SYMPOSIUM ON REMEDIES ON DEFAULT

Questions and Answers

Comment - Philip Wood:

An important issue in the UK at the moment is that we now have a new Insolvency Bill which is very hotly contested for a number of reasons, and one of the key elements in this new Insolvency Bill is the position of directors and fraudulent trading.

I expect you know that in most of the common law countries, the veil of incorporation is honoured in the sense that it is only when the directors really are fraudulent, in the sense of subjective attitude to whether or not debts can be paid, that they can be visited with personal liability. In some other countries that is not so. For example, in France, negligent trading is enough, so that if a French company goes into liquidation, that is commonly accompanied by the bankruptcy of the directors themselves, because the creditors go straight through to the directors.

I was quite interested in a comment, that I think John Cadell made, that here the rule is that there is a sort of reasonableness test for the directors, which makes life extremely tough when one is trying to work out a support agreement.

My experience is that, when a company is in difficulties, the directors don't know what has hit them, they haven't been in a bankruptcy before, they don't know what is happening, they have lost control of the situation, they don't know what to do. Their lawyers get wheeled in and say - look, fraudulent trading, you may have to pay personally - and they really don't know what to do.

The sort of advice which one tries to give them is, first, make sure you have got some merchant banker or accountancy firm to do a proper study of the company to see whether or not it will be able to pay its debts.

Secondly, make sure you get a letter from your bank creditors, so that even if the loans are on demand terms, nevertheless the banks have set out what their intentions are so that there is some sort of reassurance.

And thirdly, to deal with the question of trade credit, because if the loans are initially unsecured, then the banks scoop up new security in the form of fixed and floater. The worry of the directors is that this will terrify the trade creditors, so the trade credit will dry up, and if the trade credit dries up, the company is going to be fraudulent trading.

My experience is that this is not what has happened. Once the banks agree on a support operation, the trade creditors are happy.

But is it the position here, that there is a reasonableness test on fraudulent trade? With us it is the light at the end of tunnel - and that is subjective.

Response - Tony Fitzgerald:

Well I think we have two different areas. As I understand it there are general prohibitions on fraudulent trading, but over and above that, there is a requirement which requires reasonable care and diligence. As I understand it at the moment, although it hasn't been the subject of any particular detailed judicial investigation at the highest level in any event, the view is that reasonableness does import some objective criteria, although no doubt it must be related to the state of knowledge of the persons whose conduct is being examined.

Question - Robert Baxt:

Perhaps I could start it off Mr Chairman, by picking up Philip Wood's point in relation to Tony Fitzgerald's commentary on the directors' dilemma.

It seems to me that on a straight reading of the statute at least (and we haven't had sections 556 and 557 interpreted very widely in recent times) although the predecessors were the subject of a number of fascinating and difficult decisions for directors, it is not simply in the case of fraud that the directors have got to watch out for. If the company is in the position where it is close to insolvency, the directors run a real risk, as do those in management, in incurring debts where there is no reasonable expectation of those debts being met. Indeed, under the accounts provisions of the Companies Act, directors have to indicate in the annual report that the company is in fact solvent, or is able to meet its debts. This must accompany the annual statement.

I was particularly interested in Tony's comment about Walker and Wimbourne, Mr Chairman, and I just wondered if Tony or anyone else, perhaps Philip Wood, would like to comment on a 1983 English case, the multi-national chemical or oil case, where there was an attempt to make the directors personally liable for large debts incurred by a joint venture between three major oil companies (the creditors) and where one of the judges suggested that he would not read into the duties of directors an obligation to future creditors.

That seems to be a very different approach to that which has been adopted in Australia, because Walker and Wimbourne has been picked up in a number of cases (Ring and Sutton in the NSW Court of Appeal), it has been adopted in New Zealand as well, and there are some dicta in Victorian cases which suggest that the so called duty that directors may owe to creditors may well be expanded.

Answer - Philip Wood:

One of the major problems in a work out is that directors themselves have lost credibility. Well for good or bad, it may be just misfortune that has hit them and not misconduct. They have lost credibility and also they are unaccustomed to the situation, and therefore banks have to put in somebody else whom they can rely on and who is used to working with, and gathering the sort of information which is necessary. You can't get someone if there is a chance of fraudulent trading. He just won't go in. He will say the risk is too big.

Customarily, the man who does go in, always gets an indemnity from the banks themselves. But if the banks put in their own nominee, who happens to be an employee of the bank, eg a director of one of the banks, there is a danger of the big pocket syndrome, whereby other disappointed creditors, if the company does go into liquidation, shoot at that nominee director because he has got a big pocket behind him. This is a very awkward situation.

I think legislatures have got to walk a tightrope. On the one hand, they must stop people abusing the corporate forum; on the other hand, entrepreneurship must be encouraged. People should not be put in too risky a situation and the realities of rehabilitation must also be recognized.

