CORPORATE LAW DEVELOPMENTS AND REFORM

Trading While Insolvent: The Director's Point of View

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BACKGROUND

Traditionally directors owed no duty to protect the interests of creditors. However, in recent times, the judiciary has extended the duties imposed on company directors to protect the interest of creditors in times of marginal solvency.

The origins of the duty can be traced back to the judgment of Mason J who, in *Walker v Wimborne*,[1] called for directors to heed the interests of creditors:

> "The directors of a company in discharging their duty to the company must take account of the interest 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 as well as for them. The creditor of a company, whether it be a member of a 'group' of companies in the accepted sense of that term or not, must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent."

Some commentators have since expressed the view that Mason J was simply trying to say that creditors' interests have to be taken into account as part of the director's duty to the company as a whole, rather than as a separate and distinct duty. However, subsequent case law has interpreted Mason J as creating a new duty to creditors.

Walker v Wimborne was relied upon by the New South Wales Court of Appeal in *Ring v Sutton*[2] to hold that a liquidator could challenge, on behalf of creditors, loans entered into by a director of the company with the company.

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1 (1976) 137 CLR 1 at 6-7.

2 (1980) 5 ACLR 546.

The Wellington Court of Appeal in *Nicholson v Permakraft (NZ) Ltd*[3] concluded that directors were required to take into account the interests of creditors where:

> "... the company is insolvent or near insolvent, or of doubtful solvency, or if a contemplated payment or other course of action will jeopardise its solvency."

So, creditors' interests rise to the fore where the company is in financial difficulty – in a situation of marginal commercial solvency creditors themselves are in effect beneficially interested in the company. This was a view endorsed by Street CJ in *Kinsela & Anor v Russell Kinsela Pty Ltd (in liq)*[4] case which cited *Nicholson* with approval, and went on to discuss insolvency as a situation where the creditors' money is at risk, rather than the shareholders' proprietary interests as the value of the shareholders' interests is negligible. This is the rationale for creditors being given a higher priority.

STATUTORY DUTY: SECTION 558G OF THE CORPORATIONS LAW

Section 588G is headed "Directors' duty to prevent insolvent trading." In fact, it only prescribes the incurring of new debts rather than trading. I will now discuss the elements of the section.

1. *Debt was incurred on or after 23 June 1993*

Section 588G has retained the concept of "incurring a debt" as the focal point of the new insolvency provisions of the Corporations Law. The time at which a debt was incurred will vary, depending on the terms of the agreement between the parties, whether express or implied. Establishing this is critical to the operation of the section because it is at this time that the directors' beliefs about the company's ability to pay will be assessed.

Establishing exactly when a debt was incurred has been the subject of litigation, particularly contingent debts, as has the distinction between debts and a liability for damages.

The weight of authority favours the view that the contingent nature of a company's debt will not exclude its directors from liability under Corporations Law Part 5.7B Division 3. The debt incurred can be a contingent debt, as demonstrated in *Hawkins v Bank of China*.[5] Basically, it does not matter if the guarantee obligation is one that the company may never be called upon to honour, provided that the guarantee obligation is unavoidable and involves an obligation to pay a liquidated sum. So, incurring a contingent debt at a time when the company is unable to pay its debts contravenes section 588G to the same extent as incurring debts which become due and payable immediately.

Serial transactions are similarly problematic. A series of contracts will be treated as a series of debts, each arising when each respective liability arises. In a different scenario, if the transaction itself were illegal then no debt would be incurred, rather the transaction would be one by which the company would only purport to incur a debt: *re Ferngully Stockfeeds*.[6]

The concept of "debt" was interpreted in *Ogden's v Weinberg*[7] per Lord Davey as "... something recoverable by action for debt and nothing can be recovered in an action for debt except that which is ascertained or can be ascertained." So, the obligation needs to be ascertainable rather

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3 [1985] 1 NZLR 242.

4 (1986) 10 ACLR 395.

5 (1992) 26 NSWLR 562.

6 (1996) 20 ACSR 496.

7 (1906) 95 LT 567.

than an obligation to pay unliquidated damages, for example, such as for fraudulent misrepresentation or breach of contract.[8]

Where there is a contract for goods which are to be paid for on delivery, the company will incur the debt when the goods are delivered. However, a debt will only be incurred after a delivery is actually made, and there is no liability under this section for refusing to accept a delivery of material.

