COMPANY DIRECTORS' LIABILITY FOR INSOLVENT TRADING

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An Overview of the Insolvent Trading Debate

Ian M Ramsay*

Introduction

The duty to avoid insolvent trading is the most controversial of the duties imposed upon company directors. Indeed, as the contributors to this book make clear, it is one of the most controversial provisions in corporate law. Several of the contributors argue that the duty to prevent insolvent trading should be repealed. Other contributors strongly support the duty. Those who support the duty argue that it provides appropriate protection for the unsecured creditors of companies. Those who oppose the duty argue that it has the effect of making directors unduly risk-averse which can result in directors too quickly putting companies into voluntary administration or liquidation for fear of personal liability.

The debate concerning the appropriateness of the duty to prevent insolvent trading is important because the scope of the duty is expanding. Most recently, the duty has been expanded as part of several responses to a rise in the number of corporate insolvencies in which employees' entitlements have not been paid. This issue is discussed in Chapter 5. In addition, although the duty to prevent insolvent trading is most commonly thought of as applying to directors, it has been extended in Australia to impose liability upon a holding company of a subsidiary where the subsidiary trades while it is insolvent and other requirements are satisfied.[1] It therefore appears that expanding the scope of the duty to prevent trading is seen as a solution to a number of problems arising from insolvency — whether these problems are unpaid employee entitlements or unpaid creditors of an insolvent subsidiary in a corporate group.

In this chapter I commence by outlining the duty to prevent insolvent trading. I then provide an overview of the debate concerning the duty, and introduce each of the chapters in the book.

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1. Section 588V of the Corporations Law. See I M Ramsay, "Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective" (1994) 17 *University of New South Wales Law Journal* 520.

The Duty to Prevent Insolvent Trading: An Overview

The duty to prevent insolvent trading is contained in s 588G of the Corporations Law. This part of the chapter provides an overview of the elements of the duty to prevent insolvent trading and then identifies the potential defences available to a director who has breached s 588G. The elements of the duty and the defences are discussed in greater detail in later chapters of this book.

Section 588G applies to impose liability upon a person if:

- the person is a director of the company when the company incurs a debt;
- the company is insolvent when it incurs the debt or becomes insolvent because it incurs the debt;
- when it incurs the debt there are reasonable grounds for suspecting that the company is insolvent or would become insolvent because it incurs the debt; and
- the director is aware at the time the debt is incurred that there are reasonable grounds for suspecting the company is insolvent or a reasonable person in a similar position in the company in the company's circumstances would be aware.

Duty is imposed on directors

The duty to prevent insolvent trading is imposed only on directors. Unlike the other statutory duties,[2] it does not apply to officers other than directors. However, the broad definition of director in s 9 means that s 588G applies to de facto directors and shadow directors. A de facto director is someone who acts as a director even if they have not been validly appointed to act as a director or even if they are not described as a director. A shadow director is a person in accordance with whose instructions or wishes the directors of the company are accustomed to act.

Although a company cannot itself be appointed a director of another company, it is possible for a company to be a shadow director of another company.[3] This means that where a company is a shadow director of another company, then the first company, because it is a shadow director, is subject to the duty in s 588G not to have the second company trade while it is insolvent.

The consequences of a company being a shadow director and therefore being subject to s 588G can be very significant. Consider the example of a company which has very substantial assets and is the shadow director of a second company which has few assets. The second company is being wound up because it is insolvent and cannot pay its debts.

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2. These other statutory duties are:
   - the duty to exercise reasonable care and diligence: s 180(1);
   - the duty to act in good faith in the best interests of the corporation: s 181(1)(a);
   - the duty to act for a proper purpose: s 181(1)(b);
   - the duty not to make improper use of position: s 182(1); and
   - the duty not to make improper use of information: s 183(1).
3. *Standard Chartered Bank of Australia Ltd* v *Antico* (1995) 13 ACLC 1381; 18 ACSR 1.

The liquidator of the second company will be keen to increase the funds available to pay the creditors of the second company. If the liquidator can establish that the first company was a shadow director of the second company and breached s 588G, then the substantial assets of the first company can be made available to pay the debts of the second company.

When does a company incur a debt?

In order to decide when a company incurs a debt for the purposes of s 588G, two questions must be asked. These are:

- What types of debts can be incurred?
- When is a debt incurred?

Types of debts that can be incurred. There are two types of debts that can be incurred for the purposes of s 588G. The first are called "deemed debts". When a company takes any of the actions listed in s 588G(1A) then it is automatically deemed to have incurred a debt for the purposes of s 588G. The actions mostly relate to the laws relating to capital maintenance. The following table identifies these deemed debts.

Table: Deemed Debts

Action of company	*When debt is incurred*
Paying a dividend.	When the dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared.
Making a reduction of share capital.	When the reduction takes effect.
Buying back shares.	When the buy-back agreement is entered into.
Redeeming redeemable preference shares that are redeemable at the option of the company.	When the company exercises the option.
Issuing redeemable preference shares that are redeemable otherwise than at the option of the company.	When the shares are issued.
Financially assisting a person to acquire shares in the company or its parent company.	When the agreement to provide the assistance is entered into or, if there is no agreement, when the assistance is provided.
Entering into an uncommercial transaction (defined below).	When the transaction is entered into.

The first six actions which are identified in the table (paying a dividend, reducing share capital, buying back shares, redeeming or issuing redeemable preference shares, and financially assisting a person to acquire shares in the company) relate to specific financial transactions. The final action (entering into an uncommercial transaction) refers to a transaction that a reasonable person in the company's circumstances would not have entered into, having regard to (i) the benefits (if any) and detriment to the company from entering into the transaction; (ii) the benefits other parties gain from the transaction; and (iii) any other relevant matter. This definition of uncommercial transaction is contained in s 588FB.

In addition to deemed debts, courts have had to decide what other types of debt can be incurred for the purposes of s 588G. The courts have developed several principles, although there is some uncertainty in this area.[4] First, the debt must be for a specific amount. A company cannot incur a debt for an amount that cannot be specified or calculated. Second, the debt can be contingent and therefore can include a guarantee.[5] Third, courts have generally said that because s 588G refers to a company incurring a debt, the debt must be one which is voluntarily incurred by the company.

When is a debt incurred? It is important to answer this question because for s 588G to apply, the debt in question must be incurred when the company is insolvent. In relation to deemed debts, the table specifies when these debts are taken to be incurred for the purposes of s 588G. In relation to other debts, the answer is not always clear. In the case of the guarantee of a debt, the debt can be incurred when the guarantee is first given — not when payment is required.[6] In relation to contracts for the supply of goods to a company in the future, with payment for the goods being required upon delivery or after delivery, some courts have said that the debt is incurred at the time of the order for the goods. Other courts have held that the debt is incurred when the goods are delivered.[7] It depends upon what can be regarded as the substantial act of the company which incurs the debt.[8]

When is a company insolvent?

Under s 588G a company must be insolvent when it incurs the debt in question or else it must become insolvent by incurring the debt. Section 95A defines insolvency. Under s 95A a company is insolvent if it is unable to pay all its debts, as and when they become due for payment. It has been said that the court must ascertain "the company's existing debts, its debts within the near future, the date each will be due for payment, the company's present and expected cash resources and the date each item will be received" in order to determine whether the company is able to pay all its debts as they become due for payment.[9] A temporary lack of liquidity will not mean that the company is insolvent.

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4. See generally on these principles, H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law*, looseleaf, [20.120].
5. *Hawkins* v *Bank of China* (1992) 26 NSWLR 562; 10 ACLC 588; 7 ACSR 349.
6. Ibid.
7. *Credit Corporation Australia Pty Ltd* v *Atkin* (1999) 17 ACLC 756; 30 ACSR 727.
8. *Leigh-Mardon Pty Ltd* v *Wawn* (1995) 13 ACLC 1244; 17 ACSR 741.
9. Ford, Austin and Ramsay, supra n4, [20.140].

There are several presumptions of insolvency which can assist in establishing that a company is insolvent for the purposes of s 588G. These presumptions are contained in s 588E. First, where a company is being wound up and it is proved that the company was insolvent at a particular time during the twelve months ending on the date of the application for winding up, there is a presumption that the company continued to be insolvent through that period: s 588E(3). This presumption can be particularly useful where it is sought to establish that the company incurred a number of debts during the twelve months prior to its winding up and each time a debt was incurred, the company was insolvent. If it is proved that on one occasion during the twelve-month period the company was insolvent, then the company is presumed to have been insolvent for the entire twelve months. The presumption is rebuttable.

Another presumption of insolvency is in s 588E(4). Where a company has failed to keep or retain financial records for a specified period as required by s 286, then the company is presumed to have been insolvent for the entire period that it was in contravention of s 286. The reason for this presumption is that s 588G requires proof that, when a debt was incurred, the company was insolvent. It can be difficult for a liquidator to prove that the company was insolvent when the company has not kept proper records.

What are reasonable grounds for suspecting insolvency?

Even if a company is insolvent when it incurs a debt, this does not automatically mean that the directors of the company have breached s 588G. There must be reasonable grounds for suspecting insolvency. Whether there are reasonable grounds for suspecting that the company was insolvent when it incurred the debt in question is to be judged according to a director of ordinary competence who is capable of having a basic understanding of the company’s financial status.[10]

What does it mean to say that there must be reasonable grounds for *suspecting* insolvency? The High Court has said that it is more than mere speculation. To say that someone has reason to suspect insolvency means they must have a “positive feeling of actual apprehension” that there is insolvency.[11]

Of what must the director be aware?

The final requirement for s 588G to apply to make a director liable is that:

- the director was aware at the time the debt was incurred that there were reasonable grounds for suspecting that the company was insolvent; or
- a reasonable person in a similar position in a company in the company’s circumstances would have been aware that there were grounds for suspecting that the company was insolvent.

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10. *Credit Corporation Australia Pty Ltd* v *Atkins* (1990) 17 ACLC 756; 30 ACSR 727.
11. *Queensland Bacon Pty Ltd* v *Rees* (1966) 115 CLR 266 at 303.

The first test is satisfied if the court finds that the director was actually aware that there were reasonable grounds for suspecting insolvency. What is meant by reasonable grounds for suspecting insolvency has been discussed above. However, even if the director was not actually aware that there were reasonable grounds for suspecting insolvency, the director can still be liable under s 588G if a reasonable person in a similar position in a company in the circumstances of the company would have been aware. The reasonable person is a director of ordinary competence who has the ability to have a basic understanding of the company's financial status.[12]

Defences

Even if a director has breached s 588G there might be a defence for the director. Section 588H contains four defences. These are:

- reasonable grounds to expect solvency;
- reasonable reliance on information provided by others;
- absence from management; or
- reasonable steps to prevent incurring of debt.

1. *Reasonable grounds to expect solvency*

It is a defence if it is proved that, at the time the debt was incurred, the director had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if it incurred the debt and any other debts incurred at that time: s 588H(2).

An important point to note about this defence is that it requires reasonable grounds to *expect* insolvency while a contravention of s 588G requires reasonable grounds to *suspect* insolvency. Is there a difference? In *Metropolitan Fire Systems Pty Ltd* v *Miller* the court said:[13]

> . . . To "suspect" something requires a lower threshold of knowledge or awareness than to "expect" it . . . The expectation must be differentiated from mere hope in order to satisfy this defence . . . It implies a measure of confidence that the company is insolvent. The directors must have reasonable grounds for regarding it as likely that the company would at the relevant date have been able to pay its debts as and when they fall due.

2. *Reasonable reliance on information provided by others*

It is a defence if it is proved that, at the time the debt was incurred, the director:

- had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing to the director adequate information about whether the company was solvent; and

12. *Metropolitan Fire Systems Pty Ltd* v *Miller* (1997) 23 ACSR 699; *Commonwealth Bank of Australia* v *Friedrich* (1991) 9 ACLC 946; 5 ACSR 115.
13. (1997) 23 ACSR 699 at 711.

- had reasonable grounds to believe, and did believe, that that person was fulfilling that responsibility; and
- expected, on the basis of information provided to the director by that person, that the company was solvent at the time the debt was incurred and would remain solvent even if it incurred the debt and any other debts incurred at that time: s 588H(3).

3. *Absence from management*

It is a defence if it is proved that, at the time the debt was incurred, the director did not take part in the management of the company because of illness or for some other good reason: s 588H(4).

4. *Reasonable steps to prevent incurring of debt*

It is a defence if it is proved that the director took all reasonable steps to prevent the company from incurring the debt: s 588H(5). One matter which the court can consider is any action the director took with a view to appointing an administrator of the company: s 588H(6).

Consequences of contravention

There are several consequences which can result from a breach of s 588G. The director may be ordered to pay compensation. In addition, a breach of s 588G can result in an order banning the director from managing companies or even criminal consequences such as a fine or imprisonment if the director's failure to prevent the company incurring the debt was dishonest.

1. *Payment of compensation*

Where a company is being wound up and a director of the company has breached s 588G, then the liquidator of the company may sue the director for compensation: s 588M. The compensation that may be obtained from the director is an amount equal to the loss or damage suffered by one or more creditors whose debts were incurred by the company when it was insolvent. The debts must be wholly or partly unsecured. This means that the compensation is mostly for the benefit of unsecured creditors.

Although most claims for compensation are brought by liquidators of companies being wound up, in some circumstances, an individual creditor may sue a director for compensation for breach of s 588G. The creditor can only do so if the company is being wound up and the creditor must obtain the written consent of the company's liquidator: s 588R. It is possible for the creditor to sue a director even without the liquidator's consent where the creditor obtains the permission of the court: s 588T. However, the creditor cannot sue if the company's liquidator has already sued the director: s 588U.

2. *Consequences of breach of a civil penalty provision*

Section 588G is a civil penalty provision. Civil penalty provisions such as s 588G are enforced by the Australian Securities and Investments Commission (ASIC). Where a director breaches s 588G, the court can make the following orders:

- an order disqualifying the director from managing companies for a specified period of time;
- an order to pay a pecuniary penalty of up to $200,000; and/or
- an order to pay compensation to the company for any loss or damage it has incurred because of the breach of s 588G.

The amount of compensation is the loss or damage suffered by the creditor whose debt was incurred when the company was insolvent.

3. *Criminal penalties*

Where a director breaches s 588G and the director's failure to prevent the company incurring the debt was dishonest, ASIC can seek to have a criminal penalty imposed on the director. The criminal penalty will be a fine of up to $200,000, or imprisonment for up to five years, or both.

The Duty to Prevent Insolvent Trading: Policy Arguments

Having provided an overview of the elements of the duty to prevent insolvent trading, I now explore a number of the policy arguments relevant to the duty. These and related arguments are elaborated in greater detail in subsequent chapters.

The fact that the duty to prevent insolvent trading is controversial is reflected in the debate between several contributors to this book concerning whether the duty should be repealed. This debate is mostly contained in the chapters by Professor Oesterle and Associate Professor Whincop. However, the debate is carried on in other forums. It has been argued that the insolvent trading provisions in the United Kingdom offer limited assistance to creditors, and it therefore seems unlikely that creditors would contract for analogous legal protection if the provisions were not part of the United Kingdom Companies Act.[14] On the other hand, it has been argued that the United Kingdom provisions (i) preserve and maximise the pool of assets in the context of insolvency, which is a

14. B R Cheffins, *Company Law: Theory, Structure and Operation* (1997), 547. Professor Cheffins argues that there are a number of reasons why the insolvent trading provisions may offer limited assistance to creditors. These include (i) a defendant director may have few personal assets to pay compensation to creditors, (ii) there are few reported cases in the United Kingdom involving director liability for insolvent trading and this may dissipate the deterrent effect which these provisions should have, and (iii) procedural constraints to bringing an action for breach of the duty.

primary goal of insolvency law, and (ii) encourage directors to operate with regard for the company's unsecured creditors.[15]

There are a number of criticisms that have been made of the insolvent trading provisions. We have already seen that one commentator argues that, at least in relation to the United Kingdom, such provisions appear to be of little practical assistance to creditors.[16] One criticism that is often made is that the insolvent trading provisions have the effect of making directors unduly risk-averse. This has two consequences. First, it may be that provisions such as s 588G have the effect that directors will too quickly put companies into voluntary administration or liquidation for fear of personal liability, even in circumstances where it may be possible for a company to trade out of its financial difficulties. This is an important empirical question. Second, provisions such as s 588G may be deterring qualified people from becoming company directors, and the provisions may be having this effect precisely in relation to those companies in financial difficulties which require the best possible expert assistance from directors. Again, this is an empirical question.

Of course the major argument used to support the insolvent trading provisions is that they are necessary to protect the interests of creditors. This argument is elaborated in the next section.

Creditor protection: the rationale for section 588G

Because s 588G is specifically designed to protect creditors, a critical question that must be addressed is whether creditors require protection or whether they should be expected to contract to protect themselves. The starting point is a recognition of the conflicts of interest that exist between a company's shareholders and its creditors. Smith and Warner[17] identify four major sources of conflict:

- the payment of excessive dividends;
- claim dilution (through taking on debt with similar or higher priority);
- asset substitution (for example, substituting saleable for non-saleable assets); and
- excessive risk taking.

Although the first three conflicts are straightforward, the fourth warrants elaboration. A conflict arises because payment to a creditor may be jeopardised where the company engages in high-risk investments. Shareholders in a leveraged company have incentives to invest the company's resources in risky projects: if a project is successful, the excess returns will be distributed among the shareholders as dividends but will not be shared with the creditors who are only entitled to a fixed return on their investment. Company losses, however, are shared among both creditors and shareholders.

15. R J Mokal, "An Agency Cost Analysis of the Wrongful Trading Provisions: Redistribution, Perverse Incentives and the Creditors' Bargain" (2000) 59 *Cambridge Law Journal* 335.
16. Cheffins, supra n14.
17. C W Smith and J B Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979) 7 *Journal of Financial Economics* 177.

Creditors can generally be expected to contract to protect themselves against actions that reduce the prospect of them being paid. This contracting has two parts to it. First, the interest rate on the loan that is negotiated between the creditor and the company can be expected to reflect the risks that the creditor faces. Second, the contract may contain restrictions on activities of the company. For example, there may be restrictions on the amount that the company can pay out as dividends. There may also be restrictions on the company incurring debt of a similar or higher priority. These types of restrictions are common in debenture trust deeds.[18]

However, this type of contracting may not always be possible. The theory that creditors charge different interest rates for different levels of risk does not work where the costs of the creditor acquiring adequate information about the level of risk are disproportionate to the amount of the transaction.[19] The theory also does not work in the case of involuntary creditors (such as tort claimants).[20] Moreover, dispersed creditors face a collective action problem and may therefore lack the appropriate incentives to undertake joint action to prevent opportunistic behaviour by the company that threatens payment to creditors.[21] Finally, even sophisticated creditors cannot foresee all contingencies and contract for protection against them. Significant corporate restructurings, such as leveraged buyouts, have sometimes seen transfers of wealth from sophisticated creditors (namely some bondholders) to shareholders.[22] The result has been a vigorous debate concerning whether directors should owe fiduciary duties to bondholders as a means of protection.[23]

In addition to contractual protections, there are constraints upon companies which operate to protect the interests of creditors. First, there is the maintenance of share capital

18. R Sappideen, "Protecting Debenture Holder Interests: A Delicate Art" (1991) 4 *Corporate and Business Law Journal* 36. For an empirical study of the restrictive covenants contained in Australian trust deeds, see G Whittred and I Zimmer, "Accounting Information in the Market for Debt" (1986) 26 *Accounting and Finance* 19. See also I Ramsay and B Sidhu, "Accounting and Non-Accounting Based Information in the Market for Debt: Evidence from Australian Private Debt Contracts" (1998) 38 *Accounting and Finance* 197.
19. J M Landers, "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" (1976) 43 *University of Chicago Law Review* 527, 529. However, creditors are expected to "price protect" in this situation. In other words, they will require a higher interest rate as compensation for risk which they are unable to ascertain.
20. Ibid.
21. V Brudney, "Corporate Bondholders and Debtor Opportunism: In Bad Times and Good" (1992) 105 *Harvard Law Review* 1821.
22. This has mainly occurred in the United States: W W Bratton, "Corporate Debt Relationships: Legal Theory in a Time of Restructuring" [1989] *Duke Law Journal* 92. A leveraged buyout occurs where existing shareholders of a company transfer control of the company to an outsider. A high level of debt is used to fund the acquisition. Because this debt will be serviced by the acquired company (by cash flows of the business or by disposal of assets) this increases the risk of existing creditors of the company not being paid.
23. See, for example, M W McDaniel, "Bondholders and Stockholders" (1988) 13 *Journal of Corporation Law* 205 (arguing that directors should have a fiduciary duty to deal fairly with all investors in a company — bondholders as well as shareholders because "leveraged takeovers, buyouts and recapitalizations are having a devastating impact on existing bondholders. Stockholders are getting rich in part at bondholder expense"); L E Mitchell, "The Fairness Rights of Corporate Bondholders" (1990) 65 *New York University Law Review* 1165 (supporting fiduciary duties to bondholders on the basis that this would enhance corporate social responsibility); K Lehn and

doctrine. This doctrine states that while creditors accept the risk that a company whose members enjoy limited liability may lose money in the ordinary course of its business, they are entitled to protection against reduction of the company's net assets in other ways not specifically authorised by law.[24] However, the effectiveness of the legal rules underpinning the maintenance of share capital doctrine has been questioned by a number of commentators.[25]

A second constraint which operates to protect the interests of creditors is the reputations of the shareholders and the directors of the company with which the creditors are contracting. Shareholders and directors will be reluctant to undertake actions which harm their reputations and which may make it difficult to raise capital in the future. However, as one commentator observes, this constraint applies only when the present value of maintaining the company as a going concern exceeds the value of the benefits derived from taking action that adversely affects creditors (for example, the payment of excessive dividends).[26]

A final constraint is that, although shareholders may want to take actions which adversely effect creditors, the shareholders may lack effective control over the management of the company because of a separation of ownership and control.[27] However, whether the separation of ownership and control adequately protects creditors is open to question. First, as directors increase the percentage of shares that they own in the company, their incentive to act in the interests of shareholders increases. Second, there is evidence that Australian companies have high ownership concentration. A study of 100 Australian companies listed on the stock exchange found that the five largest shareholders held, on

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A Poulson, "The Economics of Event Risk: The Case of Bondholders in Leveraged Buyouts" (1990) 15 *Journal of Corporation Law* 199 (arguing against fiduciary duties to bondholders for two reasons. First, such duties would induce additional litigation and more resources would be expended in redistributing wealth among holders of different securities, thereby reducing the documented wealth gains created by leveraged buyouts. Second, market forces compensate bondholders for the risk of leveraged buyouts. If leveraged buyouts increase the riskiness of bonds, then this is reflected in a higher interest rate for the bondholders. In addition, investors can mitigate risk by diversifying and holding both bonds and stocks in their portfolios); T R Hurst and L J McGuinness, "The Corporation, the Bondholder and Fiduciary Duties" (1991) 10 *Journal of Law and Commerce* 187 (arguing against fiduciary duties on the basis that directors would have the difficulty of serving two masters — bondholders and shareholders — which would undercut their existing fiduciary duty to maximise shareholder returns).

