe they need to consider whether, even though not required to by law, they should be bringing to the attention of the Commission matters which amount to breaches of ethics by directors and other kinds of conduct that might well be investigated by the Commission.

Finally, in the few minutes that are available to me, I want to mention one important piece of legislation that is currently before the New South Wales Parliament and will shortly be introduced in the Victorian Parliament, which deals with this vexed question which has also been discussed by Professor Mann - ie, whether we should have a cap on the liability of auditors, or indeed other professions.

When the ***Cambridge Credit*** case was decided in Australia by Mr Justice Rogers and $145,000,000 were awarded against the auditors - since settled for a much smaller sum than that - the auditing profession again moved into high gear to introduce legislation to bring on a cap for the amount of liability they should have to meet in the event of them being negligent. That was unsuccessful despite reports by committees. One of the reasons it was unsuccessful was because the auditors were limiting the approach to their own profession. The New South Wales Occupational Liability Bill of 1990, which has been tabled recently in the Parliament, looks at establishing statutory caps, two different schemes related to professional insurance, to all occupations to be listed in the legislation. Now that is a much more important and creative approach to a very significant problem that faces both the professions and the occupations, and I would suggest that in the context of the questions that we have to face, whether they be in relation to bankers, auditors and others, that the question of statutory caps and the way in which they should be structured is worthy of very careful consideration by all professionals.

SYNOPSIS OF PAPER BY PROFESSOR ROBERT BAXT

The question of pitfalls for directors when companies are close to corporate collapse is all too familiar in the Australian scene.

In this paper I would like to outline the impact of two major provisions of the Australian Corporations Law which do not have corresponding provisions in either England or New Zealand. In New Zealand the Law Reform Commission's proposals would see New Zealand law fit more into line with Australian law on directors' duties in one sense, but would depart from our "criminal" law approach. At this stage the New Zealand provisions in relation to insolvent trading (which are more aligned to the English provisions as I understand them) create a different burden for the director than thrown up by s592 of our legislation. In addition, I do not believe that either country has the equivalent of s1324 of our Corporations Law.

LIABILITY TO CREDITORS

The starting off point is the case of ***Walker v Wimborne*** ((1975-1976) 137 CLR 1) where Mason J made his famous statement that directors would be in dire straits if they failed to take into account the interests of creditors. In that same judgment he denied the claim that directors owed a duty to a group of companies. The former statement (by way of dicta) has now been endorsed in a series of important decisions including the New Zealand case of ***Nicholson v Permakraft (NZ) Ltd*** ((1985) 3 ACLC 453), the most recent being ***ANZ Executors and Trustee Co Ltd v Qintex Australia Ltd (Receivers and Managers Appointed)*** ((1990) 2 ACSR 676; see also 8 ACLC 989). Perhaps the high water mark in relation to this series of cases is the Full Court of the Western Australian Supreme Court decision in ***Jeffree v National Companies and Securities Commission*** ((1989) 7 ACLC 556). There have of course been a number of other cases dealing with that particular issue.

I shall comment on the impact of s1324 of the Law later.

SECTION 592 - INSOLVENT TRADING

Section 592 which makes the director or a person responsible for managing a company liable where insolvent trading occurs (the incurring of debts when a company cannot meet them or when there is no expectation that the company will be able to make payment in relation to those debts) has been given an enormous lease of life as a result of two cases. The first is the minority decision of Mr Justice Kirby in ***Metal Manufacturers Ltd v Lewis*** ((1988) 13 NSWLR 315; 13 ACLR 357). Whilst Kirby P was in the minority his views were later endorsed by the Senate Standing Committee on Legal and Constitutional Affairs (the Cooney Committee) in its report on the duties of directors (see discussion of this report in Baxt, "Corporation and Securities Law" in Baxt and Kewley (eds) ***Annual Survey of Australian Law 1989*** (Law Book Company Limited, 1990) pp 311 et ff). The section has also been strengthened as a result of the decision of ***Statewide Tobacco Services Ltd v Morley*** ((1990) 2 ACSR 405; 8 ACLC 827). That case is probably well known to most readers, but basically concerned the liability of a director who had allowed the company's affairs to be run by her son following the death of the husband. She took no part in the day to day administration of the company and simply allowed the son to continue to run the business. She sought an "exemption" from liability on the basis that she had not authorised the incurring of the relevant debt on which the company was now being sued. Ormiston J denied that she could escape simply by doing nothing ("sitting on one's hands is not enough" as Kirby P indicated in the ***Metal***

Manufacturers case). Ormiston J felt that if many companies had been administered more rigorously by directors "some of the more disastrous liquidations of recent years would not have occurred, not because the companies would not have gone into liquidation, but because those companies would have stopped trading and gone into liquidation at a much earlier stage." (8 ACLC at 843; 2 ACSR at 426.)

Ormiston J also suggested that directors who could not participate in the day to day affairs of the company - because they were too busy or whatever the reasons might have been - should have resigned from the corporation rather than allow things to drift along. These words are quite chilling: "To fail to make any enquiries whatsoever is not excusable and an opinion of the company's solvency based on that ignorance could not be characterised as reasonable. Even in a small company a director should ask for and receive figures, albeit of a basic kind, on a more or less regular basis. If that is sought and it reveals no difficulties and the director has no other reason to suspect the company may not be able to pay its debts as they fall due, then the director may be shown to have acted reasonably." (8 ACLC at 847; 2 ACSR at 431). He concluded his remarks by suggesting that if a director could not persuade fellow directors to withdraw from a particular course of action or to conduct the affairs of the company in a different way then the director had little option but to resign (8 ACLC 840; 2 ACSR 422).

