DIRECTORS' DUTIES TO CREDITORS
Current Law & Proposals for Reform

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Mr Chairman, ladies and gentlemen. A businessman is in a particularly difficult situation when he has to take the stand after two accomplished speakers. One is a Queens Counsel and the other one is a Professor and a leading academic. There was a very famous American trial lawyer who, before a case commenced before a court, adopted the policy of making the statement "don't worry about the law, obtain the sympathy of the court". Well, I will do the same now.

Yesterday afternoon when I was ready to leave my office, a document arrived on my desk which was issued by the Sydney Stock Exchange. That document tells the results achieved on the stock market by a number of companies and it raised the example of $1000 invested on the 30th of June 1983 in a number of companies - Industrial Equity, Pacific Dunlop, Pioneer Concrete, TNT, BHP, Adelaide Steamship, BTI Nylex, CSR, Elders-IXL, and FAI. And let me give you the results which I have little doubt will get me something! The $1000 invested in Industrial Equity on the date mentioned has become by the 30th of April 1988 $5522. The dates are the same all the way through. In the case of Pacific Dunlop it came to $6500; Pioneer Concrete became $3006; TNT became $5211; BHP became $4679; Adelaide Steamship became $4623; BTI Nylex became $26,230 - and it might interest you if I would tell you that the sharp increase in BTI Nylex started on the date when a new Chief Executive was appointed, the old one was somebody called Henry Bosch! No connection of course! In the case of CSR it came to $1406. In the case of Elders-IXL it became $3892. And of course the undoubted winner was FAI at $27,387. I hope that you will remember this as I will proceed to read my speech. Also let me thank you for giving me the opportunity to comment on the effect of broadening the scope of the duties of directors owed to creditors of their company.

Right at the beginning let me make it very clear that the trend of extending these duties is damaging to business and thus is damaging to Australia. Professor Baxt and Alex Chernov have already outlined in detail the current state of law and the proposals for change which the Law Reform Commission has put

forward. It is for me to present what I believe are the practical implications of such proposed laws from the viewpoint of a businessman and a director. And in that context, of course, I really wish to draw your attention to the fact that whatever else I might be, a lawyer I am not.

The duties imposed upon directors to take account of the interests of creditors have ramifications far beyond the personal interests of directors. It is the indirect effects of the statutory imposition of such duties which impact upon shareholders in the company, creditors and the economy. It would be forcing directors to spend more time on self protection from the law, involving high costs which later would undoubtedly be passed on to the consumers.

Most directors act in good faith and in the best interest of the company they represent. In doing so they will, save in exceptional circumstances, also be acting in the best interests of creditors. The creditors' interests can best be served by a solvent and viable company. Extreme cases aside, the interests of creditors mostly overlap with those of the shareholders. Considering this, it is arguably appropriate that the directors owe the same duties to creditors as they owe to shareholders, and that is to act honestly, in good faith, and in what the directors believe to be the best interest of the company.

Now the best interest of the company, of course, involves the directors in taking risks that if the decisions they have made turn out to be profitable, they will undoubtedly be acclaimed. But the very same decisions, if they make them, and they turn into a loss, heaven help them! I do recognise that there are on occasion individual directors who are reckless, speculative, and indeed fraudulent. It is true that the law should offer no protection for these directors. The current law, as contained in the Companies Code, if policed properly, is sufficient to protect creditors from those few directors who act unreasonably.

The problem is that the few directors who act in an improper way, may not be dealt with under the existing laws. The reason is simply that the law in this area may not be administered as strongly as it could be. If the existing provisions were policed strictly, directors would be penalised if they were acting improperly. As is shown by the operation of the insider trading laws, notwithstanding what the law says, it will have no effect unless the offence can be proved and the law enforced. There is no need for broadening of the duties, directors or creditors, unless it is believed that the law should be further extended to regulate all directors in addition to those who are acting recklessly, speculatively or fraudulently.

The Australian Law Reform Commission's investigation and final report is unlikely to be completed and tabled in Parliament until later this year. However, the Commission has indicated that the draft legislation proposed in respect of directors' liability and

directors' disqualification is unlikely to change from its current form as published in the Commission's Discussion Paper previously.