24. Ford, Austin and Ramsay, supra n4, [20.198].
25. See, for example, Ford, Austin and Ramsay, ibid; J A Farrar and B M Hannigan, *Farrar's Company Law* (4th ed, 1998), 171–81.
26. W Frost, "Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups" (1993) 44 *Hastings Law Journal* 449, 483.
27. "This separation of ownership from control redounds to the benefit of creditors. Because managers are heavily invested in the firm and are unable to diversify their firm-specific skills, they are likely to be risk-averse. Thus, while shareholders may desire to increase enterprise risk after the interest rate of debt is fixed, managers may be reluctant to do so. The shareholders' inability to have complete control over the management of the corporate group reduces their opportunity to engage in misappropriations." Frost, ibid, 484–5.

average, 54 percent of the issued shares of these companies.[28] Consequently, the degree to which the separation of ownership and control in Australian companies operates to protect creditors of these companies is an open issue.[29]

It can therefore be seen that the debate on creditor protection is largely unresolved. However, it does not need to be resolved in order to evaluate the merits of s 588G. This is because s 588G does not provide unqualified protection to creditors. It operates only where the company is insolvent. Consequently, the question of creditor protection can be phrased in a more precise way for our purposes. Is creditor protection warranted where the company with which the creditor has contracted is insolvent?

The courts have long recognized that insolvency presents special problems for creditors. While the vexed issue of directors' duties to creditors remains unresolved,[30] there is consensus that the onset of insolvency imposes special obligations upon directors with respect to the interests of creditors. This is best articulated in the judgment of Street CJ in *Kinsela* v *Russell Kinsela Pty Ltd*:

> 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 . . . 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.[31]

The reasoning in *Kinsela* provides justification for creditor protection upon corporate insolvency. Shareholders' funds have been dissipated and it is now the creditors' funds which are at risk. However, there is a further justification for creditor protection. I have already observed that one of the problems confronting creditors is excessive risk taking by

28. I M Ramsay and M Blair, "Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies" (1993) 19 *Melbourne University Law Review* 153. See also G Stapledon, "Australian Sharemarket Ownership" in G Walker, B Fisse and I Ramsay (eds), *Securities Regulation in Australia and New Zealand* (2nd ed, 1998).

29. Increasing ownership concentration of Australian companies may not result in a reduction of the separation of ownership and control if these few shareholders who have the potential to control the companies in which they invest do not actually exercise this control. These large shareholders are typically institutional investors and there are many reasons why such investors do not exercise control over the management of companies in which they invest: Ramsay and Blair, ibid, 179–80. See also G Stapledon, "Disincentives to Activism by Institutional Investors in Listed Australian Companies" (1996) 18 *Sydney Law Review* 152.

30. The cases and issues are evaluated in D A Wishart, "Models and Theories of Directors' Duties to Creditors" (1991) 14 *New Zealand Universities Law Review* 323 and V Finch, "Directors' Duties: Insolvency and the Unsecured Creditor" in A Clark (ed), *Current Issues in Insolvency Law* (1991). See *Spies* v *The Queen* (2000) 18 ACLC 727 at 731, where the High Court of Australia stated that to the extent that previous cases suggest that directors owe an independent duty to creditors, which is enforceable by creditors, the cases are contrary to principle and do not correctly state the law.

31. (1986) 4 NSWLR 722 at 730.

shareholders.[32] As insolvency approaches, this problem is exacerbated. This is because the shareholders now have an even more powerful incentive to engage in risky investments given that most of their funds have been dissipated yet there is the possibility of a "bonanza payoff that will prevent insolvency".[33]

These and other arguments concerning the insolvent trading provisions are elaborated in detail in subsequent chapters.

Overview of Chapters

The subsequent chapters are divided into three main parts. Chapters 2 and 3 examine theoretical perspectives on insolvent trading. Chapters 4, 5 and 6 provide detailed analysis of the insolvent trading provisions in Australian law. Chapters 7 and 8 provide international perspectives on insolvent trading, with a focus upon New Zealand and the United Kingdom.

In Chapter 2 Dale Oesterle forcefully argues that Australia, England and New Zealand should repeal their insolvent trading provisions. There are many situations of insolvent trading where, according to Professor Oesterle, the imposition of personal liability upon directors is not warranted. The impact of these provisions will be felt most strongly he argues in hi-tech business sectors. These businesses are always high risk, particularly in the start-up phase, and the insolvent trading provisions may discourage these types of businesses. He also argues that the provisions will result in fewer capable people willing to serve as directors, and those who do serve on boards have an increased incentive to submit their resignation when their skills are most required because of financial difficulties confronting the company. Professor Oesterle notes that many countries, including the United States, do not have insolvent trading provisions in their corporate law.

In Chapter 3 Michael Whincop presents a case, based upon economic analysis, supporting the duty to prevent insolvent trading. Part of Professor Whincop's discussion involves a rebuttal of arguments which oppose the insolvent trading provisions. Professor Whincop uses the tools of information economics and game theory to elaborate on the strategic structure of insolvent trading. An important issue discussed by Professor Whincop is whether it should be possible for parties to contract out of the insolvent trading provisions.

The next part of the book is a detailed analysis of the insolvent trading provisions contained in Australian corporate law. In Chapter 4, Niall Coburn commences by providing the historical background for the development of the insolvent trading provisions. He then turns to examine the scope and operation of s 588G. This is followed by consideration of the defences available to an action for a breach of the duty to prevent insolvent trading and the consequences of a breach. The final part of this chapter describes ASIC's approach to enforcement of the insolvent trading provisions.

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32. See note 17 and accompanying text.
33. R Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] *Journal of Business Law* 1, 3, quoting J Coffee (1986) 85 *Michigan Law Review* 1, 61.

In Chapter 5 David Noakes discusses the recovery of employee entitlements in insolvency. As a result of changes to the Corporations Law which came into operation on 30 June 2000, the scope of the insolvent trading provisions has been widened. As explained by the author, the background to these amendments has been a rise in the number of corporate insolvencies in which employees' entitlements have not been paid.

In Chapter 6 Abe Herzberg focuses on trends in the number of insolvent trading cases. There have been many cases involving the predecessors of s 588G. However, since s 588G came into operation in 1993, there appears to have been a decline in the number of cases. The author argues that the most important reason for this development is the increasing use of the voluntary administration scheme in the Corporations Law which was introduced at the same time as s 588G. It has meant that a significant number of companies in financial difficulties are not placed in liquidation which is an essential prerequisite for a compensation claim against directors for insolvent trading. Instead, insolvent companies are increasingly placed in voluntary administration and then move to a deed of company arrangement. In this chapter, Abe Herzberg discusses a number of the cases decided under s 588G. He also discusses the factors which influence a liquidator's decision to commence proceedings against a director under s 588G.

The final two chapters deal with international perspectives on insolvent trading. In Chapter 7, David Goddard provides an analysis of the New Zealand provisions which deal with insolvent trading. He examines the cases decided under the New Zealand provisions and also provides a critical analysis of them. He concludes that the New Zealand provisions are inappropriate and should be replaced by ones that have more limited and specific application to directors.

In Chapter 8 Jenny Payne and Dan Prentice explore the civil liability of directors for company debts under English law. They commence by discussing three techniques under common law which can impose liability to creditors on directors. They are (i) lifting the corporate veil, (ii) imposing a duty on directors to take into account the interests of creditors, and (iii) imposing an independent duty owed by directors to creditors.

The second part of their chapter examines legislative responses to insolvent trading. They examine both the fraudulent trading provisions and the wrongful trading provisions under the United Kingdom Companies Act 1985. The wrongful trading provisions are the equivalent of Australia's insolvent trading provisions. Their conclusion is that the insolvent trading provisions are appropriate and should be supported. However, there are problems of enforcement.

Conclusion

Whether the insolvent trading provisions are appropriate is one of the most important debates in Australian corporate law. Are the provisions essential to protect the interests of unsecured creditors? Or do the provisions have the effect of too quickly encouraging directors to place companies into voluntary administration or even liquidation and do the provisions discourage qualified people from becoming directors? A number of the contributors to this book shed significant light on these important questions.

Another objective is to provide detailed analysis of the Australian insolvent trading provisions. The contributors explore the practical operation of the provisions, their history, and the relationship between these provisions and the voluntary administration provisions contained in the Corporations Law. Finally, at a time when the insolvent trading provisions are coming under increased scrutiny, it is important to consider international developments. Consideration is given to the operation of insolvent trading provisions in both the United Kingdom and New Zealand. The many Australian and international developments in this area will ensure that the debate concerning insolvent trading by directors will increase in importance.

PART II

THEORETICAL PERSPECTIVES ON INSOLVENT TRADING

Chapter 2

Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders

Dale A Oesterle*

Introduction

Australia, New Zealand, and England have, in their corporate codes, a style of provision that we in the United States do not. Directors of companies incorporated in these countries can be personally liable[1] when their company incurs debts when insolvent or that make it insolvent. Known as "insolvent trading" in Australia,[2] "reckless trading" in New Zealand[3] and "wrongful trading" in England,[4] these provisions are significant exceptions to the

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1. Specified conditions must be satisfied and selected defences exist, but, as noted below in the text, the conditions are easy to satisfy and the defences are narrow.
2. Corporations Law, Pt. 5.7B, Div. 4, ss 588G–588Y(Australia). See H A J Ford, R P Austin, I M Ramsay, *Ford's Principles of Corporations Law* (9th ed, 1999) at 814; A Herzberg, "Duty to Prevent Insolvent Trading" in J Lessing and J Corkery (eds), *Corporate Insolvency Law* (1995) at 8; C Bevan, *Insolvent Trading* (1994); B Mescher, "Personal Liability of Company Directors for Company Debts" (1996) 70 *Australian Law Journal* 837.
3. Companies Act 1993, ss 135–136 (New Zealand). New Zealand may have *both* reckless trading and insolvency trading provisions. Section 135 is entitled "Reckless Trading" and does not require insolvency. Section 136 could become known as a version of an insolvent trading provision although it is not so titled. The section applies when a firm does not have a reasonable prospect of repaying debts when incurred. See H Rennie and P Watts, *Directors' Duties and Shareholders' Rights* (New Zealand Law Society Seminar, 1996) at 31 (comparing s 136 to the insolvent trading provisions in Australia) and T G W Telfer, "Risk and Insolvent Trading," in R B Grantham and C E F Rickett, *Corporate Personality in the 20th Century* (1998) at 128 (using insolvent trading as a title for s 136). The original reckless trading provisions, taken from the UK, merely inserted recklessness as a culpable state of mind in the fraudulent trading provisions: see report of the Company Law Committee (1962) (Cmnd 1749; UK). For more traditional reckless trading provisions see the Companies Act of 1973, s 424(1) (South Africa); Companies Act of 1955, s 320(1)(b) (repealed) (New Zealand); Uniform Companies Act 1961 ss 374A–374E (repealed) (Australia).
4. Insolvency Act 1986, s 213 (England). See R M Goode, *Principles of Corporate Insolvency Law* (1997) at 443.

general principle that participants in corporate enterprises enjoy limited liability on corporate obligations.[5]

Interestingly, my informal[6] poll found that American academics and lawyers, when asked about the wisdom of the insolvent trading provisions, express profound incredulity.[7] A similar poll of English, New Zealand, and Australian academics and lawyers found a similar incredulousness when told that American corporate codes lack such provisions.[8] The strength of the clashing views should have all sides evaluating the wisdom of their domestic rules. Are American corporate codes deficient? Or are the English, Australian and New Zealand codes excessive?

It is argued in this chapter that the English, Australian and New Zealand codes are excessively protective of corporate creditors and inherently impracticable to boot.[9] Among other ills, insolvent trading provisions, if enforced, make timid managers out of good managers and do not help to catch the crooks. Some have argued that the provisions should be elective, as a way of reducing their sting.[10] This chapter concludes, however, that Australia, New Zealand and England would be well advised to repeal their provisions entirely.

The Social Benefits of Limited Liability Entities

Company and Corporation Codes are enabling. The Codes give legislative sanction to a form of private operating agreement that otherwise was once legally suspect. A group of individuals can, under the statutes, form an artificial legal entity that has the power, among other things, to contract, to hold property, to sue and be sued in the entity's name, and to issue certificates of participation (stock). The Codes also enable a group of individuals operating a business and a creditor to agree to limit the groups' exposure on any debt to the

5. As noted in the text and notes below, there are important differences in the detail of the three countries' provisions. I will use the Australian "insolvent trading" as a generic term for all three types of provisions whenever I am not discussing the provisions by country. Other countries also have versions of an insolvent trading provision. See, for example, the Stock Corporation Law par. 93(3) (Germany).
6. Unscientific.
7. The most common response was a version of a rhetorical question "who would *want* to be a director?".
8. Again, a common response was the rhetorical question "you have *no* protection for [company] creditors?". Professor Dan Prentice has claimed that insolvent trading provisions are "unquestionably one of the most important developments in company law in this century" in D Prentice, "Creditors' Interests and Directors' Duties" (1990) 10 *Oxford Journal of Legal Studies* 265 at 277. On this side there are several dissenters, however. See, for example, T G W Telfer, "Risk and Insolvent Trading," supra n 3 [New Zealand]; H Rennie and P Watts, supra n 3 [New Zealand]; J Mannolini, "Creditors' Interests in the Corporate Contract: A Case for the Reform of our Insolvent Trading Provisions" (1966) 6 *Australian Journal of Corporate Law* 15 [Australia]; T Cooke and A Hicks, "Wrongful Trading – Predicting Insolvency" [1993] *Journal of Business Law* 338, 350 [England].
9. I understand that I can be accused of a home-country bias here, and the accusation may have the ring of truth to it. I am not the first. See also D DeMott, "Directors' Duty of Care and the Business Judgment Rule: American Precedents and Australian Choices" (1992) 4 *Bond Law Review* 133, 142.
10. See, for example, Mannolini, supra n 8.

assets of the business[11] that are held separate from the personal assets of the managers and owners — the so-called principle of "limited liability".

The social benefits of limited liability have been well chronicled. Entities offering limiting liability to equity investors have, on average, lower total capital costs. The lower capital costs encourage business expansion, which provides jobs for workers, tax revenue for government services, and less costly products and services for consumers. A limited liability entity's lower capital costs for equity are attributable primarily to the more favourable risk/return characteristics of stock to investors and, secondarily, to the liquidity premium investors will pay for stock traded in an autonomous securities market. The lower capital costs for equity are understood to outweigh the limited liability entity's slightly higher costs for borrowing. Creditors may, at the margin, charge limited liability entities higher interest rates[12] but the lower costs of equity exceed the additional charges.[13]

An enabling provision is not a requirement. Participants in business can and frequently do elect not to offer limited liability to investors. The task for law-makers is first to define the scope of what participants are able to do and second to establish default rules for when participants may make choices but instead are silent. In the first category, common to all Anglo-American countries are anti-fraud rules. Participants in limited liability entities remain personally liable for fraud perpetrated on investors and creditors. Insolvent trading restrictions are of the first category as well; they limit the scope of limited liability which

11. Plus any unpaid stock subscriptions, perhaps.
12. The presumption of higher interest rates is not necessarily correct. The issue is multi-faceted. If there was no limited liability, equity investors would ask firms to buy or themselves buy insurance against insolvency claims. But who capitalizes the insurance companies that also do not have limited liability? To the extent that insurance will not be universally available (or be prohibitively expensive) there would be less capital and a less robust business community, fewer potential debtors, and more businesses would be thinly capitalized. Creditors may charge higher rates in such circumstances to compensate for decreased capital growth, decreased opportunities for diversification and decreased equity cushions.
13. There are those who believe that the social costs of limited liability could be further minimized if an entity's obligations to tort claimants and other involuntary creditors were excluded. See H Hansmann and R Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts" (1991) 100 *Yale Law Journal* 1879. They argue that limited liability for tort claims encourages entities to take excessive risks; such entities do not fully internalize the liability costs of their business operations. One can concede the point but answer effectively with two interrelated propositions. First, there are alternative methods of reducing the externalization of risk — minimum capital requirements, mandatory insurance, and personal liability of managers for torts, also reduce the externalization of risk. The alternatives do less damage to the capital markets. And second, a change in the limited liability rules will not necessarily produce more victim compensation as investors can develop a wide variety of sophisticated avoidance strategies. Professor Grundfest argues in an unlimited liability system, for example, that judgment-proof foreigners will hold stock in risky firms and domestic investors will hold options or futures on a risky-firm index. J Grundfest, "The Limited Future of Unlimited Liability: A Capital Markets Perspective" (1992) 102 *Yale Law Journal* 387. Since insolvency trading rules apply to consensual creditors only, the issue is not relevant to this essay. Australia has chosen to limit the limited liability principle in other ways. It also holds directors personally liable for their firms' failure to collect and remit to the government several kinds of taxes. Income Tax Assessment Act, ss 222ANA–222AQD (Australia).

participants are able to adopt.[14] As noted in the next section, however, the error in logic is the assumption that anti-fraud rules and insolvent trading restrictions are branches on the same tree.

Once the scope of limited liability is defined, the residual legal issue is what should be the Codes' default provisions. Most Corporate Codes provide that when a credit contract with a limited liability entity as a signatory is silent on the matter, the courts are to presume that the parties have agreed to the limited liability understanding. So parties must opt out of rather than opt in to a limited liability regime by, for example, having the managers or owners of the business sign the credit contract as primary parties or as guarantors. Note also that parties which accept limited liability in credit contracts can adjust substantially the risk of nonpayment with a plethora of loan covenants, covenants restricting business decisions, insisting on minimum capitalization, effecting some form of security, limiting total indebtedness, and many others.[15] Although each of these protections could be fashioned as opt-out default provisions, none of these provisions are default rules in most Anglo-American countries.[16] Thus in the United States, if a creditor wanted insolvency trading style protections, it would have to provide for them expressly in the credit contract.[17]

Legal Remedies for Defrauded Creditors

Dishonest managers of limited liability entities can attempt to defraud creditors in two ways. First, managers can misappropriate the borrowed funds for personal uses. The intent to misappropriate can exist when the funds are borrowed or develop later (when the entity is struggling, for example). Second, managers, although always intending to segregate and use the funds solely for an entity's business, can misrepresent the financial position of the entity to secure more favourable interest rates (or other terms) than would be available if a creditor knew the entity's true state of affairs. In the extreme case, managers attempt to secure loans that would otherwise be unavailable.

All Anglo-American jurisdictions provide legal relief from these schemes. General fraud principles apply in both cases, supplemented by "fraudulent trading" statutes in Commonwealth countries. In the first case, rules and statutes on improper entity

14. At least one commentator takes the position that insolvent trading rules are elective and not mandatory. M Whincop, Chapter 3 of this book. See also M Whincop, "Taking the Corporate Contract More Seriously: The Economic Cases Against, and A Transaction Cost Rationale for, Insolvent Trading Provisions" (1996) 5 *Griffth Law Review* 1 at 15. His argument depends, however, on a provision allowing director indemnification. Indemnification from an otherwise insolvent company is a far cry from a waiver of liability, however. In any event, the indemnification does not lie for a director's obligations to the company, which would exempt any claims by the liquidator on behalf of the firm.
15. For a more complete listing see A Stilson, "Re-examining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors (1995) 20 *Delaware Journal of Corporate. Law* 1 at 104; L Lin, "Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duties to Creditors" (1993) 46 *Vanderbilt Law Review* 1485 at 1506–7.
16. There have been exceptions. In the 1800s in the United States, for example, minimum capital requirements were mandatory in some states.
17. In my experience, such provisions are not common.

distributions, conversion, and fraudulent conveyances also apply. Fraudulent trading statutes, the progenitors of insolvent trading statutes (the insolvent trading statutes do not exist in the United States) thus deserve a closer look.

The origin of fraudulent trading statutes in Commonwealth countries was section 75(1) of the Companies Act of 1928 (United Kingdom). This section stated simply that directors of a company "who were knowingly parties to the carrying on [of any company business] . . . with intent to defraud creditors of the company . . . or for any fraudulent purpose" were personally liable on the obligations. Only an official receiver or liquidator winding up the business could apply to a court for the relief. Australia and New Zealand quickly adopted a version of the provision.[18]

The statute makes sense and would have sufficed had the courts not treated the statute badly. On its face, the statute would appear to catch any cases in which managers (1) intentionally misrepresent the financial condition of their companies in order to secure favourable loan terms from creditors, (2) intentionally misrepresent their intention to apply borrowed funds to the firm's business, or (3) convert borrowed funds to their personal uses.[19] The burden of proof in civil cases, one would assume, would either be "clear and convincing" evidence of any of the above[20] or "preponderance of the evidence".

Yet the Commonwealth courts, uncomfortable because the statute supported both civil and criminal penalties, construed its provisions narrowly and required very high standards of proof.[21] The courts were not content to rest on different burdens of proof in criminal and civil cases as in the United States (beyond a reasonable doubt as opposed to clear and convincing on the evidence) and required, in essence, criminal standards of proof in the civil cases. Proving intent to deceive became very difficult and liquidators stopped applying to courts for relief.

Thus began the mischief, as all became discontent with the limits of the fraudulent trading statute. In England, for example, Parliament limited the fraudulent trading statute to its criminal side and passed a new "wrongful trading" provision as a civil remedy.[22]

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18. The Australian version survives in Corporations Law Part 5.7B.
19. There are several potential schemes other than the routine criminal and civil actions. New Zealand, in the Corporations (Investigations and Management) Act of 1989 empowers its Registrar of Companies to require that companies suspected of fraudulent trading provide information on the matter. The Registrar can also appoint its own investigator to examine a company's records. If the Registrar finds wrongdoing it can take control of the company's assets.
20. The "clear and convincing" standard being the historical burden of proof for fraud cases.
21. See, for example, the Report of the Review Committee, *Insolvency Law and Practice* (Cmnd 8558, 1982) (UK; Sir Kenneth Cork Chairman), paras. 1776–7; Australian Law Reform Commission, *General Insolvency Inquiry Report*, (1988) ALRC No. 45, Ch. 7 (Harmer Chairman). In Australia the Uniform Companies Act of 1961 was amended in 1971 to include a civil offence based on reckless trading but civil liability depended on a prior criminal conviction. Uniform Companies Act of 1961, ss 374A–E (repealed) (Australia). Australian authorities rewrote the section in the Companies Code of 1981 to hinge both civil and criminal consequences on the same language. Some judges, believing that a loss in a civil trial could lead to a criminal conviction interpreted the language of the standard very narrowly. R C Williams, "Fraudulent Trading" (1986) 4 *Company and Securities Law Journal* 14.
22. Cork Committee Report, ibid.

Australia went further.[23] Finding that a strict application of the requirement that plaintiffs prove directors had an "expectation" of insolvency was too onerous, the 1992 Act both lowered the standard to "suspicion" of insolvency and added an objective test in place of the subjective one — there are "reasonable grounds for suspecting" insolvency. Had courts been more sympathetic to the development of the civil side of fraudulent trading statutes, we might have been spared the overreaction of the legislatures that produced the insolvent trading statutes.

