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Director Duties and insolvent trading – the existing law and its effects

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Australia's Insolvent Trading Regime – Concepts and Contrasts

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Sections 588G and 588H: Key Concepts

- … at the time when the company **incurs a debt**:
- the company is **insolvent** …, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
- at that time, there are **reasonable grounds for suspecting that the company is insolvent**, or would so become insolvent …; <u>and</u>
- [the director] is aware at that time that there are such grounds for so suspecting; or
- **a reasonable person in a like position in a company in the company's circumstances would be so aware.**

Key Concepts - continued

- By failing to prevent the company from incurring the debt, the person contravenes s 588G.
- It is a defence if it is proved that, at the time when the debt was incurred, the person had **reasonable grounds to expect**, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

Civil Consequences

- Pecuniary penalty (s 1317G)
- An order disqualifying the director from managing corporations (s 206C)
- Compensation to the company for the loss or damage suffered by the creditor (ss 588J, 588M)
- Entire or partial relief may be available if the court is satisfied that the director acted honestly and in all the circumstances ought fairly be excused: ss 1317S, 1318

What are the insolvent trading laws about?

- An exception to corporate limited liability?
  - Indirectly exposes directors to creditors
  - But no exposure for shareholders who stand to gain if insolvent trading is successful
- A quasi-tortious duty not to mislead creditors?
  - Reflects a policy underpinning the law
  - But the liability is independent of disclosure or consent, and the remedy is not directed to the affected creditor

What are the insolvent trading laws about?

- A quasi-fiduciary duty to the creditors, to act in their interests?
  - Creditors’ interests trump those of shareholders
  - But the duty is primarily enforceable by the liquidator and for the company
- A corporate governance rule?
  - A strong incentive for diligent and careful management
  - But operates like a compulsory personal guarantee for debts incurred between insolvency and administration

Five Questions

- Why a *duty* not to incur debts after insolvency?
- Do creditors need bespoke insolvent trading protection?
- Why penalise directors who trade whilst insolvent but improve the position of the company?
- Why not permit directors and creditors to contract out?
- Should all directors and shareholders be subject to the same rule?

Large/public vs SME/private

- Independence of directors
- Access to expert advice
- Responsiveness to advice
- Disclosure requirements and public scrutiny
- Attitude/involvement of bankers

A two-tier problem?

First Comparison – Insolvency Act 1986 (UK) s 214

(1) ...the court, on the application of the liquidator, **may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper...**

(2) ... if—

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, **that person knew or ought to have concluded that there was *no reasonable prospect* that the company would avoid going into insolvent liquidation,** and

(c) that person was a director of the company at that time...

(3) [It is a defence if] **person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into solvent liquidation) he ought to have taken**.

(4) ... the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by **a reasonably diligent person** having both—

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and

(b) the general knowledge, skill and experience that that director has.

UK vs Australia

- More latitude for directors to make decisions to maximise corporate wealth in circumstances of financial stress.
- Correspondingly, a weaker incentive to appoint external administrators – no compulsion to do so until inability to avoid doing so is clear.
- Less risk of premature appointment

Second comparison – Delaware

- No statutory bar on insolvent trading
- Some courts have entertained the idea of a cause of action for “deepening insolvency”
- Such a theory decisively rejected in Delaware:

Trenwick America Litigation Trust v Ernst & Young LLP per Strine V-C

"Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations."

Delaware vs Australia

- An approach based in respect for contracts and entrepreneurship
- Treats directors as properly and adequately constrained by their ordinary duties and existing rules
- Leaves maximum scope for directors to make business decisions to increase corporate value even in insolvency

Some Reflections

- If the underlying problem is excessive risk taking by directors compromised by their ownership interests, should the solution reflect this? Could boards dominated by independent directors be carved out, or given the benefit of a business judgment rule?
- Should exposure exist in relation to all creditors? What of those who are fully informed but take the risk - for a price?
- What price is paid by the community in the form of premature/unnecessary administration?