DIRECTORS' DUTIES TO CREDITORS
Current Law & Proposals for Reform

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A noted English judge once said that there was no rule of law which said that the directors of the company may not have their cakes and ale, but, he added, they may not have them at the expense of the shareholders. One might well add in light of recent developments in the law and proposals of the Australian Law Reform Commission, that they may not have their cakes and ale at the expense of the creditors either.

It is probably convenient to turn first to the proposals by the Australian Law Reform Commission. They may be summarised as follows:

(1) The director is placed under a positive duty (to the company) to prevent it from engaging in insolvent trading.

(2) If the company has engaged in insolvent trading, there is a presumption that the director has breached that duty.

(3) Consequently, the key question is, when does insolvent trading occur?

That occurs if one of the following situations exists.

(a) A debt is incurred when circumstances of insolvency exist (i.e. when there are reasonable grounds for suspecting that the company cannot pay its debts which is presumed if the company's liabilities exceed its assets).

(b) The company is subsequently commenced to be wound up in insolvency.

(4) As to circumstances of insolvency, they are deemed to exist if there are reasonable grounds for suspecting that the company is unable to pay its debts (after taking into account contingent and prospective liabilities).

There is a presumption that the company cannot pay its debts if the company's liabilities exceed the value of its tangible/intangible assets.

(5) Therefore, if a person is a director of a company which incurs a debt when there is reason to suspect that the liabilities exceed its assets, he will be presumed to be in breach of his duty to prevent the company from engaging in insolvent trading.

(6) A director who is in breach of that duty becomes personally liable and proceedings may be brought against him by the company, the liquidator or (subject to leave of the Court) a creditor. The amount that may be claimed against him is "such amount as is just, having regard to the interests of creditors in the extent to which the financial position of the company was prejudicially affected by reason of that breach". Any amount so recovered by the liquidator is to be applied for the benefit of unsecured creditors.

(7) The director who is presumed to be so in breach of duty can rebut such presumption if he can make out one of the following matters.

(A) (a) He had reasonable grounds to expect that the company would have been able to pay its debts.

(b) He took steps to minimise the possible loss to creditors.

(B) A competent and reliable person was charged with the responsibility of seeing that the company did not engage in insolvent trading and that that person was in a position to discharge that responsibility.

(C) By reason of illness or other unavoidable cause he did not participate in the management of the company.

(D) He comes within s.535 of the Companies Code.

A number of things stand out in the suggested changes to the law. They include the following:

(a) The first and probably the most important thing to note is that the provisions create presumptions in respect of matters which are usually required to be established by those asserting insolvent trading. For example, insolvent trading is presumed where there are reasonable grounds for suspecting that the company cannot pay its debts and that in turn, is presumed if its liabilities exceed its assets. In the usual course of events it is for the liquidator to establish insolvent trading and not only that the company's liabilities exceed its assets, but that it is unable to pay its debts as and when they fall due.

Likewise, once those presumptions are made out, the director is held prima facie liable to creditors. From a practical point of view, it probably means that in nearly all winding up cases, the director will be prima facie liable to creditors.

(b) The matter which the director is required to make out if he is to avoid the presumption operating against him effectively, will be difficult to make out, particularly if the matter is viewed (as it so often is) for the benefit of hindsight. For example, what constitutes "reasonable grounds" for the expectation that the company will be able to pay its debts and at what point in time must that expectation be held?

Similarly, what constitutes an "unavoidable cause" (other than missing a flight to the Board meeting) by reason of which the director did not participate in the management of the company?

How does one effectively charge a "competent and reliable person" (assuming one can be found) with the responsibility of seeing that the company does not engage in insolvent trading?

(c) The duty to prevent the company from engaging in insolvent trading is owed by the director to the <u>company</u>, but the damages flowing from a breach of such a duty appear to be measured principally in terms of loss suffered by creditors.

(d) A breach of that duty exposes the director to <u>personal</u> liability at the instance of the company, a liquidator or possibly, a creditor.