There is a legitimate issue over whether a "fraudulent trading" statute ought to include a duty to speak in limited occasions as well as a duty not to affirmatively mislead. One could reasonably take the position that managers negotiating new loans and knowing their firms to be insolvent have, at that point, a duty to tell potential creditors[24] of their true financial position. A failure to do so could be construed quite reasonably to be an actionable misrepresentation. But such issues were lost in the rush to pass completely new civil statutes redefining the offence and imposing new duties on directors.

From Fraudulent Trading to Insolvent Trading: A Seductive Step

The discontent with "fraudulent trading" statutes leaked in several directions. First, legislatures presumed culpability of the board of directors whenever a firm incurred new debt while facing insolvency. Second, directors became liable on the obligation whether or not they participated, directly or indirectly, in the transaction. It is easy to understand the seductive logic of the transition from fraudulent trading to the new duty against insolvent trading.

We all know not to respect the broke gambler's plea: "Loan me another hundred dollars, I can get it all back on this roll". The gambler has nothing to lose and everything to gain. Since he is already broke, owing another hundred dollars that he cannot pay is costless. Yet, his chance of winning, even if small, an amount that will repay all his debts with some left over for his pockets has positive value. Since the gambler is desperate, he is likely to lie about his chances to secure the loan and since he is broke, his skills and judgment at the table are probably suspect as well. Recipients of his plea are better to save their hundred dollars or make their own bet on the next roll (for the same risk you get a higher expected return).

An insolvent company puts management in a position similar to our broke gambler. If the managers wind up the business they lose their jobs and the value of whatever equity investment they have in the company. On the other hand, if they can borrow to keep the business operational, perhaps they can "get lucky" and resuscitate the business, keep their positions and re-inflate the value of their stock. Fully informed creditors would be well

23. Harmer Report, supra n 21.

24. Creditors whom the managers could reasonably assume did not otherwise know their company's true financial condition.

advised to demur. But managers in this position will be tempted to mislead creditors about the firm's finances to secure the loan.[25]

If managers succumb to the temptation and lie about their company's prospects and position, the principle of limited liability does not apply. The managers are personally liable for fraud. On this much all agree. The managers cannot contract away their duty not to mislead and the creditors cannot waive their rights against the managers for fraud. We presume conclusively that no-one would contract willingly to be defrauded. Any provision to the contrary must itself be part of the fraud.

With each new national financial crisis spawning multiple corporate insolvencies, legislatures, eager to appear to be doing something helpful, have reduced the burdens of proving fraud in such cases. The goal of the concerned lawmakers seems to be that, given the sizable temptations on managers to defraud creditors when their firms face insolvency, the law will conclusively presume it whenever a firm attempts to resuscitate itself outside of insolvency proceedings. Rather than require proof of a culpable state of mind, legislatures reduced the definition of culpable conduct in civil actions from intentional fraud or even reckless behaviour to something more akin to ordinary negligence.[26] But the duty of care is not delineated by good custom and practice in the industry, as is the common law baseline, but out of the fertile minds of the drafters in high-sounding, opaque statutory language. The duty of care, so defined, means directors must act to stop their companies from incurring new debt when insolvency looms.

The lowest standard of liability, in Australia, requires only that a company incur a debt when there are "reasonable grounds for *suspecting* that the company is insolvent and the director is aware of this or ought reasonably to be aware of it".[27] In New Zealand, directors must "not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so".[28] In England the test is stronger; the wrongful trading provision applies if a director "knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation".[29]

Legislatures also reduced the level of participation required for culpability. In Australia, directors no longer have to participate in the problematic loan transaction to be liable. They are liable if they did not act to stop the company from incurring debts when insolvency was suspected.[30] In New Zealand a director is liable if he "allow[s] the

25. Some directors, worried about their personal reputations in the labour market, will not succumb to this temptation.
26. New Zealand redefined "reckless trading" to refer to something more akin to "negligent trading".
27. Corporations Law s 588G (Australia). In a bizarre twist, however, a director has a defence if he "had reasonable grounds to expect that the company would have been able to pay its debts". Corporations Law s 588H(1) (Australia).
28. Companies Act of 1993, s 136 (New Zealand).
29. Insolvency Act s 214(2) (UK).
30. Corporations Law s 588H(2) (Australia). A director must prove he "took all reasonable steps to prevent the company incurring the debt".

business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors".[31]

While one can understand how seductive the progression is to well-meaning legislators, they went too far. They lost sight of a defining principle that distinguishes fraudulent trading from insolvent trading. There is a consensus that fraud in negotiating loan contracts is a condemnable practice. It is hard to imagine any exceptions. Insolvent trading blankets are not so uniform a group of situations. There are numerous situations in which insolvent trading is not a simple manifestation of our broke gambler's scenario. I mention only a few below.

Scenario One: The High-Tech, Start-Up Company

An engineer has an idea for a new laser switch (drug or biotech marvel) and needs funds to build an operational prototype. Whatever equity he had put into his company to fund his research is exhausted. He now seeks first-stage financing in anticipation of creating an operating prototype, generating customers, and beginning manufacturing operations. His firm's balance sheet shows negative equity and his best projections show negative earnings for at least another five years. Both he and his lenders understand that only one in five high-tech companies end up turning a profit and only one in ten end up a substantial success. But the lenders are willing to fund the company with convertible debt.[32] The lenders calculate that they can diversify their lending over ten or more companies and ask for a rate of return on each that will leave them a profit when eight fail, one shows a profit, and one is a success.

Under the insolvency statutes, can the engineer borrow funds from a venture capitalist with limited personal liability? These creditors are surely not a pitiful group deserving of the government's protection. Yet in Australia and New Zealand the answer has to be no.[33] His company is technically insolvent and he has reasonable grounds to expect or believe that the company will not be able to pay off its debts when they become due. So, for our entrepreneur to enjoy limited liability, the venture capitalist must take some form of equity rather than debt.

Even if one can argue that the venture capitalist and the firm can waive any right to sue directors individually for insolvent trading on the first-stage funding,[34] can the firm deal with trade creditors? Can it pay employees at the end of the week? Or must it pay cash in advance for all goods and services provided?

31. Companies Act of 1993, s 135 (New Zealand). A violation of s 136 by at least one directors would seem to trigger the obligations of s 135 for all non-participating directors. The interplay of the two provisions is not self-evident, however.
32. Each scenario assumes that the creditors are not able to waive their rights under the insolvent trading statutes, supra n 14.
33. England's wrongful trading provision is more equivocal.
34. Supra n 14.

Scenario Two: Existing Lenders and the Over-Leveraged Company

A company has strong gross income, the revenue that it gathers from selling its goods far exceeds the cost of producing the goods, but in its past the firm has made poor capital side decisions. The interest on the firm's long-term debt obligations equals the firm's income. When principal repayments become due (some of which mature in the near future), the firm will not be able to make the payments. The managers of the firm decide to raise additional funds to expand production facilities in the hope of increasing profits sufficiently to make all their full principal repayments. The chances of success are less than fifty percent.[35] The existing lenders, anxious to save their old debt, are willing to offer new loans.

Can the firm agree without subjecting the directors to personal liability if the firm fails? Again the answer appears to be no. The existing lenders must make an equity infusion for the board to continue to enjoy limited liability. Otherwise the firm must submit to whatever insolvency administration is available. If existing lenders and the firm can waive any claims under the insolvency trading provisions on the new debt, can the firm deal with trade creditors?

Assume the facts of scenario two with the following changes. A new lender is willing to make a high-risk loan to the troubled company only if all existing lenders agree that the new lender has priority in liquidation if the company fails. The existing lenders agree. Are the members of the board of directors personally liable on the new loan?

Scenario Three: Existing Lenders and the Company Suffering from Temporary Market Conditions

A company operating in a volatile market runs a tourist hotel and loses substantial revenue when an economic downturn changes dramatically the spending priorities of the citizenry. The company begins to lose money; revenues do not meet obligations. The company and its existing creditors believe that the downturn is temporary and the existing creditors are willing to offer new funds to keep the company operating until economic conditions ease. Will the directors be personally liable for the new loans?[36]

In scenarios two and three, why would the existing lenders or new lenders be willing to lend more money to an insolvent company? The lenders may want to avoid company

35. This is similar to the example in Mannolini, supra n 8 at 29. In Mannolini's example a firm is committed to a single project and has no prospect of meeting its debts unless the project is profitable. The project has a positive net present value but a 60 percent chance of failure. Mannolini states that the directors would have an obligation under the insolvent trading provisions to abort the project.

36. Ibid. Mannolini notes, citing a 1907 case, that there is "authority for the proposition that temporary illiquidity must be distinguished from the situation in which a company faces an endemic shortage". I do not find the distinction in the language of the statute. Moreover, whenever a board believes the situation is temporary and, in fact it is not, a court will second-guess the reasonableness of that belief. No director wants to assume that risk personally.

administration[37] and its effects. If a board must apply for administration, the firm is put in the hands of a stranger, an administrator, who may not be as capable as the existing board and, in any event, must get up to speed on the firm's situation. Moreover, administration has dramatic consequences for lenders, who lose their ability to enforce obligations (and control their renegotiation) and for the business's reputation with other constituencies (employees, customers and suppliers). Administration is a major, wrenching step that disrupts the continuity of the business at several levels. Many a savvy creditor is willing to take steps to avoid administration for companies that otherwise have their confidence.[38] Why should we take away this option?

In sum, there are too many situations of insolvent trading in which the facts ought not to impose personal liability on a firm's directors. Yet the insolvent trading provisions do not seem to have the flexibility to exempt such cases from the sections' harsh coverage and attendant harsh consequences. A more specific factual inquiry is necessary for the directors' personal culpability. The traditional fraudulent trading statutes, better drafted and interpreted, perhaps permit such an inquiry, as does a doctrine of limited fiduciary duty to creditors when a firm is insolvent.[39] Legislatures, to catch a few more wrongdoers,[40] have erected bars to legitimate business judgments in recurring and significant situations.

As unfortunate as this is, the insolvent trading provisions have larger problems.

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37. Australia and England use the term "administration" to refer to what in the United States is termed "bankruptcy reorganization" under Chapter 11. See A Campbell, "Company Rescue: The Legal Response to the Potential Rescue of Insolvent Companies" (1994) 1 *International Company and Commercial Law Review* 16. The procedure for putting a company in administration is much slower and more expensive and cumbersome in England than in Australia. See R Goode, "Insolvent Trading Under English and Australian Law" (1998) 16 *Company and Securities Law Journal* 170. This may explain why the Australian insolvent trading provisions are designed to encourage directors to use administration much earlier than the English provisions. An administrator is personally liable on debts incurred for services rendered, goods bought, or property leased during the administration with indemnification rights against the firm. See Corporations Law s 443A(1)(Australia).
38. In England, for example, administration procedures produce much lower returns for creditors than do voluntary arrangements negotiated outside of administration. See Goode, supra n 37 at 1745.
39. The insolvent trading rule needs also to be distinguished from case law on directors' fiduciary duties that shifts those duties from shareholders to creditors on insolvency. See S McDonnell, "*Geyer* v *Ingersoll*: Insolvency Shifts Directors Burden from Shareholders to Creditors" (1994) 19 *Delaware Journal of Corporate Law* 177 (discussing developments in the United States); R Rao, D Sokolow and D White, "Fiduciary Duty *a la Lyonnais*: An Economic Perspective on Corporate Governance in a Financially Distressed Firm: (1996) 22 *Journal of Corporation Law* 53 (same). The theory of the shift is that shareholders are no longer the residual claimants of the firm's assets when a firm is insolvent, creditors are. The character of the duty does not change. The directors are obliged to act with reasonable care and in good faith. Under even the most robust applications of the doctrine, there is no absolute prohibition on the incurring of new debts when a company is insolvent, although the activity may, under a given set of facts, constitute director misbehaviour.
40. We will catch a few more intentional wrongdoers because it is easier to prove a case against an intentional wrongdoer under insolvent trading provisions than under fraudulent trading provisions even though the later statutes apply. And insolvent trading provisions will catch a few somnolent directors for their lack of attention to their firm's financial affairs, situations in which fraudulent trading provisions do not apply.

The Effect of Insolvent Trading Provisions on Participants' Incentives: Timid Directors, Hamstrung Controlling Shareholders, Skittish Lenders, and Wealthy Consultants

Insolvent trading provisions expose directors, both actual and *de facto* or "shadow", to personal liability for corporate obligations incurred at or around the time the corporation becomes insolvent. Outside (non-executive) directors are not exempt. Shadow directors are persons who control actual directors; that is, persons in accordance with whose directions or instructions the directors are accustomed to act. Controlling shareholders and secured lenders are likely candidates for the shadow director category. There are then four common classes of participants that are affected by insolvent trading provisions: inside directors; outside directors; controlling shareholders; and secured lenders. The effect of the provisions on the incentives of each class of persons is dysfunctional.

The Executive Director: Insider or executive directors are firm managers who also have positions on the board. Their primary source of remuneration is salary or a return on their equity holdings, or both. Their current wealth is disproportionally attributable to their income flow from the firm and their future income potential determined by their reputation as managers is similarly disproportionally related to their firm's health. In short, the executive directors are undiversified in comparison with both the firm's shareholders and the firm's creditors. In good times, this usually translates into a tension between the firm's shareholders and its executive directors, as the directors refuse to take risks[41] that the shareholders would prefer.[42] Creditors, on the other hand, with their gains limited by fixed interest obligations, are more risk averse than shareholders and, once they have lent, encourage directors to be less bold in their business ventures.

Whenever a firm is close to insolvency, good judgment from a firm's executive directors is critical. Is the situation temporary? If not, can the firm change course to better its position? Or ought the firm throw in the towel and submit to some form of insolvency proceeding, either an administration or liquidation? These are not easy business decisions in the abstract and they are often complicated by the extreme tension of the moment, with disappointed shareholders and creditors voicing their considerable displeasure at the firm's distress. Now add the potential of personal liability if the directors make the wrong decision in trying the keep the firm afloat.

The results of insolvent trading provisions are predictable.[43] First, executives are less likely to take positions on the board. The incentives will be the strongest at the positions inferior to the Managing Director or Chief Executive Officer (CEO). A senior executive, who often only advises his superiors, is not likely to view a board position of a troubled company with its personal exposure to liability, as a positive appointment. Second,

41. Defined as business ventures with a positive net present value despite a broad range of possible outcomes that include net losses.

42. See E Fama and M Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301.

43. For a discussion similar to the text see Telfer, supra n 3 at 134–8.

executives on boards will be more likely to resign at the first sign of trouble. Firms may find themselves looking for directors to fill vacancies and to make critical decisions just when good business people will slam the door on inquires.

Third, those executives that remain on the board will demand additional compensation for their heightened risk of personal liability. Whether they will be fully compensated for the risk will depend on the elasticity of the market for corporate executives, but some amount of the risk will be borne by firms in higher salaries and bonuses. They will also fund lawyers who find ways to hide personal assets. (Cook Island trust funds will become popular with directors.) Fourth, executives will be more cautious in taking business risks that include firm insolvency in the list of potential outcomes even though there is a net present value to the project. The rift between diversified shareholders and executives will grow as the potential outcome of insolvency carries with it personal liability for the executives.[44] And fifth, the result expected by proponents of the provisions, directors who have not resigned will be much quicker to submit their firms to administration or liquidation to avoid personal liability.

Whether the fifth result is good on average depends on the adequacy of a country's legal insolvency schemes.[45] There will be some cases in which the creditors do not wish a board to put a firm into insolvency proceedings.[46] In those cases, the creditors' option to defer payments outside of a legal proceeding will be lost as the board rushes into the proceedings to protect its members from personal liability.

To understand the plight of an executive director, consider the nature of the advice they will receive from their lawyers. For a painful list of what a director of a struggling company should do consider the "twelve points for survival" which R M Goode offers as "practical advice".[47] Several of the recommendations are, in essence, admonitions that directors of troubled companies act at their own peril. Point one, for example, is a direction to *not* necessarily stop trading: "You can be faulted just as much for a premature cessation of trading as for continuing to trade while insolvent." Point twelve is a recommendation that a director resign if in the minority on whether to stop trading but "a director who simply resigns without having taken every step he should have done to minimise loss to creditors cannot escape liability". Other recommendations include: insist on frequent, interminable board meetings; stay instantaneously and perfectly informed in relation to all company accounts; talk incessantly with all company creditors (secured and unsecured); and hire, pay, and bow to the ablest of outside advisors.[48]

44. Ironically the personal liability of the executives may slightly increase the attractiveness of the project for the shareholders.

45. For example, New Zealand (unlike Australia) does not have an administration scheme so its directors can only choose to either encourage debenture holders to put the company in receivership or to liquidate.

46. The creditors might believe that the firm can work its way out of difficulty with minor debt deferrals, for example, and that an administration would cost the firm too heavy a penalty in the loss of its business reputation, both with customers and suppliers.

47. Goode, supra n 4 at 472–3.

48. I have exercised some license here.

The Non-Executive Director: The non-executive or outside directors are on the board to provide additional expertise for the managers, to act as a source of conflict-free decisions when the managers' personal welfare conflicts with the firm's interest,[49] and in extreme cases, to take control of the firm away from misbehaving insiders so as to protect the shareholders. For their trouble, the non-executive directors receive modest remuneration and, perhaps, some elevation in social status. Expose such directors to personal liability and one will see many resign from all but the healthiest companies. Firms cannot pay them enough to compensate them for the personal risk. Sadly, outside directors are the least needed in the best running companies and are the most needed in companies that are suffering through difficult times. If the managers are misbehaving, the outside directors can make a touch line tackle. Yet the insolvent trading provisions mean that troubled companies will have few outside directors.

The Majority Shareholder: All the insolvent trading provisions define director to include "shadow" directors, those who control the actual directors. Majority shareholders who are otherwise not on the board are the most likely candidates for personal liability under insolvent trading provisions as shadow directors. Consider the effect. Just when a majority shareholder wants to step in to protect her personal stake in a company, when the company is struggling, she risks personal liability for her efforts in addition to the loss of her investment. This is a substantial limitation on the ownership rights of an equity investor. Some shareholders will decide, quite reasonably, to remain on the sidelines and let their managers, already floundering, deal with the mess.[50] The risk of personal liability may outweigh the majority shareholder's prospects of saving her investment through personal intervention. Even the act of demanding that the board fire a bad management team may trigger personal liability under some of these provisions. Finally, since a majority shareholder, by withdrawing, can often eliminate her exposure to personal liability, she will have no incentive to push her own firm into insolvency proceedings (which rarely benefit shareholders in any event).

The Secured or Continuing Lender: Another candidate for shadow director status is the secured or open account lender. A secured lender of a failing company often has the option of exercising protective covenants that, among other things, allow for execution on the security. If such a lender directs specific action as a condition for not exercising the covenants, the lender risks classification as a shadow director and liability under the insolvent trading provisions. [51] The test seems to be whether a lender has crossed over the line

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49. As in salary decisions or in decisions to terminate shareholder derivative actions against the managers.

50. Similarly, shareholders who have had some say in the firm's affairs will also withdraw at the first indication of trouble.

51. For a discussion of the issue by a fine commercial judge, see Millett, "Shadow Directorship – A Real or Imagined Threat to Banks" (Jan 1991) 1 *Insolvency Practitioner* at 14. His Honour would disagree, perhaps, with the tenor of the text. Justice Millett states that a bank attaching conditions to continued support is not enough to make the bank a shadow director because the bank leaves the decision to the customer on whether it will comply or not. Millett's view of "control" is much narrower than the one that has favour in the United States. Millett does recognize that a bank is a shadow director if the decision to stop trading or go into liquidation "is one that the bank, and only the bank, can take" and the bank "has stepped well outside the normal banker–customer relationship". Ibid at 15. I find the distinction elusive at best. Moreover, the Millett

from simply conditioning its future cooperation on specified debtor behaviour into supplanting the board's prerogatives. No bank will want to sit through a trial listening to a clever opposing barrister characterizing the bank's conduct under such an elusive test.[52]

A similar risk exists for a periodic lender under, say, an open account, that conditions additional loans on specific firm action. Lenders to firms experiencing difficulty are, at the margin, encouraged by insolvent trading provisions to not work with the firms to help them out but to pull the plug on any future lending and exercise their options under whatever protective covenants are available. The risk of the lenders' requests and conditions being construed as directions will inhibit the cautious lender from working with the firm to protect its interests.

A secured lender with a firm wide security (a "floating charge", for example) that executes on the firm's assets and ends up, in essence, owning the business, is itself faced with the decision of whether to liquidate, sell or run the business. Its decision to sell or run the business is affected by the insolvent trading provisions as the lender/owner (or the new buyers) will face exposure on new business debts until the business can be turned around successfully.

Professional Advisors: Australia, New Zealand and England have provisions declaring that a professional person giving advice is not a shadow director. Advisors that take over major board functions will be classified as shadow directors. The risk is greatest with company "doctors", individuals, usually chartered accountants or other financial advisors, who accept temporary appointments with struggling companies to "turn them around".[53]

The Winners?: Insolvent trading provisions are designed to protect unsecured creditors in general, and specifically trade creditors. Are they better off?[54] Both a micro and macro analysis suggests they are not.

In the United States, a jurisdiction without insolvent trading protections, trade creditors worried about insolvent trading by clients have many options. First they can charge all their clients higher interest rates and diversify the risk of default.[55] Solvent clients will push for a separate classification and lower interest rates. Trade creditors can choose to classify clients for interest rate discrimination using a variety of methods. Trade creditors can rely on their own investigations that include paying independent credit reporting businesses for client ratings. Trade creditors can demand in contract negotiations that clients produce financial information to justify a privileged classification. And trade creditors can demand

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view does not take into account language in New Zealand, for example, that makes persons and entities shadow directors if they control only *one* director on a board. See D Jones, "The Phantom Director: A Comic Character?" (1997) Paper for Joint Conference of Law Society and Society for Accountants [recommending a repeal of the shadow director provisions].

52. See G Syrota, "Insolvent Trading: Hidden Risks for Accountants and Banks Participating in 'Work Outs'" (1993) 23 *University of Western Australia Law Review* 329.

53. See, for example, *Re Tasbian (No 3)* (1992) BCC 358.

54. The issue of whether unsecured creditors are better off with insolvent trading protections in place is also discussed in the last section on default rules.

55. In the calculation a trade creditor can include potential recoveries against corporate insiders for fraud on creditors. In other words, the only mandatory rule is an anti-fraud rule.

contractual protections that include, among many options, a general personal guarantee of inside directors or controlling shareholders or a *contingent* personal guarantee that vests on a corporation's breach of a contractual obligation to warn the creditor of any impending financial distress. Trade creditors and their clients will choose the option that provides the best classification system, if any, given the cost.

In Australia, New Zealand and England trade creditors do not have these options as alternatives to insolvent trading provisions. The government has decided that all debt contracts must include a mandatory term, namely insolvent trading provisions. It is not at all clear that this is the best alternative. If it is not, trade creditors and their clients will leave potential joint gains on the table as they engage in sub-optimal agreements. Whether trade creditors or firms lose the largest portion of the potential gain will depend on the market for credit, conditions that will change over time.