Do you have rehabilitation here at all? Is there rehabilitation proceeding, a Chapter 11, like in the US? You can't have a moratorium where the directors are left in place but nobody can sue the company?

[JOHN CADELL: There is nothing really like that unless you utilize the scheme of arrangement provisions which require a court appointment.]

So you have got to do it by contract. It doesn't work by contract unless you have a fraudulent trading rule which doesn't fit.

I actually don't think you need a rehabilitation statute. We are getting one. I believe it is a bad idea in that it still kills the company. In our common law system the rehabilitation is carried out by the receivership mechanism. A floating charge is really a rehabilitation proceeding because you have one creditor who possesses a monopoly of the assets and who feels protected because he has a monopoly, and he is the creditor who keeps things going. I think it works very well actually.

Comment - John Cadell:

I think the difficulty that is being experienced out here is that there is a lot more financing being done on a negative pledge basis, which means there is no secured creditor. You can't appoint under a floating charge, so creditors are bound to either go by way of the contractual arrangement or else the formal scheme of arrangement.

Question - Philip Wood:

Could I perhaps ask John Cadell, what you do about hardening up the floater on book debts? Do you convert the floating charge into a fixed charge on book debts? As you know we have just had this recent case in Northern Ireland, which basically said that if you allow the fixed charge, even though you call it a fixed charge on book debts and thereby get all the advantages it effects against only a floater; if in fact you allow the borrower to deal with the debt in the ordinary course of business, then it is just converted into a floater, whatever you may say.

Answer - John Cadell:

I guess that is the problem you have always got if you call it a fixed charge and, in fact, if you permit dealings with any asset that way, the court will read it down as only a floater. I suppose what you have got to do is look at the book debts, and cover those that are significant by a fixed charge, but then give specific releases in particular cases.

Comment - Philip Wood:

I think it is obvious that it is possible for a company to give a fixed assignment of a book debt. But it is somewhat inconvenient with a company desiring to have a cash flow, for its debts to get tied up and locked up in the bank. They have to use the debt in order to fund, to carry on the operation.

What is the degree of retention you have got to have on the bank account into which the debts flow which gives this fixed characteristic as opposed to floaters? Well the view which Barclay took, I think, until this Irish case, was that provided the money came into the bank which held the floater, the fixed charge on the book debts was enough because they had the retention. Whereas, say, Lloyds and Midland would take a different view. I can't remember which was which, but one of the banks would transfer from the book debt account to the operating account overnight, whereas another of the clearers would transfer once a week, and they thought that gave sufficient control over the book debts. Whether that was sufficient to harden the floater one really doesn't know. It is very difficult to harden a floater.

It is like all of these things, sometimes it is better to have a potential argument than none at all. Now I think it is worth going in for all of these elaborate methods of improving one's position on a floater but it plainly is much better to have a fixed charge.

Question - Adrian Henchman (Allen Allen & Hemsley):

Mr Chairman, this whole question of the crystallization on charges is a very fascinating one and it seems to me that it is rather extraordinary that the legislature hasn't stepped in. I am interested in the clause John Cadell put in his security that the bank might at any time by notice to the borrower convert the floating charge into a fixed charge - a clause that is honoured by repetition in numerous securities.

I have often wondered whether it works and I would be interested to hear whether anyone on the panel has any particular ideas about that. I suppose the extraordinary thing, from the point of view of people dealing with a company in relation to this field, is that one does a search and you see there is a fixed and a floating charge but if there is an ability or if a floating charge does get converted into a fixed charge either with the knowledge of the bank or something else, there is never any obligation on the bank, or the company I suppose it might be, or the directors, to file some notice of this so that it would be discoverable.

One makes a company search and finds out that there is a fixed charge on this and a floating charge on that and usually says well, that is the end of the matter, without proceeding to think whether the floating charges are crystallized. Philip, what is your view of the clause? Is it just a matter of contract as far as crystallization is concerned? Can the mortgagee reserve the right by notice to the mortgagor to convert the floating into a fixed?

Answer - Philip Wood:

Actually I don't know what the answer to that is, but certainly I have found that where one does have an automatic crystallization clause, then it proves to be more nuisance than it is worth because the damned thing crystallizes just when you don't want it to crystallize, and then there is the big problem whether you can de-crystallize it and start it floating again. Of course you know there is the possibility of the cheating director who will sell off part of the assets, who will create charges, but, on the whole, normally that is not a major problem in my view. You need the automatic crystallization for that and sometimes you need the automatic crystallization for technical reasons. But on the whole I think when one is taking such a major step as changing the nature of a charge, or accelerating a debt or whatever, that is something which I think should require a specific act, a considered, deliberate act, of the directors, as opposed to something which happens automatically. I really think it is more trouble than it is worth. That has been my experience, but I am sure there will be lots of situations where it was important the other way round.