(e) The duty is a positive duty, namely, to <u>prevent</u> the company from engaging in insolvent trading. Incurring a debt at a point when the company's liabilities exceed its assets is presumed to be insolvent trading. If a director is to <u>prevent</u> that from occurring, he will be required to be aware constantly as to what is the assets/liability position of the company. He has not only to seek out that information, but he must also be reasonably confident that it is correct, otherwise he may not be taking the first step along the path of <u>preventing</u> the company from engaging in insolvent trading.

One could be forgiven for thinking that the law must be very deficient to warrant the introduction of sweeping provisions of this type and in particular, reversing the well established principles in our community that he who accuses another of a wrong bears the onus of making out that accusation. Let us therefore see what is the state of the law as to the obligation of directors in respect of creditors of the company.

Traditionally, the courts have expressed the relevant duty owed by a director as a <u>fiduciary</u> duty owed to the company and its shareholders. In relatively recent times, when seeking to find a solution to the situation where creditors have been left unpaid by an insolvent company the directors of which have contributed to that insolvency, the courts have imposed a duty on them to have regard to the interests of creditors.

Before turning to look briefly at what the courts have done, I should say that the legislature has also been busy in limiting the ability of directors to take advantage of the corporate veil.

In Australia, the first significant sign of development on the judicial front came in the form of a passage in the judgment of Mason J. (as he then was) with whom Barwick C.J. agreed in Walker v. Wimborne (1975) 137 CLR 1 at p.7:

> "... it should be emphasised that the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company ... must look to the company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent."

This passage appeared in the context of proceedings by a liquidator against directors for damages based on breach of s.367B of the 1961 Act (now s.542 of the Code), namely, breach of trust, the directors having authorised the insolvent company to make uncommercial payments to related companies. Having regard to the factual context in which this part of the judgment was made, it probably means no more than in circumstances of insolvency, interests of the company require that directors have regard to the interests of creditors when the directors make decisions involving the movement of the company's assets. It should be noted that his Honour did not lay down the proposition that directors owe creditors a separate personal duty of care.

The majority of the Court of Appeal in Nicholson v. Permakraft (NZ) Ltd. (1985) 1 NZLR 242, held that where the company is insolvent, the directors owe a relevant duty to the (existing) creditors, but that no such duty exists if the company is solvent. They wisely left for another day, what principles should be applied in the intermediate situation, namely, near insolvency. Cooke J. had no such reservations. By way of a rather wide obiter, his Honour said that in the case of marginal solvency (existing) creditors are owed a duty by directors (because they may fairly be seen as beneficially interested in the company). His Honour went on to say that the recognition of such a duty is justified by the concept that limited liability is a privilege.

In that case, the liquidator sought from directors the return of a capital dividend which was paid to them by the company. He lost because it was established that the company could not have been reasonably regarded as insolvent when the directors decided to pay the capital dividend (in the course of restructuring the company).

In 1986, there was a significant decision handed down by the New South Wales Court of Appeal: Kinsela & Anor v. Russell Kinsela Pty Ltd (In Liq) (1986) 4 NSWLR 722; (1986) 10 ACLR 395. As many of you will know, the family name Kinsela has for long been synonymous with the conduct of a funeral business in Sydney. Russell Kinsela Pty. Ltd. developed severe liquidity problems through failing to manage efficiently a scheme it ran for insurance of funeral costs. In 1979 the Parliament of New South Wales passed the Funeral Funds Act which came into operation in October 1980. The directors of the company knew that the Act would require them to disclose the company's financial position, thus exposing it to the intervention of a statutory officer under that legislation. In an attempt to preserve something from an imminent wreck, the company granted a lease to members of the Kinsela family of premises which it owned, together with an option to purchase. The rental payments under the lease and the terms of the option were favourable to the tenants compared with current market rental and prices. At the time of the transaction, in January 1981, the company was insolvent. Nevertheless, the transaction was properly documented and approved of by all of the shareholders. Three months later, an order was made for winding up.

There was no difficulty in concluding that the leasing transaction was within the powers and capacity of the company. This led to the second question, namely, whether the power which the company undoubtedly possessed had been validly exercised so as to bind it. For if it had not, the transaction was voidable and the liquidator was entitled to ask the court to avoid it. The trial judge had felt constrained to hold that the transaction should not be avoided because, even though the directors had exercised their powers in a manner not for the benefit of the company as a whole, their action had been approved of by all the company's shareholders to whom the directors had made full and frank disclosure.