The primary reason for my conclusion that the insolvent trading provisions may not be the best alternative is that we see so few of them in trade creditor contracts in the United States. And the drafting of standard form trade creditor contracts is a mature and sophisticated art. By far the preferred solution in the United States for trade creditors dealing with a corporation that has no financial history or a problematic financial history is a standard form personal guarantee from large equity holders in the firm. The elegance of the solution is in stark contrast to the cumbersome definitional problems of an insolvent trading provision. Personal guarantees are usually only asked of inside directors or controlling shareholders. Outside directors are not affected. Directors of solvent firms that convince trade creditors of their firm's solvency give personal guarantees at minimal expected cost; directors of firms on the brink of insolvency knowingly risk their assets or refuse and lose the loan.

On a macro level, if I am correct that the insolvent trading provisions adversely affect the robustness of a country's entrepreneurial activity, then trade creditors suffer because their potential client base is smaller. Trade creditors, like all other corporate constituencies (employees, suppliers, customers), benefit from a thriving business community.

The real winners from insolvent trading provisions are independent accountants and other financial consultants. A lesson well learned in the United States will be learned in Australia, New Zealand and England. Directors in the United States, worried about personal liability in acquisitions, hire investment bankers to provide "fairness opinions" and accountants to provide "solvency opinions".[56] No deal is done without them. Directors in Australia or New Zealand worried about insolvent trading liability similarly will hire outside accountants to prepare a stream of reports whenever a company looks at even a remote chance of insolvency. "Provide the reports or I will resign," will be the familiar threat. Directors will attempt to shift some of their risk of personal liability to the accountants who are harder to sue.[57]

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56. See D Oesterle, "Fairness Opinions as Magic Pieces of Paper" (1992) 70 *Washington University Law Quarterly* 541.

57. Australia has a defence based on reports from "competent and reliable" persons. By hiring outside accountants, directors will seek licensed professionals with high reputations who are ostensibly independent so as to give directors the best chance of satisfying the criteria of the defence. Corporations Law s 588H(3)(a).

The Total Effect: Countries with insolvent trading provisions will have fewer capable people willing to serve as non-executive directors or as executive directors if they are not the most senior and controlling managers. Those who do serve on boards will be quick to resign or to submit their company to insolvency proceedings at the first sign of potential operating difficulties. Moreover, boards will be substantially more risk averse than the company shareholders, rejecting projects with positive net expected values when the probability of a large loss outcome is discomforting, although slight. Investors' incentives to become a majority shareholder will wane as majority shareholders that choose to direct company affairs in times of trouble find they must put their personal assets at risk.

The impact of insolvent trading provisions will be felt the strongest in high-tech business sectors. Such businesses are always high risk, particularly in the start-up phases. Yet the nourishment of these entrepreneurs ought to be a national priority. Laws that deter private risk taking hit hardest here as entrepreneurs find themselves starved for capital. Government sponsored research is no substitute for an active private market in the development and sale of technology. In the global marketplace an edge in technology development can sustain an entire national economy. In its rush to protect creditors from companies run by managers afflicted by the broke gamblers curse, countries may find that they have stifled their precious and volatile high-tech business sectors.

The insolvent trading provisions, when considered in the abstract, make the major players in corporations more timid and less willing to take business risks. This inhibiting effect of the statutes is augmented by their problems in application. Legal process concerns are the subject of the next section.

The Inherent Legal Complexities of an Insolvent Trading Remedy

A comparison of the details of the Australian, New Zealand and English statutes reveals the definitional struggles that each country had to address in formulating their own brand of the prohibition. It is hard to say one country's solution is better than another, for each solution will perplex courts with definitional and application conundrums.[58] In other words, there is no perfect legal language that will avoid the definitional problems of an insolvent trading provision.

The legal conundrums have real effects. Whenever a jurisdiction adopts an insolvent trading provision, business people, concerned about the potential breadth of the remedy and about the difficulty courts will have in accurately assessing after the fact whether trading falls outside the provisions' prohibition, will take extra precautions to stay out of court. Directors of a struggling corporation must judge not only whether they are safe from insolvent trading provisions but also whether they can convince a sceptical, hurried court much later that they acted properly if their firm does fail. As a consequence, whenever insolvent trading becomes even a remote possibility, boards, fearful of the open-ended texture of the remedy, will act precipitously to limit their personal liability. The

58. Even the most ardent supporters of the provisions concede the problem. See D Prentice, as quoted in Telfer, supra n 3 at 139.

incentives noted in the previous section ratchet up to chokeholds: board members will resign, demand the firm hire expensive experts to write reports on the firm's financial condition, or push the firm into insolvency proceedings rather than proceed.[59]

All insolvent trading provisions must provide answers to several definitional questions. Let's see how Australia, New Zealand and England do with their answers. The major differences in the three provisions relevant to the theme of this essay are in defining, first, the events that trigger the remedy; second, the time period during which the board is culpable; third, the available defences; and fourth, the amount owed.

The Triggering Event: All three provisions hinge liability on a corporation's default in repaying its debts.[60] England's wrongful trading statute also requires that the company be in liquidation proceedings. Australia has a similar requirement for private actions, which must be brought by a liquidator (or by a creditor with the liquidator's consent, or if a liquidator refuses to act). Public enforcement actions brought by the Australian Securities and Investments Commission seeking a civil penalty order, or the Commonwealth Attorney-General seeking criminal penalties, do not require that the company is being wound up, however. New Zealand does not require that a company be in liquidation.

The liquidation requirement is odd as it gives board members who recognize their personal liability under the insolvent trading provisions a strong incentive to start administration or receivership proceedings in lieu of liquidation proceedings. The type of insolvency proceeding chosen ought not affect the character of the basic offence, for the damage to creditors could be the same in each case.

The Beginning of the Time Period During Which Trading is Wrongful: The time period for director liability begins to run in England when "at some time before the commencement of the winding-up there was no reasonable prospect that the company would avoid going into insolvent liquidation and the directors knew or ought to have concluded that there was no such reasonable prospect". In Australia, the time period begins to run if a company "incurs" a debt when the company is insolvent or becomes insolvent by incurring that debt[61] and "there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent". In New Zealand the period runs when a director either "agree[s]" to, "cause[s]," or "allow[s]" the business of the company to be carried on in a manner likely to create substantial risk of serious loss to the company's creditors or when a director agrees to the company "incurring an obligation" when the director cannot be said to "believe at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so".

59. See S Pollard, "Fear and Loathing in the Boardroom: Directors Confront New Insolvent Trading Provisions" (1994) 22 *Australian Business Law Review* 392 at 396.
60. Otherwise there is no damage to the firm or creditors to assess. New Zealand may be an exception. It is possible that creditors could suffer "serious loss" outside of the occurrence of a default when, for example, the trading value of their negotiable debt instruments drops due to an increased credit risk of a solvent firm. Companies Act of 1993, s 135.
61. Neither England nor New Zealand have the Australian requirement that a company must be insolvent at the time the debt in question is incurred. Solvency is relevant under the articulated standard but not an element of it.

As one can see from the language, a rank order of the standards based on the time at which a provision requires a director to take corrective action, earliest first, would place Australia first, followed by New Zealand and England. Australia requires a director to act when she is or *ought* to be "suspicious" (defined by one court as "a positive feeling of actual apprehension or mistrust, amounting to a slight opinion, but without sufficient evidence"[62]) that her company will be unable to pay all its debts as and when they become due.[63] New Zealand also uses a cash flow test but a director does not have to act until she no longer has a "reasonable grounds" for her belief in her firm's positive cash position. England, on the other hand, requires a director to act when she knows or ought to know that there is "no reasonable prospect" of avoiding "insolvency liquidation", which is determined by a balance sheet test (negative equity).

The cash flow test provides an earlier trigger than the balance sheet test, but at the sacrifice of a considerable amount of certainty and predictability. While the balance sheet test piggybacks on well established accounting practices and principles, the cash flow test involves a number of difficult questions that courts have to sort out on the facts of each case. What debts are included other than those currently due or due in the near future?[64] When do outstanding debts become due?[65] What assets are included in the offset and at what values?[66] Do offers of unsecured credit count?[67]

One leg of the New Zealand test demonstrates the appalling mess that casual drafting can lead to on this issue. Section 135 of the Companies Act of 1993 holds directors personally liable if they "agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors". A New Zealand businessman, Roderick Deane, blasted the language for not allowing courts to consider the size of the potential rewards in offset to the potential loss.[68] He argued, in essence, that a firm with a 30 percent chance of returning $1 million and a 70 percent chance of losing $250,000 could no longer continue to trade because the 70 percent chance of losing $250,000 would be a "substantial risk of serious loss" under the provision. A New Zealand judge, in a subsequent paper, has disagreed arguing that the words "substantial" and

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62. *Queensland Bacon Pty Ltd* v *Rees* (1966) 115 CLR 266, 303.

63. Insolvency is defined in s 95A of the Corporations Law in cash flow, not balance sheet, terms. Section 588E supplements the test with two presumptions, both of which may be rebutted by evidence. The more interesting of the two is a presumption of insolvency when a company has failed to keep adequate accounting records for a specified period.

64. How does a court value obligations due in five or ten years? How does it value contingent or unliquidated obligations?

65. Does a practice of creditor extensions affect the calculation?

66. Should courts include readily realizable assets or just current cash funds? If so, at what values? Market value or distress value? How does a court value a corporation's outstanding payables? How does a court handle "running accounts"? See J Lawrence, " Are Directors Running Accounts in Breach of Their Duties?" (1997) 8 *Australian Journal of Corporate Law* 143.

67. Offers of additional unsecured credit, if taken, affect a corporation's cash position.

68. R S Deane, "Besieged by Duties: Will the New Companies Act Work for Directors?" paper presented to the New Zealand Law Society's and the New Zealand Society of Accountants' Company Law Conference (1994).

"serious" include room for balancing potential gains.[69] While one must respect the ability of a judge to put in practice his interpretation, Dean seems to have more respect for the straightforward use of the English language.[70] If Dean is correct, directors in most New Zealand companies that pursue risky strategies with positive net expected values personally guarantee their company's success.[71]

The Australian and one of the legs of the New Zealand test speak of "incurring a debt" as part of the test. The variety of obligations entered into by even a normal business make application of the language a nightmare.[72] How does one handle taxes, contingent debts (guarantees), and court judgments for otherwise unliquidated claims? Courts in Australia have been settling technical disputes over the meaning of the Australian language. Moreover, determining the time at which a debt is incurred is also difficult, as there are often time separations between the date of contract and the date of delivery of goods or services.[73] How does one handle periodic obligations for rent, interest and salaries for employees? Directors are likely to assume that the insolvent trading provisions apply to new agreements on traditional forms of commercial debt, bank debt and supplier accounts. Directors cannot be expected to appreciate the potential range of other obligations that are covered by the provisions nor to anticipate correctly the time at which their duties attach under the provisions (when, for example, the firm has outstanding, periodic contractual obligations).

The open-texture of the tests ought to cause any director of a company that is put into liquidation to hire a personal lawyer. Her personal assets are at risk. She is likely to have satisfied the primary test for liability under any one of the three insolvency provisions for some period of time prior to the beginning of the liquidation proceedings. Only a seer could escape it. Directors ought to assume that courts will find some time period prior to any liquidation proceeding that meets the standards in each of three formulations of the language. Once a company fails, it is too easy to look back with hindsight, and find a period of time in which the directors "should have known" or "should have suspected" the firm's future insolvency. In other words, whenever an insolvent company must be wound up, most directors will be put to the task of proving an affirmative defence in order to save their personal assets from execution.

The Affirmative Defences: In England, once the time period has begun to run, an English director must have taken "every step" necessary to minimize the potential loss to

69. J Tompkins, "Directing the Directors: The Duties of Directors Under the Companies Act of 1993" (1994) 2 *Waikato Law Review* 13 at 27 (Tompkins is a judge on the High Court of New Zealand).

70. Tompkins does bemoan the statute's clarity, however. Ibid.

71. The dilemma for the courts in New Zealand is classic. Should the courts interpret the statute the way it reads and inflict harm on some unlucky defendant to force Parliament's hand? Or should the courts torture the language to save Parliament from embarrassment for a very poor job of drafting.

72. See T Noble, "When Does a Company Incur a Debt Under the Insolvent Trading Provisions of the Corporations Law?" (1994) 12 *Company and Securities Law Journal* 297.

73. Compare *Shepherd v Australia & New Zealand Banking Group* (1996) 14 ACLC 987 with *Standard Chartered Bank* v *Antico* (1995) 13 ACLC 1381 (courts disagreeing on whether a failure to deliver goods that had been paid for was incurring a debt).

creditors. The steps include stopping the firm from incurring any new debt, informing the creditors, asking debenture holders to appoint a receiver, and applying for an administrator or liquidator. In Australia, a director can defend by proving that she had "reasonable grounds to expect that the company was solvent", relied reasonably on information from competent persons that the company was solvent, did not participate in the business because of illness or "some other good reason", or "took all reasonable steps to prevent the company from incurring the debt" in question.[74] New Zealand does not specify any affirmative defences but acts of the type specified as affirmative defences in Australia will affect whether or not there is primary liability under the New Zealand provisions.

The defences do not give a businessperson much solace. The forum for a decision on the defences is stacked against the director. The court (or the jury), knowing the business has failed, is evaluating the director's conduct with minimal respect for the uncertainties of the time in which it occurred. With the benefit of hindsight, one always could have done more than one did (or could have done what one did sooner) to stop what we now know happened. The phenomenon is exaggerated by judges' lack of business experience. Their outcome bias is likely to be more pronounced because they do not have an independent basis of experience in business on which to ground their judgment. Clever lawyers and paid experts will ably add to the confusion. Finally, courts' sympathy is naturally with the creditors, especially the trade creditors, who are suffering losses and leaning against the directors who, after all, ran a company into the ground. It is an undeniable opportunity for courts to engage in loss shifting and allocation based on ephemeral notions of fairness and just desserts.

Calculating the Personal Exposure of a Director: Since most directors whose companies are wound up insolvent will satisfy the primary test and not prove an affirmative defence for some period of time before liquidation, the question becomes the extent of their personal exposure to liability. Australia again leads the way; it not only has the most stringent requirements, it has the severest consequences for violations. The Australian Securities and Investments Commission can apply to a court to have directors pay a pecuniary penalty of up to $200,000, be prohibited from managing a corporation for a period, and pay "compensation" to a corporation for "loss or damage" suffered.[75] If the corporation is in the process of being wound up for insolvency, the liquidator or a creditor, with the approval of the liquidator, can sue for compensation. In New Zealand, the liquidator, a

74. In recognition, perhaps, of the breadth of the prohibition, Australia gives their courts a safety valve. A court may relieve a director of civil liability if the director acted honestly and "ought fairly to be excused". Corporations Law s 1317S. The court may consider the actions that otherwise may constitute an affirmative defence, such as the director's decision to vote for the appointment of an administrator.

75. Corporations Law Part 9.4B. The requirement of loss or damage to the corporation is odd because insolvent trading usually involves augmenting a corporation's assets, securing loan proceeds, at the expense of creditors, who will not be repaid. It is possible to show that a corporation, kept alive with insolvent trading, further dissipated assets that would otherwise have been available on liquidation, but this proof, as a condition for a compensation order, does not comport with the broader policy rationale behind the primary prohibition of insolvent trading.

creditor and a shareholder all have standing to sue directors for compensation.[76] In England, on the application of a liquidator, a court can order directors to contribute to the company's assets, subordinate the debts owed the director and disqualify a person from acting as a director in the future.

The legislatures, having taken great pains to articulate the offence, move the issue of compensation to the courts. The calculation of damages is no easy task. There are several possible theories of relief.

The primary victims of insolvent trading are, in theory, the creditors whose debts the company incurred when the directors should have known better. Directors, it is argued, should make good on this class of debts. The rub is that the directors make their payments to the firm and that the new creditors must share the payments with the old in the insolvency distributions.[77] At least one court seems to hold that the new creditors may take nothing if there are older creditors with general floating charges on a firm's assets.[78] So some older creditors, secured or unsecured, get a windfall benefit from any recovery based on the firm's wrongful trading with respect to the new.

Moreover, one could argue that the old creditors have suffered loss if their recovery under liquidation proceedings is less than it would have been had the directors acted on time to submit the company to liquidation (or receivership). The delay could have depleted the assets available to creditors on an execution of their claims. Perhaps directors are liable for the difference.

Since the primary recipient of any recovery is the firm itself, perhaps it is the firm's injury that should be the touchstone of any recovery against the directors. If so, the inquiry ought to be an evaluation of the extent of any deterioration of the net asset position caused by the prohibited trading. In most cases this will require comparing the financial position of the company with where the company would have been had there been no prohibited trading. This inquiry, involving the construction of a baseline hypothetical liquidation is an employment boon for court experts and a quagmire for judges.

Under this theory of relief one could see some bizarre results. One could, for example, envision odd cases in which companies actually gain from the insolvent trading. Consider a company that is soon to fail. Managers secure the proceeds from new debts and retain them, earning a positive return. Insolvency results nonetheless and the proceeds of the new debts have made the company and its old creditors better off, to the detriment of the new creditor! On the other hand, one could envision cases in which an insolvent company could have been turned around without the acceptance of a small but lethal new debt.[79] The lost profits may be far larger than the amount of the prohibited debt. Are directors

76. Companies Act s 301.
77. In Australia, a creditor can bring an action and recover individually only if a liquidator errs. The creditor can sue with the express permission of a liquidator or by notice to the liquidator if a liquidator refuses to sue. Corporations Laws ss 588R–T.
78. *Re Produce Marketing Consortium Ltd* (1989) 5 BCC 569 at 598. The exact nature of the holding is unclear. In Australia, by statute, payments are allocated first to unsecured creditors. Corporations Laws s 588Y(1)
79. The proverbial straw that breaks the camel's back.

liable for the entire amount of lost profits? Or is the directors' liability capped by the total sum of the debts incurred after insolvency?[80]

Which theory of relief should it be? The statutes are not helpful on the matter.

The extent of personal liability under insolvent trading provisions is not a trifling technicality. The higher the personal exposure of the directors to the firm's creditors, the higher the disincentive to be or stay a director and the more risk averse the director in making operating decisions for the firm. The harshness of Australia's remedies, for example, ratchets up the strength of the dysfunctional incentives of the Australian provisions discussed above.

Should Insolvent Trading Provisions Be Repealed or Amended to Serve Only as a Default Rule?

One solution to the insolvent trading provision debate is to amend the insolvent trading provisions to make them optional in all corporate debt contracts. The statutes could provide that the parties to a contract may waive the provision's protections. The suggestion has the benefit of political convenience; it would be easier politically to amend than repeal and such an amendment could take much of the sting out of the provisions. On policy grounds, however, the suggestion implies an answer to the "opt in" versus "opt out" debate. Since, in the absence of insolvent trading provisions, creditors could contract for insolvent trading provisions (i.e., opt in) one needs a policy justification for imposing insolvent trading as the statutory default rule, which requires the parties to opt out.

The traditional calculus depends on an analysis of transaction costs of the two alternatives. Which alternative more approximates the average bargain and reduces the parties' costs of contracting? The inquiry can be straightforward, an investigation into the terms that would most often be negotiated in the average bargain.[81] Or the inquiry can be complicated by a selection of terms that generates a bargaining process that the parties would most often desire — the one that maximizes the parties' joint gains.[82]

There is a vigorous disagreement among three Australia academics over whether insolvent trading rules are needed to force corporations to reveal their financial status to

80. In *Nippon Express (New Zealand) Ltd* v *Woodward, Re Horticultural Handling Ltd* (1998) 8 NZCLC 261, decided on the 1955 Act version of ss 135 and 189, the judge awarded compensation in the amount of the debt run up in the insolvent trading period and excluded sums advanced by the directors themselves. The judge made no adjustment for the portion of the judgment that the directors, as creditors of the company, would recover back. The directors' advances were therefore taken into account when assessing the directors' share as creditors of any residual assets. This is a very crude assessment of a company's losses from insolvent trading.

81. See F Easterbrook and D Fischel, "The Corporate Contract" (1989) 89 *Columbia Law Review* 1416 at 1432–3.

82. I Ayres and R Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules: (1989) 99 *Yale Law Journal* 87 at 95–100. The authors contend that some default rules give parties incentives to contract explicitly and the negotiating process causes one party to reveal information to the other that otherwise would not be transferred. The revealed information leads to better bargains that maximize joint gains.

trade creditors.[83] Mannolini and Byrne argue that a trade creditor presumes corporations to be credit risks when those firms do not disclose financial information. Whincop argues that trade creditors' continuous relations with their clients means that silence is customary over time.

I side with Mannolini and Byrne. Trade creditors can get credit information from a variety of public sources (including other trade creditors) and pay for information from credit rating agencies when a client's solvency is in doubt. When suspicious, trade creditors can demand financial information from their clients. Many standard-form credit contracts also carry financial assurance clauses that require clients to provide assurances of future payment when the creditors demand it.[84] Whincop's sympathy for trade creditors who are in long-term relationships with clients and thereby lulled into complacency does not describe many suppliers who remain in business very long. Successful suppliers are vigilant.[85] Whincop's paternalism rewards and even encourages creditor complacency. Indeed, trade creditors can be the first outsiders to know of a client's troubles as payments slow and excuses accumulate. When trade creditors choose not to act on the warning signs of default, they assume the risk. Finally, it is not at all clear that trade creditors, asked to waive their insolvent trading protections by a potential client, will demand the kind of information that Whincop assumes to execute the waiver. The market for credit, the bargaining power of the potential client, the creditor's special knowledge of the client, and custom and practice will inevitably affect a creditor's demand for more information even with an insolvent trading default rule in place.

The limits of Whincop's analysis are evident when he recoils from requiring, as a default provision, personal guarantees from directors: "Directors are inherently risk averse and a guarantee would merely increase this risk aversion."[86] Attempting to distinguish insolvent trading provisions from personal guarantees he notes that a director subject to insolvent trading provisions can control insolvent trading by informing himself of the financial situation of his firm and taking steps to put his firm into administration when insolvency looms. But our director subject to a personal guarantee on *only* trade debts (debts with 60 to 90 day maturities) could do much the same,[87] and may have a stronger incentive to be

83. Compare Whincop, supra n 14 at 21–22 with M Byrne, "An Economic Analysis of Directors' Duties in Favour of Creditors" (1994) 4 *Australian Journal of Corporate Law* 275 at 277; J Mannolini, supra n 8 at 25.

84. Whincop incorrectly assumes that the only remedy for a breach of contract is damages which, as against an insolvent company, are useless. The financial assurance clause is both an early warning system, before insolvency, and self-enforcing. No assurances, no more credit (and all outstanding debts accelerate and become due immediately).

85. The best discussion of the many options available to trade creditors is in Telfer, supra n 3 at 129–32.

86. Whincop, supra n 14 at 23.

87. Whincop worries that a personal guarantee is unrestricted. If a personal guarantee from insiders is limited to trade debts with less than 90 day maturities the personal guarantee is somewhat more open-ended than an insolvent trading provision but not significantly so. Indeed, because the looser forms of the involvement trading rules apply in advance of actual insolvency, the short maturity dates on trade debt may result in roughly equivalent director liability under both styles of default rules. An executive director subject to a personal guarantee on trade debts would take care to assure herself that her firm could pay off whatever trade debts the firm was incurring at any point in time and, using Whincop's logic, control her fate.

vigilant.[88] If director vigilance in favour of corporate creditors is one's goal, a default rule on personal guarantees for executive directors would seem to be preferable to an insolvent trading default rule.[89] A deeper analysis of director incentives is necessary to draw the line between appropriate and inappropriate default rules, which, when drawn without care places both of the above default rules in the same category — dysfunctional. Whincop's argument that directors are already too risk averse and ought not suffer the additional burden of a default rule of personal guarantees applies also to a default rule on insolvent trading exposure.