That decision is now on appeal.

The New Zealand law is not the same - it refers to reckless trading (the same approach basically as in England). For an interesting New Zealand case on the duties of directors in the context of solvency see ***Hilton International Ltd (in liq) v Hilton & Anor*** ((1988) NZCLC para 96-365).

GENERAL OBSERVATIONS ON DUTIES

It should be noted that the standard that is expected of directors has gradually been raised, not only by decisions in the courts, but by general statements made by judges. So, for example, readers are reminded of the remarks of Sir Daryl Dawson at a Business Lawyers' conference on 10 April 1989 in which he was concerned at the huge salaries being paid by directors without appropriate authorisation from the shareholders. His remarks have been "endorsed" in part by a powerful decision of the House of Lords in ***Guinness PLC v Saunders*** ([1990] 1 All ER 652).

The concerns about breaches of duty which may have had some influence in setting up the Cooney Committee inquiry led Brooking J in ***Knightswood Nominees Pty Ltd v Sherwin Pastoral Co Ltd*** ((1989) 15 ACLR 151; 7 ACLC 536) to make these remarks: "My own experience, especially in this [Commercial Causes] List, suggest that there are many serious breaches of duty in relation to the affairs of listed public companies." He went on to allow the NCSC to have an interest in the inspection of the books etc of the company under the Corporations Law (s319 of the Corporations Law is now the relevant provision) (see 15 ACLR at 159; 7 ACLC at 543).

See also the important decision of the Privy Council in ***Kuwait Asia Bank EC v National Mutual Life Nominees Ltd*** ([1990] 3 All ER 404) where the Privy Council denied any general duty owing by directors to creditors.

SECTION 1324

Section 1324 of the Corporations Law allows remedies to be sought (by way of injunction, but goes wider than that) where there is a contravention of the Law. The persons who may seek a remedy include the Commission or a person whose interests have been or would be affected by the relevant conduct.

It is highly arguable in the light of the ***Walker v Wimborne*** line of cases that creditors are persons whose interests have been or would be affected by breaches of duty on the part of directors. Where those breaches of duty coincide with the statutory breaches (as has been identified as being the case in a number of cases such as ***Marchesi v Barnes*** [1970] VR 434, and most recently endorsed (although queried) by the Full Court of the South Australian Supreme Court in ***Southern Resources Ltd and Others v Residues Treatment and Trading Co Ltd and Others*** (1990) 8 ACLC 1151; 3 ACSR 207) the utility of s1324 becomes even more relevant.

A failure to act in good faith (which could include the failure to take into account the interests of creditors) could be used by a creditor to bring an action under s1324. That section itself (or its predecessor) has hardly been used if reported cases are an indication. However, it was given a generous interpretation by Hampel J in ***Broken Hill Proprietary Co Ltd v Bell Resources Ltd*** ((1984) 2 ACLC 157), and most recently a similarly generous reading was given by the South Australian Full Court in ***Residues Treatment and Trading Co Ltd v Southern Resources Ltd*** ((1988) 14 ACLR 569; 6 ACLC 976 - see Baxt, "Will Section 574 of the Companies Act Please Stand Up" (1989) 7 ***C & SLJ*** 388). One very important part of s1324 is sub-s(10) which enables the court to award damages "in addition to or in substitution for the grant of an injunction" and these may be awarded to "any ***other*** person in addition to the applicant. The "equivalent" provision proposed for the New Zealand Companies Bill is clause 138, but it does ***not*** extend rights to creditors and has no equivalent provision to s1324(10).

CODE OF CONDUCT SUGGESTED FOR DIRECTORS

The suggestion that we do not need any changes to the law in Australia but rather should proceed by way of a code of conduct for directors and others is one that will no doubt receive a good deal of sympathy from many in the community who argue that there is too much law. Certainly when the law is drafted it is very long winded and highly technical. That can lead to significant difficulties for the courts. But I for one do not believe codes of conduct work and that we need a more policy oriented approach by the courts to the broad issues of directors' duties.

AUDITORS AND DIRECTORS

The directors also run the risk of being challenged by auditors who have a responsibility under the Corporations Law (s332) to bring to the attention of the Australian Securities Commission matters which might well "sound the death knell" of the particular corporation. The auditor must bring to the attention of the ASC information which relates to a contravention of the law. Furthermore, the auditor if satisfied that in his view the specific problems that he has uncovered cannot be adequately dealt with by way of comment in the auditor's report or by bringing the matter to the notice of the directors he is required to forthwith report the matter to the Commission. This section is untested but it seems to me to require auditors who deal with corporations which are close to insolvency or where directors may be shifting funds around in order to save the corporation from particular difficulties may have a direct obligation to provide information to the ASC.

Caparo, which is the subject of other commentary, may well be distinguished in Australia - it has already not been followed by Vincent J in ***AGC (Advances) Ltd v R Lowe Lippman Figoor and Franck*** ((1991) Australian Torts Reports par 81-072) and of course we have the Trade Practices Act and the Fair Trading Acts.