In the leading judgment of the Court of Appeal, the Chief Justice, Sir Lawrence Street, in whose judgment the other judges agreed, analysed the issue on the basis of directors' duties to the company. He recognised that in the context of a solvent company, it should be regarded as being constituted by shareholders; on the other hand in the context of an insolvent company, interests of creditors "intrude" and effectively displace those of shareholders pending either liquidation, return to solvency or the imposition of some alternative administration. His Honour said (NSWLR pp. 729-30):

> "The authorities to which his Honour submitted, notwithstanding the generality of their enunciations of principle, were not intended to, and do not, apply in a situation in which the interests of the company as a whole involve the rights of creditors as distinct from the rights of shareholders. In a solvent company, the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of

> directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent, the interests of the creditors intrude. They become prospectively entitled through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is, in a practical sense, their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration."

His Honour also said, after referring with approval to (but not adopting) Cooke J. in Nicholson, that the directors' duty to a company as a whole extends in insolvency to not prejudicing the interests of creditors (and shareholders do not have the power to absolve the directors from such a breach).

In the event, the New South Wales Court of Appeal had no difficulty in concluding that the directors of Kinsela had thus acted in breach of their duty to the company in that their action directly prejudiced its creditors. But the Chief Justice did say (NSWLR 733):

> "I hesitate to attempt to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors. For present purposes, it is not necessary to draw upon Nicholson v. Permakraft as authority for any more than the proposition that the duty arises when a company is insolvent inasmuch as it is the creditors' money which is at risk, in contrast to the shareholders' proprietary interests ..."

Two points should be made. First, this case does not establish that a company director has a personal duty to creditors of the company. It does however elaborate the nature of the duty to the company and makes it clear that at least when a company is insolvent the fulfilment of that duty requires a director to consider the interests of the company's creditors. Secondly, the Court of Appeal was careful not to extend the principle beyond the situation where the action or decision of the directors is taken at a time the company is clearly insolvent. This left open for further judicial determination those circumstances in which interests of the creditors must be considered, even though a company might not yet be insolvent.

Arguably, a broader approach was taken by the South Australian Court of Appeal in Grove v. Flavel (1987) 11 ACLR 161. Grove was a director of a series of companies. He sought a loan for one of them, Brian Grove Constructions Pty. Ltd. This was refused, leaving that company in a position where liquidation was a definite possibility. He caused a series of cheques to be drawn and paid (by way of "round robin") resulting in a benefit to himself and some of his other companies, but without affecting the liquidity position of the company in question. He was convicted under s.229(3) for improperly using information (that information being that the company was at risk of liquidation).

The only issue before the court was whether in acting as he did, he made "improper use" of information which he had as a director. Even though the company was not insolvent at the time, the Court of Appeal held that the section would still be breached where, as in the case before them, the director knew of a real risk of insolvency.

The point to be made about that case is that the court chose to treat knowledge of a real risk of insolvency as attracting the same duty as that which applies where a company is in fact insolvent, thereby suggesting that a duty to creditors can arise where the directors have knowledge of a real risk of insolvency of the company even if it is solvent at the time of the transaction.

In England in 1987, the House of Lords was a little bolder in stating the nature of both the company's duty and that of its directors:

> "But a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the payment of its debts. The conscience of the company, as well as its management, is confined to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors." (Winkworth v. Edward Baron Development Co. Ltd. [1987] 1 All ER 114 per Lord Templeman at p. 118).

These cases give some indication of how the law has been developed by the courts so as to provide a greater measure of protection to creditors of a company which is insolvent or close to insolvency. To reiterate, the present position may be summarised in the following terms.

(a) Where the company is solvent, no duty is owed by directors to creditors - it is owed only to the company which is represented by shareholders. (Kinsela; Multinational Case [1983] 2 All ER 563; Rolled Steel Case [1985] 2 WLR 908, 947-8).

(b) Where the company is insolvent, the directors' duty to the company requires them to take into account interests of creditors and treat those interests as overriding those of shareholders in case of conflict. Thus shareholders cannot effectively sanction a decision of directors which results in the interests of creditors being prejudiced in favour of shareholders. (Kinsela; Walker v. Wimborne).