Conclusion

In a free market economy it is easy for the citizenry and their elected officials to overreact to economic failures. We attach blame knowing the failures of the past, forgetting that business people make decisions based on projections on the future. We choose trade creditors as sympathetic victims and directors as villains, making assumptions about personal wealth and the effect of losses that are often inaccurate.[90] We assume the victims could not help themselves and the villains were unbridled. And, our biggest fault, we believe that we can pass some magic language that will minimize the number of business failures or make their effects less painful. More often than not our efforts in this regard make things worse.[91] In private business, people risk negative results to pursue positive opportunities. Other than rules that prohibit fraud among the participants, a legislature should be very wary of disturbing this basic process that drives free market economies. Insolvent trading provisions are well intentioned but, in the end, not helpful.

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88. The advantage of personal guarantees is that only inside directors or controlling shareholders, those with sizable equity stakes, make them. An insolvent trading provision applies to all directors.
89. It is easier to apply and harder to avoid because of its simplicity. An insolvent trading provision will inherently offer a number of definitional quagmires.
90. Trade creditors are just as likely to be large corporations as small suppliers and the firms that collapse are just as likely to be small family operations as those run by scam artists. Trade creditors may have diversified their losses and the owners of small family corporations may have lost everything.
91. Consider the recent efforts of the Japanese government to stop the fall in its stock market by prohibiting new equity issues or to stop the fall in the value of Tokyo real estate by prohibiting land sales, well intentioned but disastrous moves.

Chapter 3

The Economic and Strategic Structure of Insolvent Trading

Michael J Whincop*

Introduction

The insolvent trading provisions of the Corporations Law are perhaps the most immediately important provisions for corporate directors in the entirety of the statute. Especially in proprietary companies, directors will only occasionally be confronted by the duties arising when a takeover or a capital raising requiring a prospectus are pendent. Only the most unethical ones will face a prosecution for a contravention of the duties of directors contained in ss 181–4. Derivative suits by shareholders alleging breach of duty are rare too. But for many corporations, insolvency is an ever-present risk, as it must be if a capitalist system is to retain its incentives. Conformably with my claim about their importance, corporate law reports document a number of cases in which breach of the insolvent trading provisions has been alleged. As I have observed elsewhere, the consideration of the content of these provisions in these cases had a catalytic effect on the development of directors' statutory duty of care, and the related common law obligation.[1]

The insolvent trading provisions' place of honour as some of the most salient provisions in a statute thought by many to be too long, too prescriptive, and too hostile to entrepreneurship, made them a target for two kinds of criticism. First, one group of critics, mostly practitioners, articulated an essentially practical fear of the provisions.[2] Liability under the provisions would potentially be unclear, given that many firms waft in and out of

*Associate Professor, Faculty of Law, Griffith University; Leader, Business Regulation Program, Key Centre for Ethics, Law, Justice & Governance. This paper is a substantially revised version of my article "Taking the Corporate Contract More Seriously: The Economic Cases Against, and a Transaction Cost Rationale for, the Insolvent Trading Provisions" (1996) 5 *Griffith Law Review* 1. Content common to those articles is published with the kind permission of the Review's editors.

1. M Whincop, "A Theoretical and Policy Critique of the Modern Reformulation of Directors' Duties of Care" (1996) 6 *Australian Journal of Corporate Law* 72 [hereinafter Whincop, *Care*]; M Whincop, "Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate Law" (1997) 21 *Melbourne University Law Review* 187 [hereinafter Whincop, *Contractarianism*].
2. See, for example, R Baxt, "Insolvent Trading: The Nightmare Continues" (1992) 62:5 *Charter* 24; R Baxt, "Liability of Shadow Directors for Insolvent Trading: Australian Authorities Start to Bite" (1996) 14 *Company and Securities Law Journal* 121; "Directors Face Growing Statutory Obligations" (1994) 10:8 *Company Director* 44.

insolvency, and that management information systems are often unreliable in smaller firms. That argument feeds into what might be called the "frightened director" syndrome, in which high potential liabilities are thought to discourage qualified people from becoming, or continuing to act as, board members.[3] Implicit in this argument is that the supply of directors and entrepreneurs is elastic, and will shrink substantially if directors face higher risks.

The second group of critics, mostly academics, restate the criticisms of the first group, and certain other concerns, in the formal language of economic efficiency. The need to make an economic argument for this issue is clear — one might accept that the insolvent trading provisions make directors worse off, or that shareholders are worse off, because directors demand higher compensation, because directors' and officers' insurance is more expensive, or because managers make suboptimally high expenditures on management information systems in order to avoid liability. However, insolvent trading provisions were introduced to benefit creditors. Thus, the welfare gains to creditors, or to the operation of credit markets, must be considered before one pronounces a conclusion on the allocative inefficiency of the insolvent trading provisions.

These critics (I shall call them the "economic critics") use the tools developed by American law and economics scholars in the mid-1980s to address other issues in corporate law, such as aspects of the manager–shareholder relation and limited liability.[4] The economic critics argue that the welfare gains to creditors are minimal or nil. The core propositions are these: first, that creditors are capable of ascertaining, and protecting themselves against, the risk of insolvency by contractual means; second, that providing a remedy under the insolvent trading provisions "overcompensates" the lender for the risk he or she assumes; third, that the director is an inefficient bearer of the risk that the legislation imposes; fourth, that the provisions do not respect the need for business judgment by directors; fifth, that the provisions are not susceptible to contrary contracting. There are substantial analytical flaws in all of these arguments. This shows two things: first, the danger of uncritical economic analysis, especially of the Coase theorem's "irrelevance" claim;[5] and second, the need to investigate possible forms of strategic behaviour by corporations, and the effect of legal rules on strategic behaviour. Demonstrating these claims is the purpose of this chapter.

Initially, I describe the economic context of insolvent trading. I use some informal game theory and information economics to demonstrate the strategic nature of the problem. This is in the nature of an adverse selection problem, which debilitates the formation and operation of markets, coupled with a final period problem, which makes opportunistic behaviour more likely. As a preliminary to this part, I discuss the contractual theory of the firm, on which the economic critics draw, and why we must be hesitant in generalising its

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3. See J Coffee, "No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies" (1988) 53 *Brooklyn Law Review* 919 at 927. This thread is also implicit in Corporate Law Economic Reform Program, *Proposals for Reform: Paper No. 3: Directors' Duties and Corporate Governance* (1997).
4. US bankruptcy law has nothing directly analogous to our insolvent trading provisions, although directors may have fiduciary duties when the corporation is proximate to insolvency.
5. R Coase, "The Problem of Social Cost" (1960) 3 *Journal of Law and Economics* 1.

conclusions to all firms, and for all species of claims on the firm. The part that follows discusses in some detail the analysis of the economic critics, and demonstrates why their arguments are either wrong or misspecified. The final part discusses the true problems with the insolvent trading provisions, their severity, and how they might be solved.

The Economic Context of Insolvent Trading

The insolvent trading provisions impose liability on directors where an insolvent company incurs a debt. By doing so, they use legal liability as a means of deterring directors from incurring such debts. Creditors should normally have an incentive to ensure that corporate debtors can and do repay their loans. Given the efficiency of this private incentive, and the apparent absence of third party effects or externalities, we must ask a question: what can insolvent trading provisions do that creditors cannot do for themselves?

The tenor of much corporate law and economics research of the last decade is to doubt whether regulatory intervention affecting the terms of contracts struck in functioning markets has any allocative efficiency effects at all, in the absence of third party effects.[6] This is a restatement of the Coase theorem.[7] This theorem holds that where transaction costs are zero, allocations of property rights have no effect on allocative efficiency. Zero transaction costs enable parties to achieve gains from trading inefficiently allocated rights; those contracts maximise social welfare. It can be inferred from the Coase theorem that regulatory alterations to the rights parties trade will have little effect where transaction costs are low (albeit not zero).[8] The formation of markets implies that transaction costs are relatively low. At best, legal rules can anticipate the contractual provisions typical parties would agree to in the relevant marketplaces.[9] This spares them the costs of negotiating these rules directly.

Initially, these arguments were applied to the manager–shareholder relation. The principal contracting problem — ensuring that managers serve honestly, loyally, and competently — could be addressed by various explicit contracts and formal governance devices. According to the standard argument, promoters offering shares in the corporation would seek to restrict the capacity of managers to act opportunistically in order to maximise the return on the shares.[10] Corporate law serves some purpose in this respect by offering basic fiduciary duties, for which shareholders and managers would otherwise have to contract explicitly, although it does not have a major role.[11] The fact that modern

6. Eminent examples of this literature include B Black, "Is Corporate Law Trivial?: A Political and Economic Analysis" (1990) 84 *Northwestern University Law Review* 542; H Butler and L Ribstein, "Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians" (1990) 65 *Washington Law Review* 1; F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (1991).
7. Coase, supra n 5.
8. J Johnston, "Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures" (1992) 70 *Washington University Law Quarterly* 291.
9. F Easterbrook and D Fischel, "The Corporate Contract" (1989) 89 *Columbia Law Review* 1416.
10. See, for example, Easterbrook and Fischel, supra n 6 at 4–7.
11. Ibid at 34–5.

American corporate law provisions are generally susceptible to private ordering by provision in the corporate charter was favoured as efficient.[12] It permits Coasean bargains where parties prefer to put aside legal protections in favour of, say, contractual ones thought to be more effective in addressing agency problems.[13] Of enormous assistance to this argument was the evidence from financial economics that share markets react swiftly and accurately to new information relevant to stock prices.[14] This makes it likely that the terms of contracts defining the rights of securities holders will be "priced", which in turn suggests that those contracts will maximise social welfare.[15]

It seems a small step to adapt this to the market for credit. With the troublesome exception of involuntary tort creditors,[16] economic argument seems to suggest that the terms of credit contracts will be allocatively efficient.[17] Corporations seeking debt finance will provide information about their solvency, and agree to contractual terms that optimally reduce the various risks faced by debtors lending to limited liability companies.[18] Corporations that do not do so will face higher costs of credit. The notion that borrowers voluntarily disclose information about solvency applies a principle in information economics called the *unravelling result*.[19] It holds that where it is common knowledge that A possesses verifiable information (that is, information the truth of which can be evaluated by a third person), A will disclose it rather than risk the formation of adverse inferences by the person he trades with. Borrowers with very high asset backing for their debt will disclose that fact, followed by each subsequent "layer" of borrowers, leaving only those whose assets will not support further borrowing on any terms. Once again, the existence of markets for corporate debt suggests that transaction costs are low and the need for intervention, such as insolvent trading provisions, is minimal.

We should treat this argument with caution. There is a fundamental difference in market structure between equity and debt markets. In public corporations, a corporation's

12. General Corporation Law, 8 *Del Code* § 102(b)(7) (1998). See generally Whincop, *Contractarianism*, supra n 1.
13. Johnston, supra n 8.
14. See generally E Fama, "Efficient Capital Markets II" (1991) 46 *Journal of Finance* 1575. For application of the theory by lawyers, see R Gilson and R Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 *Virginia Law Review* 549; J Gordon and L Kornhauser, "Efficient Markets, Costly Information and Securities Research" (1985) 60 *New York University Law Review* 761; D Langevoort, "Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited" (1992) 140 *University of Pennsylvania Law Review* 851.
15. Cf M Eisenberg, "The Structure of Corporation Law" (1989) 89 *Columbia Law Review* 1461 at 1500–6.
16. H Hansmann and R Kraakman, "Towards Unlimited Shareholder Liability for Corporate Torts" (1991) 100 *Yale Law Journal* 1879.
17. F Easterbrook and D Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 89.
18. The customary risks are of wealth transfers from lenders to shareholders by any of the following: (1) substituting high risk assets for low risk assets when the debt is priced on the basis of the low risk assets; (2) diluting the priority of existing debt by issuing senior debt; (3) rejection of assets earning in excess of their cost of capital where the advantages would accrue to lenders; (4) stripping out the assets of the corporation by paying capital dividends to shareholders or by buying back shares. See generally C Smith and J Warner, "On Financial Contracting: An Analysis of Bond Covenants" (1979) 6 *Journal of Financial Economics* 117.
19. See E Rasmusen, *Games and Information: An Introduction to Game Theory* (2nd ed, 1989) at 197–8.

equity is almost perfectly fungible, because rights are not differentiated (excepting the case of dual class equity). Provided that there are sufficient informed traders in the equity market, smaller shareholders are able to take a free ride on their monitoring.[20] Thus, an argument about market efficiency need not differentiate between classes of shareholders. That however is not true of debt markets. The markets in which trade credit is extended, for example, are likely to be affected by high information costs, limited liquidity, and imperfect substitutability in the underlying property rights created by the debt contract. The relatively low gains from trade in this market are likely to create a significant collective action problem in the acquisition of information by the large number of creditors any one corporation trades with. Although news of insolvency will disseminate relatively quickly, there may be substantial opportunities for inefficient trades in the interregnum.

This means that we cannot depend on the efficiency of the capital market to cure the information deficiencies of individual creditors. The questions that must then be asked are whether the unravelling result will occur in the contracting process, or whether the contracting process makes it sufficiently likely that creditors will set terms and make decisions on an informed basis. To examine this, however, we need first to understand something about how insolvent trading affects the contracting process.

The economic problems associated with insolvent trading have essentially two sources. First, there is an adverse selection problem. Adverse selection is a pervasive problem in markets, most famously in insurance markets.[21] It arises when one of the contracting parties has private information the other does not have. In these circumstances, the parties most likely to want to contract are those whose private information is adverse. In insurance contexts, for example, where risks are hard to differentiate, high risks are more likely to seek insurance than low risks.[22] The problem is that if the difference between the undifferentiated risks is great enough (that is, risk-pool variance is high enough), the underlying market may unwind. Low risks drop out of the market, which gradually increases the mean risk of, and thus the price charged to, the remaining pool. This in turn leads to the lowest remaining risks departing, followed by the next lowest, and so on.

Adverse selection is the essence of insolvent trading. If lenders cannot distinguish insolvent from solvent creditors, credit will be extended at a (higher) pooled rate, reflecting the presence of insolvent creditors. However, as interest rates rise, solvent creditors will gradually drop out of the market. Projects may cease to be viable under higher interest rates, or alternative forms of finance, where information asymmetries are less problematic, may become preferable. However, insolvent creditors will remain since they are likely to be motivated by the need to obtain the capital to delay the commencement of insolvency proceedings, and, being incapable of repaying any debts, are not discouraged by borrowing at a higher rate.

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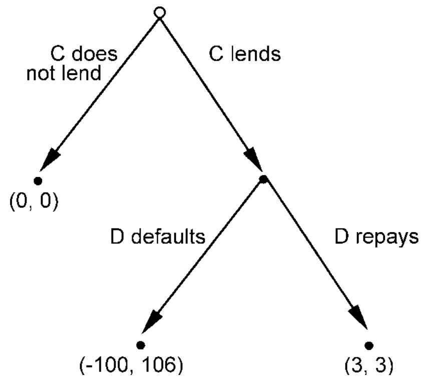
20. Gordon and Kornhauser, supra n 14.
21. G Priest, "The Current Insurance Crisis and Modern Tort Law" (1987) 96 *Yale Law Journal* 1521.
22. The other famous example is the market for used cars: G Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (1970) 84 *Quarterly Journal of Economics* 488.

Insolvent trading situations are also characterised by final period problems.[23] Seen at a snapshot in time, the performance of credit contracts, for example, resemble the prisoner's dilemma problem, the most famous paradigm in game theory.[24] The essence of a prisoner's dilemma is that even though parties would both be better off acting cooperatively, it is individually rational for both to act opportunistically. The prisoner's dilemma is often illustrated by the use of a normal form game, in which parties make simultaneous decisions. However, the same insight holds if the game is recast in extensive form in which parties make decisions sequentially. Thus, if one considers a game in which C must decide whether to lend money to D, and D must decide whether to repay or default, we might imagine the following hypothetical payoffs in Figure 1.

Figure 1: The Lending Game



Even though both parties maximise their joint welfare when C lends and D repays, this is not the game's solution.[25] D maximises his welfare by defaulting (106 is better than 3). Applying the solution concept of iterated dominance,[26] we can see that C will recognise D's strictly dominant strategy, and choose not to lend (0 is better than –100).[27] What permits the parties to avoid the extended-form prisoner's dilemma is that the parties often

23. Rasmusen, supra n 19 at 121–3; J Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 *Columbia Law Review* 1549 at 1592–3. Thus, Corey et al state that "market forces are only effective if more [debt is] offered in the future": G Corey, W Marr, and M Spivey, "Are Bondholders Owed a Fiduciary Duty?" (1991) 18 *Florida State University Law Review* 971 at 978.
24. A Dixit and B Nalebuff, *Thinking Strategically* (1991) at 12–14, 98–113.
25. The payoffs are based on a hypothetical contract in which C lends $100 to D who invests it in a project earning a return of $6. For illustrative purposes, I have assumed that C and D set the terms of their contract to divide the gains from trade equally.
26. Rasmusen, supra n 19 at 19–22.
27. The assumption is that C's costs to sue would exceed the amount recovered. Thus, C will not sue, and cannot credibly threaten to sue (unless C can irrevocably commit himself at the time of lending to do so — burning his bridges, in effect).

anticipate future interaction.[28] The "shadow of the future"[29] may enable cooperation to emerge, since the other party will be capable of punishing the other for acting opportunistically in future rounds. Parties may be better off sacrificing the present gains from opportunism in favour of the future gains from acting cooperatively.

However, an essential precondition for cooperation is that the "game" recur perpetually or for a finite but unknown number of times. If parties know when the "endgame" occurs, the strategic structure of that endgame will have the same result as the one-shot prisoner's dilemma, there being no future round in which punishment can credibly be threatened. However, this also has upstream effects on earlier rounds before the endgame. If the parties know that each party will play the opportunistic strategy in round n, they have no incentive to cooperate in round n–1, since they will get no reciprocal benefit from doing so in round n. Since the parties defect in round n–1, it likewise sets off the same reaction in n–2, n–3, and so on, back to the beginning.

An insolvent trade is a classic endgame situation, since the corporation is likely to be incapable of borrowing in the future, or repaying anything it borrows now. The particular problem arises from the fact that the transaction is known to the borrowing corporation to be an endgame, and therefore an occasion for opportunism, but not to the creditor, who may expect cooperation.

The crucial issue is how often credit providers will enter insolvent trades having incorrectly believed the corporate borrower to be solvent — which in turn depends on the capacity of the borrower to conceal that information, and to avoid that information being unravelled. This in turn depends on the structure of the parties' interactions. Contrary to the claims of the economic critics, we can in fact say very little in general terms. As is commonly the case with game theoretic problems, virtually everything depends on the sequence of moves, the information available to, and the beliefs of, the parties, the ability to verify information, the cost of verification, and so on. Nonetheless, we can gain some insight by exploring a strategic representation of the situation.[30]

"Nature" has the first move by imposing (on a random basis) conditions on some firms that reduce them to insolvency. Thus, a credit provider may be confronted by a solvent corporation, or an insolvent corporation. Solvency is private information. The corporation may choose to send a signal to the credit provider, as to its solvency. Sending a signal is costly ($1), and the cost of the signal is sunk (i.e. irrecoverable, whether or not the credit provider lends). The signal is verifiable — the credit provider, and any other third party, could use the signal to determine the corporation's solvency. The lender must then decide whether or not to lend, which will yield the lender a positive payoff only if the corporation is solvent. That positive payoff is somewhat higher where the corporation signals, which might be because the credit provider can select a more suitable contract; the payoff is

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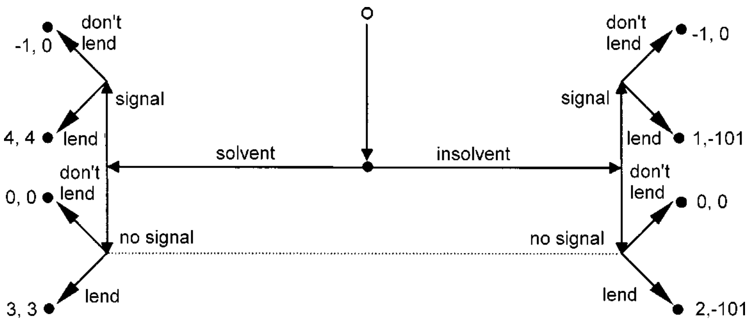
28. See generally R Axelrod, *The Evolution of Cooperation* (1984); Dixit and Nalebuff, supra n 24 at ch 4.

29. Axelrod, supra n 28 at 126–32.

30. The following game has some analogies to the Cho-Kreps beer-quiche game: I Cho and D Kreps, "Signalling Games and Stable Equilibria" (1987) 102 *Quarterly Journal of Economics* 179. In that game, the information is unverifiable. While solvency may strictly be verifiable, the costs to do so and the time required may be so costly that it does not occur.

also higher for the borrower, for instance, because the borrower can borrow at a lower rate of interest. I have included a positive payoff for the insolvent corporation if it obtains the loan, reflecting the advantages to it if it is able to secure funds (for example, the advantages from delaying bankruptcy) The game appears in Figure 2.

Figure 2: A One-Shot Model of Insolvent Trades



Unravelling should occur in this case. Insolvent corporations will never signal in equilibrium, because they would sink the cost of the signal for nothing — no credit provider will lend to a corporation that it verifies as insolvent. What of solvent corporations? The risk for a solvent corporation which signals is that of sinking the cost of the signal without getting finance. However, in this game, it is not a best response for the lender to not lend to a solvent corporation which sends a signal, since the lender can earn a payoff of four, compared to 0. Compare this outcome to that which prevails where a solvent corporation does not signal. The willingness of the credit provider to lend to a corporation that does not signal depends on the beliefs of the credit provider as to how likely he or she is to be dealing with a solvent corporation.[31] For instance, if the credit provider believed that, of the corporations that did not signal, only one percent were insolvent, it may be rational to lend.[32] But this outcome cannot hold. This is because the belief cannot form part of the equilibrium for this game. No solvent corporation will not signal, since the outcome from doing so should be four, since lenders should always lend to corporations known to be solvent, which is better than three. Thus, the equilibrium for this game is a *separating equilibrium* — all solvent corporations signal, and all insolvent corporations do not signal (and do not get credit). Insolvent trades never occur in equilibrium.