2. *The person was a director at the time when the company incurred a debt*

Section 588G does not expressly refer to other persons in management, based on the rationale that directors have the primary responsibility for directing the affairs of a company, although elsewhere in the Corporations Law the class of directors has been construed more widely. Section 60's definition of directors, for example, includes de facto and shadow directors.

3. *The company was insolvent*

Section 588G specifies that a company must have been insolvent at the time the debt was incurred, or have become insolvent by incurring the debt. Section 95A of the Corporations Law defines insolvency. Pursuant to subsection (2), a company which is not solvent is insolvent. According to subsection (1):

> "(1) A [company] is solvent if, and only if, the [company] is able to pay all the [company's] debts as and when they become due and payable."

The test therefore necessitates a consideration of the whole of the company's future cash flows, allowing for its credit resources. Many companies depend heavily for short-term liquidity on credit provided by their banks. If for some reason that credit is withdrawn, a huge surplus of assets over liabilities does not prevent insolvency. Some of the most difficult decisions for directors arise in such situations, where they are concerned for the position of the company's shareholders and employees.

It is not a question that can be answered solely by reference to the company's balance sheet. A balance sheet will show a company's assets and liabilities at a given time but will not demonstrate its liquidity. The entirety of the company's financial position needs to be considered – the nature of its business, the method of payment of debts, of obtaining credit, and the nature of its assets.

A balance sheet (if, for example, it is the one most recently prepared in accordance with the Corporations Law) may mislead. It may overstate the company's position if asset valuations based on underlying assumptions on continuation of the company's businesses are no longer true. Conversely, accounting practice which is imported by the Corporations Law may require depreciation of assets (for example, in the nature of goodwill) to below the value they have in the open market.

A lack of liquidity in the short term will not necessarily mean insolvency. Jacobs J in *Hymix Concrete* said that: "... a temporary lack of liquidity must be distinguished from an endemic shortage of working capital."

The ability to raise a loan to pay debts is not indicative of solvency either. If the company is simply replacing one debt with another debt and assets exceed liabilities, then that company is insolvent regardless.

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[8] *3M Australia Pty Ltd v Watt* (1985) 9 ACLR 203 at 206-7.

4. *Directors need to be aware at the time that there were grounds for suspecting insolvency, or a reasonable person in a like company in the same circumstances would realise*

Judicial consideration has so far suggested that the concept of suspicion is wider than that of expectation. In *3M Australia Pty Ltd v Keemish*,[9] Foster J discussed the distinction, citing Mahoney JA in *Dunn v Shapowloff* who pointed out that "expecting" was more like "predicting". The Victorian Bar voiced its disapproval of the use of the word "suspecting" as they felt that directors should not be required to make important business decisions on the basis of suspicion alone.

The test for suspicion is an objective one, centring around objectively reasonable grounds which must be judged by the standard appropriate to a director of ordinary competence: *3M Australia Pty Ltd v Keemish*. In fact, there is authority to suggest that in determining reasonable grounds, the actual state of mind or knowledge of a director will not be a relevant factor. In *Metropolitan Fire Systems Pty Ltd v Miller & Ors*,[10] Einfeld J cited with approval the judgment of Duggan J in *Group Four Industries Pty Ltd v Brosnan & Anor*[11] who, in dealing with the predecessor to section 592 (section 556 of the Companies Code) remarked:

> "The state of knowledge of the particular defendant and any assessment he may have made as to the ability of the company to pay its debts are irrelevant consideration insofar as this subsection is concerned. It is for the court to make a judgment on the basis of the facts as they existed at the relevant time and *without the benefit of hindsight*."

Alternatively, Hodgson J of the New South Wales Supreme Court in *Standard Chartered Bank of Australia Ltd v Antico & Ors* [Nos 1 & 2],[12] was of the view that when assessing whether or not there were reasonable grounds to suspect that the company would not be able to pay its debts, the assessment would extend to all facts actually known by the director, and not limited to facts reasonably capable of being known by the director.

However, regardless of interpretation, it is clear that section 588G is intended to set directors a higher standard of responsibility than its predecessor. There will be no hesitation in finding directors to be personally liable for debts of a company if they ignore their responsibilities in this regard.