(c) Where a company is in a state of marginal solvency, or where there is real risk of insolvency, the position is less clear, but it may be that depending on how obvious and real the risk of insolvency is, directors may be required to have regard to the interests of creditors at the expense of shareholders. (Nicholson; Grove v. Flavel; Winkworth; Walker v. Wimborne).

But personal liability to creditors does not appear to arise except perhaps in the eyes of Cooke J. in Nicholson at p. 249.

There are, in addition, presently existing provisions of the Companies Code which bear upon the same question. Time does not permit their analysis, but some of the more important sections may be mentioned briefly. Section 556 creates criminal and civil liability and makes it an offence to take part in the management of the company at a time when a debt is incurred where, immediately before it is incurred, there are reasonable grounds to expect, inter alia, that the company will not be able to pay all its debts as and when they become due. Not only is it an offence punishable by imprisonment and/or a fine, but creditors have a right to recover the debt from the director. In such proceedings, the liability may be established on the balance of probabilities. Several defences are open to the director against whom proceedings have been brought under that provision.

Another significant section is s.229 which has already been mentioned.

The obligation towards creditors is affected by three separate provisions of the section. In the first place there is the general statement of a director's liability in sub-s.(1), placing on him a duty to act at all times honestly in the exercise of his powers and the discharge of the duties of his office. Secondly, he has, by virtue of sub-s.(2), the obligation at all times to exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties. Finally, pursuant to sub-s.(3), he may not make improper use of information acquired by virtue of his position to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

A breach of any of these provisions is an offence. But equally important, for present purposes, is the right conferred upon a corporation by sub-s.(7) in circumstances where there has been a breach of any one of these provisions (regardless of whether the person has been convicted of an offence) to recover as a debt due to the corporation an amount equal to any profit made or damage or loss suffered as a result of such a contravention or failure. It should also be noted that in any such proceedings, the onus of proof on all of the relevant matters remains firmly upon the corporation, for which one will normally read "the liquidator".

Having regard to the present law which does not exactly disregard the failure by directors to take proper account of the interests of creditors in an insolvency context, one may well ask: what is the purpose of the provisions proposed by the Law Reform Commission? Any attempt to simplify the expression of the existing law should be applauded. But in my view they seem to go beyond that and place on directors an onus which appears to be impractical and what may be even more important, not necessary because the existing situation already gives adequate protection to creditors while recognising at least to some extent that directors and creditors operate in a commercial context.

A major consequence of the Law Reform Commission proposals would be to make it easier for liquidators to establish a claim against directors who have breached their duty to the company and to creditors. If it can be demonstrated that the present position is such that a liquidator is unable to make out the case against a defaulting director because difficulties of proof are such as to preclude him from so doing and that therefore, many directors unfairly escape their obligations, then the new proposals reversing the onus of proof and creating the presumptions to which reference has been made, may well be justified. I have not myself experienced, nor have I heard anybody put forward tangible evidence that liquidators cannot at present make out the case against directors who have so breached their duty. It is therefore difficult to justify the proposal of the Commission. Moreover, it is likely that if the proposals are put into effect, the courts will seek to read them down with the result that it will be many years before the ramifications of the proposals are fully worked out. There is no doubt that this will be in the short term commercial interests of lawyers, but one wonders whether it will be in the interests of the commercial community or the community at large. I doubt that it will.

There is another point that may be mentioned and that is that in the case of most liquidations, the companies involved are small companies involving a husband and wife or a like partnership trading as a corporation. If the evil that is sought to be met by the Law Reform Commission proposals is that many of those small companies leave creditors unpaid because of the failure by directors to appreciate fully their legal obligations, then one may well ask, what is the point in contriving to allow such small businesses to incorporate and afford them the benefits of a corporate veil? Perhaps the law should look again at the question of allowing such small ventures to incorporate. It may be that all interests will be best served by allowing incorporation of such businesses only on the basis that the principals are effectively liable for the debts of the company. This legislation exists, for example, in South Australia in respect of the legal profession. Should it apply to similar small ventures which seek incorporation?