If real life resembled this one-shot model, the claims of the economic critics would be persuasive. But reality may differ from this model. An equilibrium is likely in which solvent corporations do not signal; that strategy is easy (cheap) for insolvent corporations to emulate. Such an equilibrium is referred to as a *pooling equilibrium*. Consider some of the situations where solvent corporations may not disclose. First, the cost of sending and

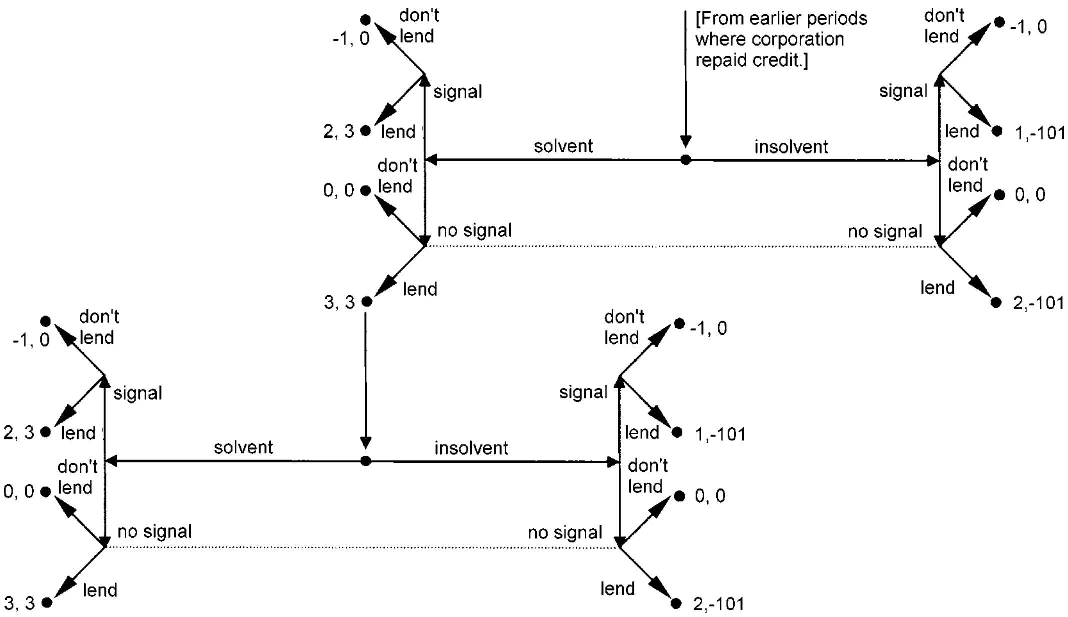
31. The dotted line between nodes indicates that the credit provider does now know which node he is at, given the absence of the signal.

32. The payoff from lending is (0.99 × 3) + (0.01 × –101), which is positive (1.96).

verifying the signal may be high, compared to the gains from trade. As just one example, corporations with different forms of business may have different costs of sending the signal. Corporations with transaction-specific assets generating significant quasi-rent streams arising out of their transaction specificity may have high costs in sending the signalling.[33] Unless solvency can be verified in a cost-effective way, insolvent corporations may be able to pool with solvent, high-cost corporations. Second, if credit providers have market power, corporations may be unwilling to signal if that signal would reveal the private gains from the transaction.[34] A credit provider with market power may engross those gains from trade by changing the terms of the transaction. Here, too, pooling is possible, if low-gains corporations do not signal.

Third, and perhaps most importantly, disclosure may not occur because transacting is not one-shot but iterative. As I noted above, iteration over time has a vital role in many market transactions.[35] In many forms of credit, a primary source of information about

Figure 3: A Multi-Period Model of Insolvent Trades



33. O Williamson, "Corporate Governance and Corporate Finance" (1988) 43 *Journal of Finance* 567.
34. I Ayres and R Gertner, "Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules" (1992) 101 *Yale Law Journal* 729; J Johnston, "Strategic Bargaining and the Economic Theory of Contract Default Rules" (1990) 100 *Yale Law Journal* 615.
35. See text accompanying nn 26–9 supra.

solvency comes from historical information about the demonstrated ability of corporations to repay. An equilibrium is likely to develop over time in which signals are not sent, given that their costs exceed their new information content. However, an event causing a substantial change in the solvency of the corporation may not be observable from past transactions. Figure 3 is a multi-period version of Figure 2, depicting the penultimate and ultimate rounds of the game, between which time the corporation goes from solvent to insolvent. The payoffs differ from Figure 2 because the signal has no information content when the corporation is solvent, given the information available from previous rounds of the game. Thus, the equilibrium does not involve signalling. An insolvent corporation is therefore able to emulate its own behaviour in earlier periods in which it was solvent and so gain credit.

Thus, insolvent trading may be most problematic where repeated transacting is involved, as it often is in trade credit situations. Because of the possibility of insolvent trades in equilibrium, the cost of providing credit is higher. Sometimes, that cost will be reflected in the terms of trade, although the extent to which this occurs depends on the elasticity of demand and other conditions in the market for credit. Sometimes, the risk will be decreased by other means, such as personal guarantees or security.

Can the law decrease the expected costs of insolvent trading? There are two overlapping means by which it could do this — by affecting the terms of exchange between corporations and their credit providers in order to emulate the sorts of protection that the latter might take to minimise losses from insolvent trades; or by changing the structure of the game or the payoffs of particular strategies. The law can use protective means only very sparingly. Contractual protections are typically of limited use, since they depend on the corporation's solvency. Other means, more proprietary in character, such as personal guarantees by a director or security interests, seem inappropriate as the background rules for credit transactions.

A personal guarantee, for example, would force the directors to bear much of the risk of the corporation's cash flows. Directors are poor risk bearers.[36] They are inherently "over-invested" in the corporation, as they must inevitably make sunk cost investments of substantial human capital.[37] Their risk aversion is also exacerbated by the risk of losing deferred compensation used for incentive purposes, in the event of insolvency. Using default security arrangements (e.g., by entitling creditors to assert a floating charge) is unlikely to change the situation, since it simply changes the distribution of the corporation's estate in the event of insolvency by elevating the typical parties to insolvent trades

36. K Arrow, "The Economics of Agency" in J Pratt and R Zeckhauser, eds, *Principals and Agents: The Structure of Business* (reprint edition, 1991) at 37, 44–5; R Kraakman, "Corporate Liability Strategies and the Costs of Legal Controls" (1984) 93 *Yale Law Journal* 857 at 858–67; J Coffee, "Shareholders Versus Managers: The Strain in the Corporate Web" (1986) 85 *Michigan Law Review* 1. Since insolvent trading imposes some of this risk on the director it seems equally subject to this criticism, a point I Ramsay makes: I Ramsay, "Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective" (1994) 17 *University of New South Wales Law Journal* 520 at 540. However, the insolvent trading provisions do not function primarily as a risk allocation, but change the structure of the game to induce separation in equilibrium.

37. D Haddock, J Macey and F McChesney, "Property Rights In Assets and Resistance to Tender Offers" (1987) 73 *Virginia Law Review* 701.

above tort creditors. Thus, security and guarantee arrangements are unsuitable to some credit transactions, which would force the parties to incur the unnecessary transaction costs of contracting out of default rules implying them.

The alternative possibility is to change the structure of the game in a way which minimises the likelihood of insolvent corporations being able to pool with solvent corporations. This is broadly similar to Ian Ayres and Rob Gertner's proposal that one use "penalty defaults" as background rules in contract law.[38] Penalty defaults are legal rules applying to matters in respect of which the parties have not expressly contracted; their content is such that one or both of the parties may dislike that rule. The rule is set in that way to induce the party disfavouring the rule to contract around it. There may be two objects for doing so. First, contracting around the rule may communicate information to third persons, such as judges; second, where preferences for the term vary between types of contracting parties, but type is private information, the reaction to the penalty default may induce separation in equilibrium and the communication of private information by the informed party. The concept is described as "information-forcing".[39]

It may be possible to use an information-forcing game structure to decrease pooling by insolvent corporations. I considered the possibility above of using a personal guarantee by a director of the borrowing corporation. This is penal in one sense — it will frequently be a disfavoured term. However, if it is not favoured by directors of solvent corporations as well as the directors of insolvent corporations, it will not induce the efficient separating equilibrium.

A more general problem with the penalty default concept is that it can only work if transaction costs are relatively low. If parties do not contract around inefficient rules, the use of a default that cannot be justified on the basis of party preference may induce welfare losses. Thus, an optimal legal rule is likely to be partially "tailored", applying to some cases but not to all. It should impose a disfavoured rule applying when the corporation is insolvent, but it should not impose that rule in any other case. Hence, we find the essential structure of insolvent trading, which applies a personal liability to directors, when their corporation contracts a debt when it is insolvent, or becomes insolvent by the assumption of the debt. The rule should be able to induce separation in equilibrium, since the directors of insolvent corporations should be incapable of imitating the actions of directors of solvent corporations in seeking credit, because of the high personal cost to them. A better description than that of "penalty default" for the rules used to change the structure is that of equilibrium-inducing defaults.[40]

It is useful to turn, in the next part, to the arguments of the economic critics. As I have said, their arguments are by no means wholly incorrect, and they raise important issues. The important issues are addressed in the final substantive part of this chapter.

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38. I Ayres and R Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 *Yale Law Journal* 87.

39. R E Scott, "A Relational Theory of Default Rules for Commercial Contracts" (1990) 19 *Journal of Legal Studies* 597 at 609.

40. Ayres and Gertner, supra n 34; A Schwartz, "The Default Rule Paradigm and the Limits of Contract Law" (1993) 3 *Southern California Interdisciplinary Law Journal* 390 at 390–2.

The Economic Critics

A summary of the criticisms

There are four articles critical of the insolvent trading provisions. First, Ian Ramsay commented on the effect of the provisions in an article mostly devoted to holding company liability for insolvent trading by subsidiaries.[41] Two articles by by Mark Byrne and Justin Mannolini are directed to the insolvent trading provisions generally.[42] The fourth is a working paper by Colin Anderson and David Morrison, which expresses disagreement with my original analysis of the insolvent trading provisions.[43]

Byrne states that the appropriate duties imposed on directors must be considered as part of a wider question about the allocation of risk between the parties.[44] He starts from a premise that in perfect markets, in which all participants have complete information, creditors will be compensated for the risk that they assume. In an imperfect market, however, creditors may not obtain complete information in order to accurately price the risk. Following Easterbrook and Fischel,[45] Byrne argues, however, that creditors need not be undercompensated for risk in imperfect markets. Creditors can price protect themselves, by charging a higher interest rate or by taking security, so shifting the incentive to corporate borrowers to eliminate information asymmetries; and borrowers can bond themselves in a way that reduces agency costs.[46] Therefore, the most important inquiry is whether the creditor was compensated (through the "price" charged for credit) for the ex ante risk of insolvency of the borrower.[47] If a creditor makes an informed decision about the risk of a company on the brink of solvency, there is no case for a further remedy.[48] As we shall see below, focusing on overcompensation opens up problematic inquiries.

Justin Mannolini also advances an argument addressing this issue of compensation. He argues that the insolvent trading provisions are unnecessary as creditors are compensated for the risk they assume, "provided there is no active misrepresentation".[49] Insolvent trading therefore overcompensates creditors.[50] Mannolini seems to assert, astonishingly,

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41. Ramsay, supra n 36.
42. M Byrne, "An Economic Analysis of Directors' Duties in Favour of Creditors" (1994) 4 *Australian Journal of Corporate Law* 275; J Mannolini, "Creditors' Interests in the Corporate Contract: A Case for the Reform of our Insolvent Trading Provisions (1996) 6 *Australian Journal of Corporate Law* 14.
43. C Anderson and D Morrison, "The Economic Implications of the *Corporations Law* Insolvent Trading Provisions", paper presented at Corporate Law Economic Reform Program Conference at Australian National University, November 1997; M Whincop, "Taking the Corporate Contract More Seriously: The Economic Cases Against, and a Transaction Cost Rationale for, the Insolvent Trading Provisions" (1996) 5 *Griffith Law Review* 1.
44. Byrne, supra n 42 at 278.
45. F Easterbrook and Dl Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 89.
46. Byrne, supra n 42 at 277.
47. Ibid at 280.
48. Ibid at 281.
49. Ibid at 25.
50. Ibid at 30–1.

that creditors are price protected against the risk of insolvent trades as if it were axiomatically true, whereas Byrne says merely that courts must *look* for overcompensation.

Mannolini draws analogies between creditors' contracts and the contracts between shareholders and managers. Much law and economics analysis refers not only to explicit contracts, which are recognised as enforceable by law, but also to implicit contracts.[51] An implicit contract is a pledge to act in a certain way. The pledge cannot be enforced by legal intervention, but the parties may structure their property rights in such a way that performance is in the interest of the obliged party. Cooperation in an iterated prisoner's dilemma may be the subject of an implicit contract. Mannolini asserts that corporations seeking finance implicitly contract with their creditors not to act opportunistically; those who do act opportunistically will be punished in later returns to credit markets.[52] Mannolini asserts that implicit contracts may protect creditors, and that such protection may be preferred to that offered by mandatory law. Implicit contracts are undoubtedly important to an understanding of debtor behaviour, but the claim is out of order in insolvent trading contexts. As I have observed, insolvent trades are final period problems, where opportunism is most likely and implicit contracts least effective.[53]

Mannolini curiously suggests that managers may be motivated by their implicit contracts with *shareholders* not to act opportunistically with respect to creditors.[54] The argument appears to be that opportunism will increase the risk of their displacement by takeover, and decrease the value of their human capital in managerial labour markets. Again, the argument fails to recognise the final period problem. The shadow of the future cast by these other markets is likely to be a singularly short one to the manager of an insolvent corporation. While shareholders and creditors both have a common interest, to some extent, in minimising the cost of capital to the firm, explicit contracts are typically negotiated and legal rules implied to minimise the major risk that the common interest will be dominated by opportunistic plays in a prisoner's dilemma.[55]

Mannolini then identifies problems with the form of the provisions. The first criticism is that the insolvent trading provisions effectively prohibit the possibility of "trading out" of insolvency.[56] This, he argues, causes profitable projects to be foregone.[57] Second, Mannolini argues that even if the insolvent trading provisions had advantages, such as screening good and bad quality debtors, this would not justify the mandatory quality of the rules. It should be possible to opt out.[58] The mandatory/enabling balance in the insolvent trading provisions is indeed a crucial issue. However, Mannolini's analysis is rendered

51. These are contracts the law does not recognise. For a critique of the concept of the implicit contract, see Eisenberg, supra n 15 at 1487–8.
52. Mannolini, supra n 42 at 24–5.
53. See Corey et al, supra n 23 at 978 and C Frost, "Organizational Form, Misappropriation Risk and the Substantive Consolidation of Corporate Groups" (1993) 44 *Hastings Law Journal* 449 at 483.
54. Mannolini, supra n 42 at 24–5.
55. J Coffee, "Corporate Governance as a Multi-Player Game" (1990) 78 *Georgia Law Journal* 1295.
56. Mannolini, supra n 42 at 29.
57. Byrne supra n 42 at 283.
58. Mannolini, supra n 42 at 31.

nugatory due to legal errors, and because he ignores important issues that the complex provisions raise, as I shall show below.

Third, Mannolini argues that the conduct that contravenes the insolvent trading provisions goes beyond fraud and deliberate wrongdoing, and includes some cases[59] of simple errors of judgment.[60] If there have been cases in which the laws were misapplied, the fault would seem to lie with the judge. Under the present provisions, a judge who considered a director had made an honest commercial misjudgment could hold that the director had reasonable grounds to expect the company was solvent, and would remain so after incurring the debt.[61] If these provisions cannot be effectively used by judges sitting in ex post review, one must wonder why Mannolini ends up advocating the courts and the common law as superior controls on director opportunism.[62]

Fourth, Mannolini accepts that some creditors may not assess commercial risks properly, but that in order to favour "entrepreneurial risk taking" the director and not the creditor must be preferred.[63] Mannolini offers this more as a scholarly "just-so" statement than as a serious theoretical proposition. I doubt that permitting the directors of insolvent companies to incur further debts encourages entrepreneurship. On the contrary, it promotes adverse selection. It will also encourage a species of moral hazard, as directors of insolvent companies are particularly vulnerable to the temptation of asset substitution. When insolvency is imminent, investments offering returns with high variance may be preferred to investments offering positive net present value.

Colin Anderson and David Morrison take a position quite similar to those of Byrne and Mannolini.[64] First, they repeat the criticism that credit providers who advance credit by contract can protect themselves contractually. Second, they argue that limited liability is efficient and that its efficiencies will be eroded by the insolvent trading provisions, which, they say, serve only distributive purposes. Third, they argue that the insolvent trading provisions shift risk to the director who is not an efficient bearer of that risk. I have already demonstrated why the first argument may often be unpersuasive. The second seems somewhat out of place since the efficiencies of limited liability are directed to the contractual nature of shareholders' claims across the life of the firm, not to the obligations of directors under conditions of insolvency. This is exemplified by the fact that most of the supporting literature Anderson and Morrison cite is directed to the moral hazard problems of limited liability, not to the adverse selection problem focused on here. The third argument is more substantial, and I address it below.

59. Only one is cited. This is *John Graham Reprographics Pty Ltd* v *Steffens* (1987) 5 ACLC 904. However, Connolly J regarded the defendant's conduct as going an unacceptable distance beyond a bona fide error of commercial judgment: at 910.
60. Mannolini, supra n 42 at 32.
61. Corporations Law, s 588H(2). The general defence in s 1317S may also be available: *Byrne* v *Southern Star Group Pty Ltd* (1995) 13 ACLC 301; cf *Commonwealth Bank of Australia* v *Friedrich* (1991) 9 ACLC 946.
62. Mannolini, supra n 42.
63. Ibid at 32.
64. Anderson and Morrison, supra n 43.

In reviewing the arguments in my earlier article, Anderson and Morrison argue, first, that the insolvent trading provisions may not have information-forcing properties because the fact of insolvency may be unclear. This may be so, and, in particular, it may increase the need for contractibility of, and defences to the provisions. But, since the director's information is bound to be better than the credit provider's, it does not affect the justification for the provisions offered in this chapter, although it may affect their optimal form. Second, Anderson and Morrison argue that the obligations created by the insolvent trading provisions are of little value, because creditors want to know about the firm's prospects over the longer term, or are redundant, because personal guarantees suffice for any purpose the insolvent trading provisions might serve.

These comments about the focus of the information seem misplaced. Recall my earlier argument that the information-forcing effect of the insolvent trading provisions is likely to be greatest in iterated credit transactions, especially trade credit. The short-term structure of trade credit means that the primary concern is with present solvency, not future prospects. Moreover, my argument is really one about how the structure of the game can be changed to induce separation in an equilibrium that will be characterised by adverse selection, not about the quality of creditor decision-making per se. I have also indicated above why an opt-in requirement for a personal guarantee is insufficient. An opt-in term can induce separation if solvent creditors self-select contracts with personal guarantees, but there may be many reasons why they do not do this (e.g. the length of time for which they must assume the risk, and the variability of cash flows).

The other problem with the use of an opt-in term is that it generates some transaction costs.[65] Costs associated with the execution of a personal guarantee are unlikely to be zero, and may therefore never be used, especially in transactions such as trade credit where gains from trade may be especially low. On the other hand an opt-out term only generates transaction costs where a corporation is close to insolvency and seeks to contract around the default — which is precisely the case where the adverse selection problem arises. The transaction costs of an opt-in requirement are likely to be higher, which suggests the redundancy argument is false.

Anderson and Morrison's principal normative claim is that any problems raised by insolvent trading would better be addressed to prohibitions in the current law of misleading and deceptive conduct — a comment that comes close to Mannolini's claim that common law controls on fraud are sufficient. I address this under the next heading.

An evaluation

One argument that runs through the arguments of the economic critics is that creditors can protect themselves completely, so that any rights under the insolvent trading provisions

65. For example, the costs of drafting the guarantee, the corporation's cost of reading the terms, the cost of complying with formal, procedural requirements, and so on.

must (or, per Byrne, may) "overcompensate" the creditor.[66] The argument is clearly wrong. The insolvent trading rules are known, and their impact on the allocation of risk between the parties can be ascertained and priced. If parties can price-protect in the absence of the rules, they are capable of price-protecting when they are present. In other words, parties will take the lower likelihood of insolvent trading into account when negotiating prices.

Even Byrne's more guarded argument that courts should inquire whether lenders are overcompensated by the insolvent trading provisions is in error. If overcompensation is possible (but not certain in all cases), undercompensation seems likely in other cases.[67] If overcompensation and undercompensation are *both* possible in credit contracts, is there any reason to expect that *systematic* overcompensation prevails? A reasonable null hypothesis seems to be that in a world with insolvent trading provisions, lenders are overcompensated as frequently as they are undercompensated. Why then would we care? Overcompensation seems really to be an argument about the distribution of wealth between creditors and company directors. It is difficult to see how overcompensation would result in allocative inefficiency, unless it induces too much lending, or unless the claim is that recovery from the delinquent creditor results in deadweight losses.

The second objection to the overcompensation issue is indeterminacy. For a court to assess, in a particular case, whether a creditor has been overcompensated requires the following: (i) a model for pricing debt; (ii) information about how interest rates are set in equilibrium; (iii) the information about the borrower available at the time of the loan; and (iv) knowledge of how lenders trade off contractual protections in the debt contract and price protection. It may be very difficult to even obtain this information; the costs of an attempt to apply it would be prohibitive, and it is difficult to have confidence in the result.[68] Such estimation is conceivable for traded debentures, but virtually impossible for the majority of debts to which the insolvent trading provisions apply.[69]

Mannolini argues that the insolvent trading provisions are mandatory. As I have said, this is an important issue. However, his analysis is undermined because he applies the wrong law. Mannolini quotes the provision which was repealed by the Corporate Law Reform Act 1994.[70] The provision was replaced by s 241(1) and (2) which read:

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66. This view also seems to be held by J Farrar, "The Obligations of a Company's Director to its Creditors" unpublished paper, New Zealand, 1987 at 32, quoted in J Dabner, "Trading Whilst Insolvent — A Case for Individual Creditor Rights Against Directors" (1994) 17 *University of New South Wales Law Journal* 546 at 574.

67. Insolvent trading is not a perfect solution, given that some directors will be insolvent, and others may flee the jurisdiction. The transaction costs of suing insolvent trading directors is significant. Thus, ex post undercompensation is inevitable.

68. As Brudney states, "[w]hatever may be the pricing miracles that the market can perform, registering the appropriate equilibrium between gains and losses from loopholes in protective covenants is not one of them.": V Brudney, "Corporate Bondholders and Debtor Opportunism: In Bad Times and Good" (1992) 105 *Harvard Law Review* 1821 at 1875.

69. Ibid at 1825–6.

70. Mannolini, supra n 42 at 30 (footnote 74). That provision was effective until 14 April 1994, about two years before the publication of the article.

(1) A company or a related body corporate must not:

(a) indemnify a person who is or has been an officer or an auditor of the company against a liability incurred by the person as such an officer or auditor; or

(b) exempt such a person from such a liability.

(2) Subsection (1) does not prevent a person from being indemnified against a liability to another person (other than the company or a related body corporate) unless the liability arises out of conduct involving a lack of good faith.[71]

Section 241 was repealed by the Corporate Law Economic Reform Program Act 1999 and replaced by ss 199A–C. Section 199A now reads:

199A

(1) Exemptions not allowed

A company or a related body corporate must not exempt a person (whether directly or through an interposed entity) from a liability to the company incurred as an officer or auditor of the company.

(2) When indemnity for liability (other than for legal costs) not allowed

A company or related body corporate must not indemnify a person (whether by agreement or by making a payment and whether directly or through an interposed entity) against any of the following liabilities incurred as an officer or auditor of the company:

(a) a liability owed to the company or a related body corporate;

(b) a liability for a pecuniary penalty order under s 1317G or a compensation order under s 1317H;

(c) a liability that is owed to someone other than the company or a related body corporate and did not arise out of conduct in good faith.