DEFENCES

Defences available to directors under section 588H are:

(a) the director had reasonable grounds to expect that the company was solvent;

(b) the director reasonably relied on another person to provide adequate information (for example, a finance director);

(c) illness; and

(d) the director took reasonable steps to prevent the incurring of the debt.

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9 [1986] 10 ACLR 371.

10 Unreported.

11 [1991] 9 ACLC 1181 at 1184.

12 [1995] 38 NSWLR 290.

Defences need only be established on the balance of probabilities, and hindsight is not a relevant fact as the time at which the reasonable grounds are to be established is directly before the incurring of the debt in question. As Justice Foster stated in *3M Australia*:

> "The fact that a person can look back to the financial situation of the company at the time when the subject debt was incurred, and express the value that the relevant 'reasonable grounds' to expect then existed, does not mean that some impermissible operation of 'insight' is taking place, provided that in expressing that view, the person is doing no more than evaluating facts which were or should have been known to the defendant at the time of incurring the debt."

Defences afforded by the legislation are limited however, consistent with the view that "... people who cannot read balance sheets should not become company directors": *CBA v Friedrich.*[13]

SOME CHANGES FROM SECTION 592

The introduction of Part 5.7B of the Corporations Law effected a substantial change to the legislative regime governing insolvent trading. Section 588G and its subsequent sections were introduced as a result of the Harmer Report Recommendations. This section represents a departure from the approach of previous insolvency sections, namely, section 592 of the Corporations Law and section 556 of the Companies Code.

Section 592 is now limited in its application to debts incurred prior to 23 June 1993. Continued operation of this provision is provided for by section 1384.

Under section 592, there was no "reasonable person" test. Rather it was necessary for a creditor to establish that directly before the debt had been incurred, there were reasonable grounds to believe either that the company would not be able to pay that debt and all of its other debts as and when they became due, or that, if the company incurred the debt, it would not be able to pay all of its debts as and when they became due.

Section 592(1) extended beyond those who were directors of the company to those who took part in the management of the company. Any director/manager of a company who has fraudulently incurred debts before Part 5.7B commenced (that is, 23 June 1993) will be liable for those debts under this section.

Section 588G sets an easier task for liquidators than section 592. Under section 592, they had to show that directors *expected* insolvency. Section 588 requires only that they show the directors had reason to *suspect* the company was or was about to become insolvent. This change was aimed particularly at family companies where spouse directors would claim complete ignorance of the company's affairs and say that they had formed no expectation on its solvency.

Similarly, it is now more difficult for directors to use defences available to them as outlined in section 588H. The new test imports an objective element, requiring that whatever the directors suspected must be based on reasonable grounds.

Section 588 takes a more restrictive approach to individual creditor's rights. Now only liquidators can sue on behalf of unsecured creditors generally. (An individual creditor can sue if the liquidator fails to take action within three months.)

Section 592(2) provides for a director or other officer a defence whereby the director can establish that the transaction was entered into without his or her express approval or authority. Silent directors are no longer offered this sort of protection under the new regime. Section 588H will,

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13 (1991) 5 ACSR 115.

however, protect a director who has acted diligently but, in spite of their best efforts, a debt has been incurred.

COMPANY SURVIVAL STRATEGIES

The statutory procedure of appointing an administrator provides a solution which was not available during the eighties. Nevertheless, directors may believe that the appointment of an administrator will prejudice the interests of shareholders, creditors or employees. Directors may be unwilling to give up control. Among the possible solutions, three are most common.

The first solution relies on section 588G not prescribing continuing to trade as such, but rather the incurring of new debts. It is therefore quite permissible for the company to continue trading if it can persuade major creditors (and there is enough cash flow) to postpone payment and to pay for new goods on a cash on delivery basis.

The second solution is to trade through a company, whether existing or newly incorporated and capitalised, which is itself solvent, even if the parent company is insolvent.

The third solution is to persuade one or more major creditors to put their debts on a contingent basis, so that the sum of other liabilities does not exceed the company's assets. It is not enough for the debt to be subordinated to other ordinary creditors. The debt must be provable on a liquidation only to the extent there are surplus assets.