The. Commission proposes that a director will have a duty to the company to prevent the company from engaging in insolvent trading. The company is to be presumed to have engaged in insolvent trading where it incurred a debt at a time when there are reasonably grounds for suspecting that the company was unable to pay its debts or where the company subsequently commenced to be wound up in insolvency. A director who held office during the period when the company engaged in insolvent trading is presumed to have been in breach unless he or she had reasonable grounds to expect that the company would have been able to pay its debts, or the directors took steps to minimise a possible loss to the creditors of the company within a reasonable time from the date that the company was found by the director to be insolvent. It is answer to the presumption that the directors have breached their duty, that directors have placed the company in a form of administration in insolvency under the Act.

This duty which is effectively a duty to creditors even though worded in terms of a duty to the company, is broader than the current law and potentially more damaging to the economy. The duty will mean that either a receiver or manager or a liquidator may be appointed by the company directors in circumstances where under the old law the company would in many instances be able to trade on.

It should be remembered that insolvency may occur if manufactured goods become temporarily unsaleable, due even to floods or drought, natural resources may not be mined on account of strikes at the mines or may not be delivered on account of strikes at the wharfs. Small manufacturers may be put to insolvency through a temporary change in fashion or a belated commencement of a season.

The economic effects of compelling such behaviour of directors will obviously be detrimental to Australia. To place a liquidator in a company will hurt the company, its shareholders, and the economy. It may well be putting the company into receivership or liquidation, it may also be prejudicial to the interests of creditors, as I will discuss later.

I wish to make two general points in relation to the duties directors owe creditors. First, is it reasonable to expect directors to be fully appraised as to the company's solvency at any point in time? Secondly, where the company may be insolvent, is it not in the interest of creditors and the company for the directors to attempt to manage to trade the company back into solvency?

How many non-executive directors are really aware what the company's debt position is on a 30, 60 or 90 day basis? To

ascertain the company's short term debt position it is obviously essential to ascertain the company's ability to pay its debts. It may be unreasonable to expect a non-executive director to be continuously up to date with the company's short term creditors. Such financial position may also be affected by the slowing down of sales, by delays of manufacturing or by delays on the waterfront. When directors make investment decisions, they may for perfectly justifiable reasons, not be fully aware of the company's true financial position.

Most directors only receive one audit report a year, and this report may be the only accurate one that they see in the whole financial year. It also applies to the financial position of the company only on one single day. Non-executive directors rely heavily on the chief executive, who may or may not tell them all they need to know, even assuming that he himself is in full possession of all the relevant facts. Yet, the Companies Code charges a non-executive director with the same duties as it does a chief executive.

Similarly, the individual directors of small companies, who only use the company structure as a corporate shield or veil, are charged with the same duties to creditors as a non-executive director or chief executive of a large company. There is, in my view, a strong argument for the duties of directors to creditors to defer between these three different categories of directors.

It may be possible to have directors better briefed as to the company's ability to pay its debts but the administrative cost of such better briefing would be great when the information is required on a continuous basis.

The broadening of directors' duties to creditors may lead to the widening of auditors' duties and roles, who may be required to monitor matters even weekly or monthly - presently outside the normal audit functions. This would obviously increase auditing and accounting costs quite tremendously.

For directors to be truly appraised about the company's solvency on a continuous basis, directors will obviously have to rely even more on internal accounts and on their lawyers. As a result the company's overheads will be increased further limiting both our internal and our international competitiveness. It must also be remembered that internal auditors report to management and have no direct access or responsibility to outside directors.

Governments often regulate businesses while only looking at the possible benefits achieved. The economic cost of higher overheads on business profits is often forgotten. In terms of increased expenses, the cost of broadening the duties directors owe to the creditors is high and is ultimately borne by the community.

I now will have moved to my second point of why it may be in the best interests of the creditors and the company for the directors

to attempt to manage the company back to solvency and profitability. The duties directors owe creditors can effectively place a limitation on when directors can decide that the company can trade out of its difficulties.

It may well be and indeed is often the case that an insolvent company can recover to be both profitable and solvent. There are reasons for most things including the company's insolvency. Given that there will always be reasons for the company's failure there will in many cases be a solution which will again produce a liquid and viable company. To close the door to a possible solution, and in many cases create greater hardship for creditors and the company even leading to increased unemployment. By broadening the duties which directors owe to creditors and backing these duties up by penalties relating to the loss caused to the creditors, we could be frightening honest directors to such an extent that they will be reluctant to accept invitations to join the boards of new or small companies or refrain from taking legitimate business risks to attempt to trade the company out of insolvency. By putting companies indiscriminately into liquidation there would also be a great pressure on the remaining solvent companies by putting stock for sale at a cut price as goods of a company in liquidation always demand a lower price on the market place.