This subsection does not apply to a liability for legal costs.

Neither section expressly prevents any creditor from contracting out, provided the insolvent trading liability does not involve a lack of good faith. However, aside from the need to investigate the normative desirability of making the insolvent trading provisions explicit defaults, given the theory of those provisions advanced above, there is a deeper issue that Mannolini does not touch on, and that is, the person with whom one would have to contract if the insolvent trading provisions were to be excluded. I address this in the next part.

Both Mannolini, and Anderson and Morrison, advocate the use either of the common law of fraud or prohibitions of deceptive and misleading conduct as superior controls. This argument taps into a familiar one concerning the superiority of rules, in which the content of a legal norm is specified ex ante, or in which content is ascertained by ex post

71. Because the Corporations Law contains an express provision concerning opting out and release, it is unnecessary to deal with the general law concerning waiver of rights under a statutory provision: see generally *Wilson* v *McIntosh* [1894] AC 129; *Toronto Corporation* v *Russell* [1908] AC 493; *Davies* v *Davies* (1919) 26 CLR 348; *Brown* v *R* (1986) 160 CLR 171. Under the general law, statutory rights may be waived if the provision was introduced for their benefit, rather than for the benefit of the public.

adjudication.[72] Standards are mostly advocated as efficient in cases where the underlying phenomena to be regulated is highly heterogeneous; thus, negligence is used for personal injury situations. It is curious that economic argument should favour the use of unclear standards as to the basic terms of credit contracts, which are formed a multitude of times a day, instead of relatively explicit rules. The risk that the current provisions might apply overinclusively (i.e., too many "honest" directors are held liable for insolvent trading) counsels in favour of making the insolvent trading provisions default rules, or for using a standard as a basis for exculpation from prima facie liability — it does not argue against rules as the principal basis for liability.

The use of a standard is undesirable for several reasons. First, since insolvent trading is primarily a problem of non-disclosure it would return us to a painful debate, familiar from contract law, about when silence can be actionable. This question has received a multitude of answers in the context of s 52 of the Trade Practices Act and common law misrepresentation. These answers have changed over time. The legislation's meaning may not be constant, which increases uncertainty.[73] Second, by extension, rules permit the use of explicit safe harbours, such as the "accounting" defence in s 588H(3) which substantially immunises directors who make regular use of the output of adequate accounting information systems. Precedents may eventually form de facto defences, but it is unlikely that they will be better than intelligently drafted legislative defences.[74]

Third, misleading and deceptive conduct prohibitions have always had strong mandatory overtones, so the adoption of this standard would make contracting around prohibitions impossible. An argument of this sort is an argument for mandatory rules, which is very surprising from law and economics scholars. Fourth, even if opting out is possible, separation may be reduced if directors of solvent corporations attempt to contract out of liability on the ground of the unclear application of a standard-based form of liability. Fifth, a misleading and deceptive conduct prohibition may easily turn out to be wider than the insolvent trading provisions. It might be misleading not to disclose financial difficulties falling short of insolvency. The provision might in this case permit the recovery of the entirety of the loan, rather than just the debts incurred in insolvency on the ground that the failure to disclose those financial problems denied the credit provider the opportunity to claw back the amounts outstanding at the time of that failure. Given the plasticity of the provision, it strikes me as disingenuous to imagine that s 52 would be narrower than s 588G. Arguably, Mannolini's attempt to limit curial intervention to cases of fraud avoids several of these criticisms, but it does not avoid the deeper criticism that it ignores the combined adverse selection and final period problems.

72. The use of rules and standards in corporate law is discussed in M Whincop, "Rules, Standards and Intransitive Statutes: What the Economic Reform of Corporate Law Might Have Looked Like" (1999) 17 *Company and Securities Law Journal* 11, including references to literature.

73. See generally A Duggan, M Bryan and F Hanks, *Contractual Non-Disclosure* (1994).

74. Ibid at 19–21.

Restructuring the Insolvent Trading Provisions

So far I have argued that insolvent trading is an economic problem, and that the insolvent trading provisions may provide a means to address it. However, I have spent little time describing whether the extant provisions are in fact suitable in this regard. The other overlapping issue relates to the contractibility of the insolvent trading provisions. I have referred to opting out of the insolvent trading provisions without ever indicating whether this is appropriate or not. I address these issues below.

Are the insolvent trading provisions efficient?

The insolvent trading provisions can only achieve the purposes I have described if the following conditions hold:

(a) Those to whom the insolvent trading provisions apply have private information about insolvency, or those persons have the lowest costs of acquiring that information.
(b) Solvency at the time of the impugned transaction must be verifiable.
(c) The strategy space for an insolvent corporation must include an action of incurring a debt which generates insolvent trading liability, and at least one other alternative action in which insolvent trading liability is not incurred.

The insolvent trading provisions come quite close to meeting these requirements. They are limited to directors, who typically have the formal authority to requisition information about solvency, and to decide to take the "other action" described in (c).[75] The predecessor provision were less desirable in this regard as they extended to persons who simply took part in the management of a company.[76] For clear enough practical reasons, the sections predicate not only on actual knowledge of insolvency, but where there are reasonable grounds for expecting insolvency of which a person in the director's position would be aware.[77] This constructive obligation to be informed conforms to trends in modern corporate law requiring a considerably stronger duty to be informed than the law has normally recognised.

Elsewhere, I have argued that the contemporary duty to be informed may be misspecified, given the difficulty a director faces in assessing the marginal benefit of acquiring an incremental piece of information under conditions of uncertainty, and the possibility of systematic biases in ex post review by judges.[78] That analysis endorsed the application of a gross negligence standard to substantive and information acquisition decisions: were the directors cognisant of circumstances of such a plain and simply appreciated character that no reasonable person would enter into the transaction?[79]

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75. "Director" is defined expansively in s 9 of the Corporations Law, and will catch "shadow" directors. See also *Standard Chartered Bank of Australia Ltd* v *Antico* (1995) 18 ACSR 1.

76. For example, s 592(1). Insolvent trading liability is, however, extended to a holding company under similar circumstances: s 588V. See generally Ramsay, supra n 36.

77. Sections 588G(2); 588H(2).

78. Whincop, supra n 1, *Care* at 85–7.

79. *Overend and Gurney Company* v *Gibb* (1872) LR 4 HL 480 at 487.

Nonetheless, I apprehend comparatively little to be of concern in the insolvent trading provisions. First, directors who do nothing whatsoever would normally be grossly negligent. Second, the legislation offers the accounting defence in s 588H(3) which permits the director to avoid liability where a competent person is responsible for providing information about solvency, that responsibility was being discharged, and that information indicated that the company was and would remain solvent. This absolves the court from the need to evaluate the marginal benefit of the information acquisition, so avoiding the difficult judgments that the general duty to be informed requires. A court need only be satisfied that an adequate process exists to inform directors, and that the director takes heed of the information produced. In addition, the marginal cost of imposing this duty will often be minimal, because most corporations will invest in information systems for management and external reporting reasons.[80]

The insolvent trading provisions have been drafted and interpreted in such a way that debts are incurred at the time when the binding contractual commitment is made under which obligations to pay will arise — not when each specific obligation arises. For example, the accrual of obligations according to the terms of a lease contract is not regarded as the incurring of a debt.[81] Provided the company is solvent at the time of the lease, no liability arises. The word "debt" narrows the section to obligations to pay ascertained sums. Unliquidated damages obligations or equitable compensation liabilities are outside the provision.[82] This is important because it enables one to make the generalisation that ascertained sums are incurred in a voluntary (contractual) manner, such as borrowing money, or buying goods on credit. Therefore, the act which invokes the section is, to a significant degree, a voluntary one, and, therefore avoidable.[83] This helps to fulfil the criterion in (c), while at the same time limiting the significance of the economic critics' claim that the insolvent trading provisions allocate substantial risk to the director.

Solvency as verifiable information: cognitive biases and the "accounting defence"

Two crucial issues remain — is solvency verifiable, and is there a suitable alternative to the insolvent trade? Solvency, in the sense in which it is defined in the Corporations Law as the inability to pay debts as and when they fall due, would seem to be verifiable. Moreover, insolvent trading litigation only occurs in relation to insolvent corporations. However, this is not precisely the point — the question is one of *timing*. This is a harder exercise because

80. Cf Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) § 307 (the defence encourages the establishment of such monitoring). Note also that the insolvency presumption in s 588E(4) encourages the installing of an accounting system.

81. *Russell Halpern Nominees Pty Ltd* v *Martin* (1986) 5 ACLC 393. See also *John Graham Reprographics Pty Ltd* v *Steffens* (1987) 5 ACLC 904 (liability for interest on a debt). Cf *Leigh-Mardon Pty Ltd* v *Wawn* (1995) 17 ACSR 741.

82. See, for example, *Jelin Pty Ltd* v *Johnson* (1987) 5 ACLC 463 at 464–5; *Geraldton Building Co Pty Ltd* v *Woodmore* (1992) 8 ACSR 585 at 590.

83. *Russell Halpern Nominees Pty Ltd* v *Martin* (1986) 5 ACLC 393 at 396 (Burt CJ), 398 (Olney J). See also L Proksch and R McKenzie, "Guarantees and Section 592, Corporations Law: The Dynamics of Debt" (1993) 21 *Australian Business Law Review* 212 at 214.

many corporations may "slide" only gradually into insolvency as they gradually use up their working capital. There is a double peril here — first, that directors, especially entrepreneur-directors, may have a cognitive bias which disinclines them to recognise insolvency; second, that judges may have a cognitive bias which inclines them to hold that insolvency had transpired earlier than in fact it did.

Although ultimately these questions are empirical — as all cognitive biases are — we might consider documented biases as indicating some likelihood that these hypotheses might hold. The judges' bias resembles a *salience* bias.[84] Salience biases refer to the tendency of decision-makers to estimate the likelihood of an event based on their recollection of salient events of that type. The fact that insolvent trading cases only involve insolvent corporations may bias the judge to over-estimate the probability of the corporation being insolvent at any particular time. For example, particular facts (for example, dishonoured cheques) may be common to solvent and insolvent corporations, but the unrepresentative nature of insolvent trading cases may induce the judge to code those signals as strong evidence that the corporation was insolvent.

The entrepreneur's bias may be an example of two documented effects. The first is a status quo bias — people have a strong bias in maintaining the status quo and are biased against changes to it.[85] Recognising insolvency requires a change in the status quo because the law compels the director to initiate insolvency proceedings, by which the directors lose control of the corporation. The second, which is related to the status quo bias, is endowment effects. An endowment effect indicates a substantial disjunction between the amount the owner of an asset would be willing to accept to sell it, compared to the amount that person would be willing to pay for it if he or she does not own it.[86] It is often thought to have some basis in sunk costs, which are formally irrelevant to economic decisions.[87] Entrepreneurial directors may be especially biased against the need to recognise a condition (insolvency) in which they effectively must engage in a forced sale of "their" assets.

These problems diminish the capacity of the legislation to achieve its ends, as they increase the allocation of risks to directors, and diminish the likelihood of separation. As I have said, the legislation introduces a circuit-breaking provision in s 588H(3). That provision provides a defence where, in effect, a competent person is responsible for providing, and does provide, financial information, which gives the director an expectation that the company is solvent at that time and will remain so when it incurs the debt. The advantage of this provision is that it directs attention to more easily verified facts — the existence and use of an adequate information system, and the appearance of solvency from that

84. A Tversky and D Kahneman, "Judgment Under Uncertainty: Heuristics and Biases" in D Kahneman, P Slovic and A Tversky, eds, *Judgment Under Uncertainty* (1982) at 3.

85. See generally R Korobkin, "The Status Quo Bias and Contract Default Rules" (1998) 83 *Cornell Law Review* 608.

86. R Korobkin, "Policymaking and the Offer/Asking Price Gap: Toward a Theory of Efficient Entitlement Allocation" (1994) 46 *Stanford Law Review* 663 at 675–97.

87. C Jolls, C Sunstein and R Thaler, "A Behavioral Approach to Law and Economics" (1998) 50 *Stanford Law Review*. 1471 at 1482–4.

information.[88] It also permits (without requiring[89]) delegation, at least of the process of preparing and providing the information, if not of the actual analysis of it.

Voluntary administration versus contracting around the default

The next question is whether there is an alternative action to incurring the debt within the insolvent firm's strategy space under which the directors of an insolvent corporation will be better off. If there is no alternative, or the director is better off (or no worse off) incurring the debt, the posited advantages of the insolvent trading provisions will be nugatory. Obviously, the scope of liability for breach of those provisions is the primary reason why the director would be worse off incurring the debt. Their capacity to make the insolvent-trading director worse off depends in part on whether the director is judgment-proof. A judgment-proof director cannot be sued for compensation under s 588M. Nonetheless, there are other potential sanctions that might be imposed under the civil penalty provisions which do not depend on judgment-proofing, such as orders prohibiting the director from managing a corporation.[90] Let us assume — not least because the economic critics do — that the net present value of liability to directors under these provisions is negative and substantial.

What are the alternatives to incurring further debts? There would seem to be three. First, the director can do nothing. Presumably, creditors would then bring proceedings to wind up the corporation. Second, the board could appoint an administrator under Pt 5.3A. Third, if the law permits, the directors could attempt to contract out of the insolvent trading provisions by agreement with each creditor.

Which strategy a board will prefer obviously varies from case to case, but one generalisation can be made: one would expect the voluntary administration action to strictly dominate the do-nothing-and-be-liquidated action. The reason is obvious: directors who have made transaction-specific investments in the corporation can only anticipate returns on those investments if the corporation is reorganised, not if it is liquidated, and the former is only possible under administration. There may also be strategic advantages if the board, rather than other creditors, initiates proceedings (for example, the right to appoint the first administrator[91]).

The central policy question seems, then, to involve an exercise in comparative statics; That is, of the equilibria that form on the basis of three different legal rules — the current regime with the preference for administration, insolvent trading provisions which are explicit defaults, or the regime the economic critics envisage in which there are no insolvent trading provisions besides general law constraints. Which maximises social welfare? I cannot offer a definitive conclusion (although I am certain it is not the third). Before I can explore their advantages and disadvantages, I need to examine the conversion of the insolvent trading provisions into explicit defaults. Two specific issues need analysis: first,

88. D Baird, R Gertner and R Picker, *Game Theory and the Law* (1995) at 110–11.

89. The director could investigate these matters personally: s 588H(2).

90. Sections 206C; 1317E.

91. Section 436A.

whether there is a case for permitting creditors to contract out of the insolvent trading provisions; second, having regard to the law, what contract would suffice to contract around the provisions, and what effect would it have?

The normative case for establishing the insolvent trading provisions as default rules is linked to the capacity of courts to verify the timing of the corporation's insolvency. If the court can verify insolvency, the case for using defaults is a harder one. It would need to rest on a premise that both the social benefits, and the private benefits to the lender, from lending money to insolvent corporations can be positive. If there are no private benefits, a mandatory rule prohibiting contracting out would simply mimic the market because no lender would advance finance; if there were no social benefits, the contracting should not occur at all.

A problem case arises if there are positive private benefits, in consequence of the rights conferred on the creditor under the debt contract, but these exceed the social benefits or the social benefits are negative. This is possible where the effect of the contract transfers wealth from the other creditors to the creditor under the insolvent trade. An example might arise in some cases of asset substitution, where the lender advances money to finance a project with higher risk than normal on the terms of a convertible note, so that he shares in the upside by conversion but shares in the remaining estate as a lender if the project fails. The project would transfer wealth from the current creditors to the creditor under the insolvent trade, without satisfying a first-order efficiency criterion. This risk can be partially controlled under the voluntary administration regime — further discretionary investment in an insolvent corporation must be the subject of collective decision-making under a majoritarian regime, which limits the capacity of any one of the creditors externalising costs to others, or to otherwise act opportunistically. Provisions such as those in Division 2 of Part 5.7B dealing with voidable transactions also may preclude negative value projects such as these being pursued.

If, on the other hand, courts have difficulty verifying the timing of insolvency, and systematically err by holding that firms became insolvent before in fact they did so, the case for contract becomes clear. In this situation, Ian Ramsay's claim that the insolvent trading provisions inefficiently allocate risks to the directors is compelling. Contract is needed to reallocate these risks. Given my comments above, I think that the "accounting" defence is likely to reduce this risk substantially. Nonetheless, much depends on whether courts engage in the unproductive practice of trying to second guess the appropriate responses of directors who are informed under s 588H(3). In these cases, there would be a clear justification for attempting to exclude the directors' liability. The fact that directors seek to contract out of that liability continues to have information-forcing value, because it will indicate concerns about insolvency. Provided the contract struck is not value-decreasing in the sense we studied above, the contract's enforcement is appropriate. But what form would that contract take?

Beneficiaries of the insolvent trading provisions: reserving and sharing rules

As I said in evaluating Justin Mannolini's mandatory/default argument, s 199A is not explicitly inimical to contrary contracting. What contract, then, would suffice to contract around the provisions, and what effect would it have? The answer depends on who has the benefit of insolvent trading provisions. Here we confront a problem, because there is a disjunction between the circumstances in which the provisions are invoked, and the persons who get the benefit of compensation paid under the provisions. This disjunction is in a sense new. Prior to the 1993 amendments to the Corporations Law, which introduced the current insolvent trading provisions, the main plaintiff in insolvent trading cases was the creditor whose debt was incurred at a time when the company was insolvent (the "insolvent trading creditor").[92] The essence of the current provisions is that compensation becomes part of the general fund, and is distributable among all unsecured creditors.[93] The distinction is thus between sharing compensation (a "sharing rule") and reserving it for the insolvent trading creditors (a "reserving rule").

The distinction between the two rules maps onto the essence of the distinction between the current regime and the insolvent trading rules as explicit defaults — that between collective and individual responsibility for post-insolvency decisions. If a sharing rule is used, the only way the parties could contract around the insolvent trading provisions without entering administration, is by securing the (probably unanimous) consent of the unsecured creditors. Each of those creditors has some interest in the compensation payable by the director. On the other hand, a reserving rule restricts the interests in the compensation to the party extending the new credit, and only that person would need to agree to waive the default. Contracting out would basically occur with each new creditor — the corporation would informally trade out of solvency.

Even if contracting out of the insolvent trading rules is permitted under a sharing rule, it is highly unlikely to happen. First, because a larger number of creditors must consent, the transaction costs of obtaining the necessary consent are higher. If consent must be unanimous, there is a strong risk of strategic "hold out" behaviour by individual creditors.[94] The other obvious problem is identifying the creditors, as not all who prove their debts in the estate may be apparent, such as tort creditors. Second, the strategic structure of such a contracting would be unworkable. The directors would have to attempt to obtain those releases once insolvency becomes likely. Under most circumstances, creditors may rationally decide not to agree to opting out, especially those with low priority, as they must agree to forego their interest in compensation under the insolvent trading provisions in return for a highly uncertain chance that the firm may return to solvency.

A related difficulty is that the legislation creates a limited entitlement in the creditor to the insolvent trade to recover debts where the liquidator consents to this, or the liquidator fails to bring an action.[95] In this case, one returns to the reserving rule. This combination of

92. Corporations Law s 593(1) (old law enabling creditor under the insolvent trade to sue); cf s 588M (new law entitling liquidator to seek compensation on behalf of all unsecured creditors).

93. These provisions are criticised by J Dabner, "Trading Whilst Insolvent — A Case for Individual Creditor Rights Against Directors" (1994) 17 *University of New South Wales Law Journal* 546 at 566–75.

94. R Epstein, "Holdouts, Externalities and the Single Owner: One More Salute to Ronald Coase" (1993) 36 *Journal of Law and Economics* 553.

95. Corporations Law ss 588M(3), 588R–588U.

rules creates the possibility for antagonism between the liquidator and those insolvent trading creditors who would be prepared to sue. If the liquidator sues, their recovery decreases. The creditor to the insolvent trade therefore has very little incentive to assist or encourage suits by the liquidator, because he or she will be worse off, compared to the situation where the liquidator does not sue.

Insolvent trading creditors who lack incentives to sue personally may, however, prefer to encourage suits to be brought if the costs of the suit are less than the expected recovery. However, since these creditors will typically only have smaller interests, and can expect little cooperation from larger creditors, there may be collective action problems which preclude the suit from being brought. These arguments tend to fortify the superiority of a reserving rule. It would align the incentives of all creditors party to insolvent trades. All are likely to cooperate with, and assist the liquidator in the action, if, as the legislation assumes, there are procedural cost savings where the liquidator brings a single application on behalf of all insolvent trading creditors. The more applications for compensation, the greater is the deterrence of insolvent trading.[96]

Can it be argued that the reserving rule is more distributively fair? Even the distributive fairness ground is doubtful, when viewed logically. The insolvent trading provisions are intended to achieve a result where no insolvent trading occurs, by putting pressure on directors to appoint an administrator or not to trade. Once that happens, putative insolvent trading creditors will not extend credit to the company, and therefore lose no money; however, other unsecured creditors will lose money from asset deficiency. A reserving rule in the insolvent trading provisions creates precisely that result by leaving the uncharged company assets to the unsecured creditors and by the director indemnifying the insolvent trading creditors. Thus, a reserving rule is preferable to a sharing rule even if contracting around the insolvent trading provisions is not permitted; and unarguably superior, if opting out should be permitted.

The process of contracting around default rules

So far, I have identified two possible rationales for contracting out of liability for insolvent trading — a clearer rationale if the timing of insolvency is difficult to verify, and, otherwise, a more troublesome rationale, which depends on the superiority or lower costs of individual decision making compared to collective decision making via the voluntary administration process. I want now to say something about the process by which parties might contract around the insolvent trading provisions. I will make a simplifying assumption that the corporation has only one creditor in order to eliminate the disjunction between sharing and reserving rules. I have already indicated the reasons why I believe reserving rules are superior to sharing rules.

96. This conclusion may have to be slightly modified, as the Corporations Law permits the preferential payout to a creditor who indemnifies a liquidator against costs: see s 564. However, this depends on the ratio of insolvent trading creditors' debts to other unsecured creditors. Cf S Worthington, "Liability for Insolvent Trading: Routes and Rules in Reform" (1992) 10 *Company and Securities Law Journal* 214 at 215.

As Ian Ayres and Rob Gertner have observed, the procedure for contracting around the default rule is very important because it can affect the achievement of the purpose justifying the default rule.[97] Obviously, this is relevant here, too, because I have used an information-forcing justification for the insolvent trading provisions. If properly used, the process of opting out will provide the formal structure for separation in equilibrium between solvent and insolvent corporations. In other words, following the procedure for contracting out will itself signal the credit provider that it is dealing with a corporation that has potentially adverse information about its solvency.