Question - John Cadell:

I suppose I have got to defend my document briefly. I think the important thing to bear in mind about automatic crystallization is that you have got to be very selective, and I entirely agree with Philip, that it can be a damned nuisance if you are suddenly crystallizing a charge every Tuesday morning.

On the other hand, I think particular companies, with particular types of assets which may be critical to their essential well being, should be considered as targets for automatic crystallization. I think the secret is to be very selective when you do it. Like everything, it is a matter of judgment.

Question - Rory Argyle (Parker & Parker):

I wonder if any of the panel or if the audience would have a comment on the de-crystallization of a floating charge that Philip alluded to a minute ago?

Answer - Dr Spry:

I would be hesitant in expressing a view unless I saw the actual document in question, but certainly as a matter of theory, it is possible to have a de-crystallization if one could establish that there was a sufficient consensus between the parties - either by reason of something in the original agreement operating upon an event, or by reason of some subsequent agreement, and you could in fact effect a de-crystallization. It would require consensus unless there was something in the original document which operated upon some act of one of the parties.

I suppose the way that customarily would be done, would be to say in the charge, that where following crystallization the secured creditor gave a notice indicating that he had waived the circumstance which gave rise to the crystallization, that the effect would then be reversed. It would normally be a unilateral act that is set out in the original charge.

Question - Philip Wood:

Could I perhaps ask David Crawford, whether you do hive down the assets into a newly formed subsidiary of the company in difficulty?

Answer - David Crawford:

It is not a common practice unless you have a situation where you might ultimately have, say, a product liability claim such as the Rolls Royce situation, where the receiver was faced with a 747 coming down and copping the personal liability. In that case, yes, you hive down, but it is not common.

Question - Bruce Cutler (Freehill, Hollingdale & Page):

My question concerns the taking of directions from banks, whether that could be a valid provision in any event, as breach of the Articles perhaps, on management power?

Answer - Philip Wood:

Well, you don't do it that way. What you say is that the company can't act without asking the bank. So that it is a question of getting a consent each time to dispose or to borrow or to incur a liability or to make an investment. But that is not just a bald "do what we say" clause. It is a covenant and, of course, then the question is whether that amounts to participation which is trading. We would not have Articles problems on that.

Question - Cathy Walter (Duvall McCutcheon):

Mr Wood, I'm wondering as an alternative perhaps to the utilization of a directors' provision, consideration could be given to utilizing say a power of attorney clause? The attorney would be the financier in the name of the company doing what the financier wished to have done.

Answer - Philip Wood:

I am not too sure one really needs to go to such lengths. I think what one does need to decide is what sort of things the company should get approval for from its creditors. And the typical things are the undertaking of new borrowings, the making of investments, capital commitments and disposals. And provided one controls those by appropriate convenants, provided of course you can trust the company - you know there comes a point where you ought to be able to do that - then that is all you need. If the covenants are tight enough then you really don't need any more mechanisms, because the company knows that if it doesn't stick by these rules, the loans are going to get called in.

In practice, my experience is that very often these covenants are much too tight and have an enormous nuisance value, and a company can't even sell a typewriter without coming to the creditors to ask for permission. It is very much a question of discretion. I am very doubtful about the need for these elaborate precautions to see that a company sticks by rules which they have agreed that it ought to adhere by.

Question - Cathy Walter:

And you don't see in the support agreement something in addition to the rights the financier has under those sorts of clauses.

Answer - Philip Wood:

No. Obviously once the receiver goes in, then he has got the power to run the company.

Question:

This question is probably more directed to the practicality of the situation, and just in reference to the creation of support agreements. I appreciate that the creditors in this case were all unsecured and they elected that the company should trade on. I would probably put it to David Crawford, more than anyone else, does he think support agreements really have the teeth to exercise the disciplines on the company, to turn it around, because it would seem to suggest that directors seem to follow the course that led them into the situation in the first place, rather than taking the hard decision, to get out.

Answer - David Crawford:

I support what Philip Wood said earlier on. I don't think that contractual arrangements, such as what we have here in the support agreement, really do work. We are faced with a number of practical problems. Bankers are bankers, and the man making the shoes knows how to make shoes. And to try and put bankers into the position of making shoes is a recipe for disaster. But at the same time, the bankers have lost confidence, generally speaking when it gets to this stage, in the existing management. It seems to me that there is need under the legislation that we have, to act within that legislation. Hopefully at some stage we will get a controlling administrative provision into the Companies Code which is not there yet. I would strongly prefer to go by way of the formal scheme of arrangement, which binds everyone in, and allows the banks to get on with their business of banking, but to have appointed somebody who hopefully knows something about running that particular business.