Australia can simply not afford to put the directors of its companies in risk adverse straightjackets which will mean that some companies will cease trading unnecessarily. The broadening of directors' duties may have this effect and the national economy will be much harmed by the result.

When directors make decisions as to whether their failing company continues to trade, it should be made on the merits of the business by looking to the proper commercial conduct of the business. I do not think it should be a decision which the directors are forced into by virtue of duties owed to creditors only. However, where a director is without doubt acting improperly, with unnecessarily high risks or recklessly, attempting to trade out of a difficulty, the creditors should be protected. The present law, properly administered, adequately deals with such recalcitrant directors.

The company solvency problem may in many cases be merely a short term cash flow problem. If the term "insolvency" is defined to include such short term cash flow problems, imposing a duty to prevent the company engaging in insolvent trading will have very wide implications for the developing economy. Short term cash flow is not the problem as far as the creditors are concerned, as creditors will normally accept a delay in payment if they are likely to be ultimately repaid.

In some situations it will be legitimate to attempt to trade back into profitability which will lead to the solvency by delaying payment to creditors, given that when a company is insolvent, its

creditors are unlikely to be paid all their debt. It may well be in their best interest that the company continues to trade and pays the amount it owes at a later date, sometimes even including a loading for the delayed payment. It is possible that the company's position will deteriorate further and the return to creditors will in fact be less than if trading has ceased. However, it is worth remembering that the directors have no interest in the company losing money. So long as they are not acting unreasonably, they should be allowed to decide whether the company should attempt to trade out of its difficulties.

The appointment of a receiver and manager as allowed for by the Companies Code is the last measure directors can resort to for delaying payment to creditors. It allows the company to continue to trade even though it is clearly insolvent. This formal delay in payment to creditors provides directors with the opportunity to assess if the business should be liquidated or sold as a going concern, and gives them the opportunity to see if the company can trade into solvency.

Of course, the appointment of a receiver will deter a number of the company's customers from dealing further with the company but very valuable and virtually irreplaceable executives and staff will both wish to seek other employment and will also be the targets for head hunters, accelerating the demise of the company.

It may be in the best interests of creditors and the company that the directors procrastinate in paying out creditors while hopefully being able to make more full payment at a later date. If we were to resort to common sense to determine what the law should be, surely the duty directors should owe creditors is an attempt to maximise their recovery of the amount owed to them. The direction the law is taking in this area does not encompass this common sense duty. The broadening of legal duties to creditors has not incorporated the reality that temporary insolvent trading may actually increase the creditor's recovery.

There are many great companies in the world which at one time or another have had solvency problems but have recovered to benefit both creditors, the company and the nation's economy. Notable examples include such well-known companies as the Ford Motor Company in the United States and General Motors. Imagine had they had to cease trading some time ago. If Citibank and the Bank of America had written down their Latin-American debt some time ago they could well have been facing technical insolvency. Does that mean that directors should have been under a duty to liquidate these banks or to have appointed a receiver to run them? Local banks would have been in a similar position had they written down the value of the government bonds during the early Whitlam years when rates increased to 18 percent in a very short period of time.

It is worth remembering that most businesses will have solvency problems at one time or another. If we discourage directors from

attempting to trade out of difficulties we can be assured that some of the companies which cease trading as a result, could otherwise have become successful.

The potential damage done to our economy in the Law Reform Commission's proposal is very great. I believe it is important that directors be discouraged from acting recklessly, speculatively or fraudulently, where it is clear the interests of creditors will be unfairly prejudiced by such behaviour. However, my concern is that we are trying to catch a few bad fish with a very big net which will also catch innocent fish better left swimming.

To have even one business put into liquidation unnecessarily requires a major benefit to the economy or to creditors and I cannot see any such benefit being created. The duties directors owe to creditors must be looked at in the context of the reality of directors' involvement in a company. Directors cannot always know the exact financial position of the company or always be correct when they make decisions. By imposing additional rigorous duties upon them which constrain the scope of the risks that they can take, the law is striking at the heart of the free enterprise system.

A further broadening of directors' duties to creditors in the form of the Law Reform Commission's proposal for change would act to force directors not to accept opportunities for development or businesses. The current law is quite adequate to catch the few unreasonable directors who exist if it is only policed properly.

As members of this association I would hope you will do all in your power to oppose the Australian Law Reform Commission's proposals and press for a Companies Code which recognises the right of directors to accept legitimate business risks including the right to nurse businesses back to health. Without such rights we will see new business developments reduced materially whilst existing businesses will be eliminated at an ever increasing rate. A consequence that Australia cannot and should not afford.