One of the implications is that courts should not normally permit provisions in standard form terms which release the directors from liability on any future occasion when the corporation incurs a debt from the particular credit provider. There is, first, a risk that the term may not be read.[98] Second, if the corporation is solvent at the time of the original contract, the term will not induce separation unless the contract also imposes a disclosure obligation on the directors to provide information regarding the corporation's solvency on an ongoing basis. Instead, the contract formation process could be regulated by requiring, first, where the term is not actually negotiated, the party acting for the corporation to formally disclose the existence of a term excluding insolvent trading liability. Second, the effect of the term is limited to debts incurred at the time the term begins to take effect. That is not to say that a new term would need negotiation every time an obligation to pay arose, because that obligation may be referable to the original contract, as rent payments are under a lease.[99] This simply ties in with the substantive ground of liability under the legislation — incurring a debt.

These requirements make it likely that contracting out of liability will have its signalling effect. In addition, they make opting out a highly specific exercise confined to particular debts (i.e. each insolvent trade). The more specific the "opt-out" transaction, the more likely it is that the credit provider will act on the basis of full information, and cut a deal with the corporation that is value-increasing. The specificity required to opt out of the term is a theme that I, amongst others, have noted as characteristic of other key structural default rules in corporate law which control adverse selection and moral hazard problems.[100]

The formal terms of the contract entered would not normally be investigated by the court, provided the contract does not on an expectations basis make other creditors worse off. This guards against the suboptimalities I mentioned above when contrasting individual and collective decision making by creditors in insolvency. The voidable transaction provisions of the Corporations Law would also be relevant in this respect.

97. Ayres and Gertner, supra n 38.

98. A Katz, "The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation" (1990) 89 *Michigan Law Review* 215 at 272–93.

99. See text accompanying notes 81–3.

100. J Coffee, "The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role" (1989) 89 *Columbia Law Review* 1618 at 1667–72; Whincop, supra n 1, *Contractarianism*; M Whincop, "Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law" (1999) 19 *Oxford Journal of Legal Studies* 19.

One issue that may arise in contracts purporting to opt out of the insolvent trading provisions is misrepresentation by the directors. As with most areas of law, courts should take a moderately robust view of materiality, and not strike the provision down merely because some fact can be identified as undisclosed. A stringent view of misrepresentation would increase the costs of contracting out, which is not desirable. Parties do not expect every fact to be disclosed. The parties may make their own contractual provisions regarding the consequences of non-disclosure, such as an agreement by the directors to pay liquidated damages. A standard of materiality is a good response to these sorts of problems. Defining materiality is difficult, but a lead could be taken from the American securities cases, which attempt to equate the marginal costs and benefits of disclosure. In *TSC Industries Inc* v *Northway*, the US Supreme Court said that an omission would be material "if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote", and held that an omission was immaterial, as the information could have been inferred from other data disclosed.[101]

Summary

In this section, I have argued that the broad form of the liability and the explicit defences to the insolvent trading provisions have the capacity to induce the purposes I have described — minimising the deadweight losses arising from final period problems, and the distorting effects of adverse selection on credit markets in which pooling equilibria otherwise obtain. The principal problems we have observed are, first, the potential that the timing of insolvency may not be verifiable. This affects the allocation of risk between creditors and directors. Nonetheless, some of the severity of this criticism is mitigated by the use of the accounting defence.

Second, in the absence of empirical evidence or robust conclusions from a formal model, we are incapable of concluding that the legislation's policy emphasising formal, collective decision making via voluntary administration is the optimal response. Third, the use of a sharing rule is likely to create a number of problems, both with cooperation in the assistance of liquidators between classes of creditors, and in particular if contracting around the insolvent trading provisions is to be permitted. Fourth, if opting out is permissible, it would be important to introduce procedural provisions to fortify the information-forcing purpose of the legislation, and to provide some limits on the entitlement of the creditor to claim vitiation of the bargain. Finally, if opting out is possible, some limits on the contractual freedom of the insolvent trading creditor and the corporation are important in order to prevent the other creditors from being made worse off.

Conclusion

My analysis differs from those of the economic critics in conclusions but also in method. I have attempted to use the tools of modern game theory and information economics to

101. 426 US 438, 449 (1976). Followed in *Basic Inc* v *Levinson*, 485 US 224, 232 (1987).

clarify the strategic structure of insolvent trading. Although one of the prices of doing so is to diminish the generalisability of my conclusions, it points out several things. First, it recommends more analytical care be taken when moving out of manager–shareholder issues arising in the domain of publicly listed corporations to different issues and different contexts. Coasean irrelevance remains the baseline, but most earlier analyses failed to think clearly about sources of transaction costs. It is little wonder their conclusions take the form they do.

Second, my analysis clearly implies that trade creditors are likely to be the primary victims of insolvent trading, because of the multiperiod structure of their relations with customers, their relatively high information and contracting costs, and the likely prevalence of pooling equilibria. One of the advantages of this analytical focus is that it suggests empirically testable propositions — insolvent trading cases are likely to be particularly common amongst this class of creditors who have multi-period relations with corporations. If this is so, insolvent trading can be seen less as an anti-libertarian fetter on contractual freedom but as a provision which addresses a basic problem — what should be done when the music stops and markets cease to constrain opportunism?[102]

Third, my analysis suggests that much of the earlier debate has mostly been a scholarly exercise in the methodology of economic analysis. It never asked the hard policy question — what sets of regimes and property rights for the administration of insolvent corporations maximises social welfare. Australia has a wealth of doctrinal literature on insolvency and corporate governance, and a thriving economic literature of corporate governance, but serious economic analysis of insolvency remains *terra incognita*. Would we do better with our current system, or a system more like the American one in which corporations are the primary initiators of insolvency proceedings, or a system in which corporations commit themselves in their constitutions to one of a range of insolvency procedures? The latter, contract bankruptcy, has been advocated by various American lawyer-economists.[103] With increased attention being given to structural issues and potential biases in the voluntary administration process as a result of various high profile insolvencies, there is an immense amount of work to be done — once we lay the insolvent trading debate to rest.

102. R Cooter, "The Cost of Coase" (1982) 11 *Journal of Legal Studies* 1.

103. See generally A Schwartz, "A Contract Theory Approach to Business Bankruptcy" (1998) 107 *Yale Law Journal* 1807.

PART III

INSOLVENT TRADING IN AUSTRALIA

Chapter 4

Insolvent Trading in Australia: The Legal Principles

Niall F Coburn*

Introduction

This chapter considers the scope of the Australian prohibition on insolvent trading. To do so, it is firstly necessary to consider the background to the current prohibition in s 588G of the Corporations Law. Part two of this chapter will therefore examine the often rocky road that has led to the current provisions. This will comprise a brief review of predecessor legislation as well as the main law reform proposals in this area. Part three will then review the scope and operation of the prohibition in s 588G. This then leads to part four which is a consideration of the defences available under s 588H to an action for breach of the prohibition. Part five considers the parties which may commence an action for breach and provides an overview of the civil and criminal consequences of such a breach. The final part six draws on the experience of the author's position within the Australian Securities and Investments Commission (ASIC) and describes ASIC's approach to the enforcement of the insolvent trading provisions.

Part One

The Development of the Insolvent Trading Provisions in Australia

The imposition upon officers of corporations of liability for the debts of those corporations is a relatively recent development in Australia. The principle evolved out of the English fraudulent trading provisions contained in s 275 of the Companies Act 1929 (Eng). A similar fraudulent trading provision was first introduced in Queensland in 1931[1] and later by other Australian states.

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1. Companies Act 1931 (Qld) s 284.

From 1961: Section 303(3) of the Uniform Companies Act 1961

The shift to provisions dealing with the specific case of insolvent trading can be traced to the offence introduced by s 303(3) of the Uniform Companies Act 1961. This legislation was based on the British Bankruptcy legislation,[2] which had made it an offence for a person to contract a debt with no reasonable grounds of being able to repay the debt.

Subsection 303(3) was the first provision to deal specifically with insolvent trading as distinct from fraudulent trading. The elements of the offence required a person to *knowingly* be a part of the contraction of the debt and that when the debt was contracted, there was *no reasonable or probable ground or expectation* that the company would be able to pay the debt. However, the provision was not without problems. The court had the power under s 304(1) to impose personal liability on a director where it appeared that any business of the company had been carried on with the intent to defraud creditors.[3] Subsection (3) introduced a new criminal offence, and a person so convicted could be personally responsible without any limitation of liability, for the payment of the whole of any part of the debt. The liability was criminal only. If a conviction was obtained, it was of no benefit to the individual creditor involved in the transaction.

While the insolvent trading provision was taking shape in Australia, the Jenkins Report[4] in England considered the inadequacies of its Companies Act 1948 (Eng) in dealing with the liability of directors in failed companies to creditors.[5] The Report recommended that civil liability should be extended to make directors who had carried on the business of the company in a reckless manner, personally responsible without limitation of liability, for all or any debts or other liabilities of the company.[6]

1964: Lifting the Corporate Veil

In Australia, civil (as opposed to criminal) liability of a director responsible for insolvent trading was first introduced in New South Wales by s 5 of the Companies (Amendment) Act 1964, which inserted a new subsection 1A to the fraudulent trading provision in s 304.[7] The provision was passed against the background of heated debate. It was welcomed by some parliamentarians as "imposing greater responsibilities on directors",[8] but

2. Debtors Act 1869 32 & 33 Vict C 62 and Bankruptcy Act 1914, 4 & 5 Geo 5, C 59 51, subs 1, para (g).
3. New South Wales, *Parliamentary Debates*, Legislative Assembly, 8 April 1964 at 8381.
4. United Kingdom, *Report of the Company Law Committee*, HMSO, London (1962) Cmd 1749 para 497 (Jenkins Report).
5. Ibid.
6. Ibid at para 503.
7. Section 304(1A) of the Companies Act 1961 (NSW) provided: "Where a person has been convicted of an offence under subsection (3) of section three hundred and three as is referred to in that sub-section the Court, on the application of the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt."
8. New South Wales, *Parliamentary Debates*, Legislative Assembly, 2 April 1964 at 8257 (Mr Jago).

to others it was mere "panic legislation".[9] The failing of s 303(3) was the lack of directors liability for irresponsible and reckless decisions affecting creditors. This was overcome by the new s 304(1A) which made a director of a company personally liable, if he or she acted in a manner that resulted in the company incurring a debt without having reasonable grounds for believing the debt would be paid.[10]

During the parliamentary debates, there were some interesting criticisms concerning the provisions which were never addressed. For instance, it was pointed out that the provisions were silent both as to whom the money was to be paid and how it was to be distributed.[11] Questions were raised about individual creditors taking proceedings, when all creditors should have an opportunity to share in the collection of monies from directors. These issues were never addressed and were later the subject of concern and criticism.

The prediction by some parliamentarians that the new provisions were "only a smoke screen against snide company operators" was an accurate prediction.[12] In the main, the policy of the legislation was to address the irresponsible behaviour of some directors. However, the new section was poorly drafted and was not a commercially useful tool for creditors, as it essentially provided that civil liability for directors was only consequent upon conviction for the associated criminal offence under s 303(3) and only upon conviction was the court able to declare the director liable for any part of the debt. Creditors had to rely upon the Director of Public Prosecutions to prosecute the criminal offence and satisfy a criminal standard of proof before there was any prospect of civil recovery. There were very few instances of successful prosecutions and fewer instances of successful civil recoveries.[13]

1971: The Introduction of Broader Civil Liability

In 1971, ss 347C and 374D were introduced into New South Wales companies legislation by the Companies (Amendment) Act 1971. These provisions empowered the courts to give civil remedies to creditors and were followed by similar legislation in other states at later dates. These new amendments made it clear that if a director incurred a debt without reasonable expectation of repayment then he or she would be personally responsible without any limitation of liability. However, like its predecessor, personal liability under this provision was dependent on the appropriate authority proceeding against a director and obtaining a conviction. The parliamentary intention and policy for the operation of s 374C and s 374D was to give the law teeth which did not previously exist, in order to deal with persons who carried on the affairs of a company recklessly.[14]

9. Ibid, 8 April 1964 at 8387 (Hon H J R Clayton).
10. Ibid, 8 April 1964 at 8380 (Hon A D Bridges).
11. Ibid, 9 April 1964 at 8466 (Hon R R Downing).
12. Ibid at 8461 (Hon H D Ahern).
13. The Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45, 1988 (Harmer Report), Vol l at 123.
14. Victoria, *Parliamentary Debates*, Legislative Assembly, 27 September 1966 at 361. The full quotation of the Honourable R J Harmer's speech on ss 374C and 374D is as follows: "Proposed new sections 374C and 374D

The introduction of these provisions and the issues raised in the parliamentary debates indicates that progressively more was expected of directors. It is interesting that there was no consideration of the court's approach to the issues of directors' diligence in relation to insolvent trading. Instead, it was considered that the new laws were "tools" to assist the courts in their public duty. Moreover, the failing of the old s 303(3) was never analysed by parliament and as a result the problems of that section were passed on to its successors. Sections 374C and 374D consequently had little effective operation. The criminal purpose continued to be primary and so the use of the sections was restricted to business decisions of directors affecting creditors that were dishonest, but not those that were reckless or careless errors of judgment.

In 1981 the High Court considered the operation of s 303(3) in *Shapowloff* v *Dunn*.[15] The section was considered because it had become the subject of a number of appeals in the lower courts since 1975, evidencing the controversial and arguably ineffective operation of the section.[16] *Shapowloff* can be regarded as the first important decision to offer judicial guidance on the operation of the insolvent trading provisions under the uniform legislation, making it worthy of detailed consideration. The case concerned a director who entered into a series of transactions involving the purchase of shares from a stockbroking firm. The share purchases were debited to the company account. The company paid its account from time to time, but in 1971 the company was wound-up leaving its account with the stockbrokers unpaid. Because there was a series of share transactions not paid, the question for consideration was at what point of time did the "debt" arise? Did it arise at the time of each transaction, or at the conclusion of all transactions when the balance was declared or computed? The High Court in considering these questions resolved that the time when the debt was due or each contract was formed, was the time when each liability arose and not when the debt was recorded or computed.

The leading judgment was given by Stephen J who considered that s 303(3) could not be understood by looking at the "ultimate fate of the debt"[17] but instead the section looked to the date "when debt was contracted".[18] Accordingly, His Honour concluded that the "debt" was, in the circumstances of the case, contracted by the company on the date when the broker bought the shares, as this was the point of time when the liability arose.

The second leading judgment was given by Wilson J who recognised that the meaning of "debt" within s 303 had long been the subject of controversy,[19] and considered s 303

re-enact the provisions which make it an offence for an officer knowingly to contract a debt at a time when there is no reasonable prospect of the company being able to pay, and of carrying on business with intent to defraud creditors or otherwise. If a person is convicted of either of those offences, on the application of the appropriate officer or, with the consent of the Attorney-General, any creditor or contributory, the court may make an order against the convicted person to pay to the company the whole or such part as it thinks fit of the amount of the debt incurred in the first case, or the total or such part of the total of the debt incurred by the company as the court thinks fit in the second case."

15. (1981) 148 CLR 72.
16. *Shapowloff* v *Dunn* (1973) 2 NSWLR 468.
17. *Shapowloff* v *Dunn* (1981) 148 CLR 72 at 78 (Stephens J).
18. Ibid.
19. Ibid at 82 (Wilson J).

against the background of bankruptcy legislation. His Honour thought it clear that the prosecution must prove beyond reasonable doubt "expectation, reasonably grounded in the whole of the circumstances" of inability to pay the debt.[20] This approach involved a blending of subjective and objective considerations. In Wilson J's opinion the test imported an objective standard, but was to be applied to the facts known to the defendant.[21] In finding that a "debt" arose under s 303(3) at the time it was contracted, the High Court took a narrow approach to the interpretation of the section, but this is not surprising given that the section under consideration had a criminal operation.

The courts in Australia had historically recognised that directors and officers of the company were not liable for honest errors of commercial judgment.[22] Directors could not be held responsible for the debts of creditors short of dishonesty; a reckless attitude was insufficient to invoke the operation of the provisions. The judiciary showed a reluctance to review business judgments made in good faith,[23] perceiving directors not as criminals, but merely people who made mistakes in business. The position can be best summarised in the words of the High Court who commented that "directors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be saved may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the Courts".[24] Convictions against directors for insolvent trading were difficult to obtain and the procedure was lengthy. In *Shapowloff* alone, there were no less than five hearings between 1973 and 1981.[25] This did not seem to be too unusual. In another case a director was convicted five years after the winding-up of the company for which he was fined $500.[26]

It cannot be said that the insolvent trading law up to 1981 developed with any form of direction. This lack of direction could be attributed to the fact that unlike England, Australia had not undertaken any national investigation into insolvent trading but had instead relied on the British law reform experience. The policy considerations as articulated by parliamentarians addressed a perception rather than specific problems within the legislation and failed to separate the civil and criminal consequences of insolvent trading. As a consequence, the insolvent trading legislation in Australia up to 1981 had no effective commercial remedies for creditors.

From 1979: The Introduction of the National Scheme

From 1979 there was a push for a national scheme to regulate companies and the securities industry. This culminated in the National Companies and Securities legislation and the establishment of the National Companies and Securities Commission. The Companies Act

20. Ibid at 85.
21. Ibid.
22. *Hardie* v *Hanson* (1960) 105 CLR 451 at 464 (Kitto J).
23. Commonwealth, *Hansard*, House of Representatives, 3 November 1992 at 2400–1.
24. *Harlowe's Nominees Pty Ltd* v *Woodside* (1969) 121 CLR 483 at 493 (Barwick C J, McTiernan and Kitto JJ).
25. *Shapowloff* v *Dunn* [1973] 2 NSWLR 469 (Cantor J) and (1981) 148 CLR 72.
26. Harmer Report, supra n 13 at 124.

1981 reformulated the uniform companies legislation and amended the existing insolvent trading provisions by introducing ss 553, 556 and 557, referred to as the "minicode".[27] Section 556(1) was the insolvent trading provision that made directors and managers personally liable for incurring debts in circumstances were there was *reasonable grounds to expect that the company would not be able to pay all its debts when they became due*.[28]

The provision was intended to place greater responsibilities on directors and managers of a company at the time that the unreasonable debts were incurred. The question of what constitutes *reasonable grounds* was to be considered by reference to the decision of the High Court in *Shapowloff*.[29] Section 556 provided a mixture of civil and criminal sanctions.[30]

Importantly, s 556(3) allowed civil proceedings to be brought by a creditor, whether or not a person was convicted under subsection (1). It was clearly the intention of s 556(1) to increase the obligations imposed upon officers of a corporation. The provision expanded the circumstances in which company officers could be liable to creditors for debts of the company. The purpose of s 556(1) was to discourage officers of corporations from committing the corporation to obligations to pay a debt, when they had reasonable grounds for expecting that their corporation, upon incurring the debt in question, was or would become insolvent.[31]

The provision also provided statutory defences in 556(2) for directors and those who took part in the management of the company, where debts had been incurred without the person's express or implied authority, or the person did not expect that the company would be unable to pay the debt when the debt was incurred.[32] Where a person was convicted under ss 556(1) or ss 557(1) and (2), the court was empowered to make a declaration that

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27. *Australia Pty Ltd* v *Watt* (1984) 9 ACLR 203 at 207 (Rogers J).
28. Section 556(1) provided if:
    (a) a company incurs debt, whether within or outside the Territory;
    (b) immediately before the time when the debt is incurred —
        (i) there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or
        (ii) there are reasonable grounds to expect that, if the company incurs the debt it will not be able to pay all its debts as and when they become due; and
    (c) the company is, at the time when the debt is incurred, or becomes at a later time a company to which this section applies, any person who is a director of the company, or who took part in the management of the company, at the time when the debt was incurred is guilty of an offence and the company and that person or, if there are two or more such persons, those persons are jointly and severally liable for the payment of the debt.

    Penalty: $5,000 or imprisonment of 1 year, or both.
29. Explanatory Memorandum, National Companies Legislation (1981), para 1219.
30. Harmer Report, supra n 13 at 124.
31. *Hawkins* v *Bank of China* (1992) 10 ACLC 588 at 599 (Kirby P).
32. Subsection 556(2) provided a defence where:
    (a) the debt was incurred without the person's express or implied authority or consent; or
    (b) the person did not have reasonable cause to expect at the time "that debt" or all debts were incurred, it would not be able to pay the debts as they became due.

the person so convicted was personally liable for the debt or debts incurred. However, s 556 and s 557 were restricted in application by the provisions in s 553 (previously s 374E of the uniform code) which limited their applications to companies and their officers in certain situations. The companies to which s 556 and s 557 applied were: those in the course of being wound-up,[33] those in the course of being wound-up but whose proceedings had been stayed or terminated,[34] those under official management,[35] those whose affairs were under investigation,[36] those that had ceased to carry on business or were unable to pay their debts,[37] and those that had entered into a compromise or arrangement with their creditors.[38]

Section 556 presented difficulties of interpretation for the judiciary. Numerous cases bare out the difficulties of the provision. One in particular is *NEC Home Electronics Aust Pty Ltd* v *White,*[39] where Rogers J found insufficient attention had been paid by the draftsman to the fact that s 556 created a civil liability on the part of the directors to pay the amount of the debt, while s 374C of the Companies Act 1961 (NSW) (which it replaced) only provided for a criminal offence.[40]

Also considered in detail later in this chapter are the difficulties determining the ambit of s 556.[41] Of particular importance is the decision in *Metal Manufacturers* v *Lewis*.[42] This case considered the ambit of defences under s 556(2) and found that a housewife and director of a company that incurred substantial debts was not liable under s 556(1), for she had not participated in incurring the debts and therefore could rely upon the defence of s 556(2)(a), as the debt was incurred without her express or implied authority or consent.[43] This case is a good example of the differences of interpretation that s 556 permitted.[44] The decision does not attach any emphasis on the duty of directors to inform themselves of the company's affairs, and attracted much criticism.[45]

The *Metal Manufacturers* case effectively blunted the effectiveness of s 556 and was arguably inconsistent with the aims of the new legislation, which had intended to place

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33. Section 553(1)(a).
34. Section 553(1)(b).
35. Section 553(1)(c) and s 553(1)(e).
36. Section 553(1)(d).
37. Section 553 (1)(f).
38. Section 553(1)(g).
39. (1984) 2 ACLC 621.
40. Ibid.
41. *Ross McConnell Kitchen & Co Pty Limited (in liq)* v *Ross* (1985) 3 ACLC 326 at 327–8.
42. (1988) 13 NSWLR 315.
43. Ibid at 322.
44. (1986) 4 ACLC 739. Note the comments of Kirby P who criticised the majority decision at 730:
    In dissenting Kirby P said that it seems "scarcely credible that parliament would have intended the blanket operation of this defence [s 556(2)(a)] to the frustration of the obvious scheme of the section and the achievement of its purposes, by the simple expedience of a director surrendering all of his or her powers to a company director or managing director".
45. A Herzberg, "The Metal Manufacturers Case and the Australian Law Reform Commission's Insolvent Trading Recommendations" (1989) 7 *Company and Securities Law Journal* 177.

greater responsibility on those who were directors and managers of companies.[46] By the mid-1980s, Australian law reformers, in considering the British approach,[47] were starting to investigate the inadequacies of the insolvent trading provisions. The provisions were considered so inadequate that the Australian Law Reform Commission called for the repeal of s 556 and the enactment of a new restructured provision,[48] which would be clear, rational and readily enforceable in a manner which permitted all creditors to share equally in the sum recovered.[49] This criticism of s 556 was also endorsed by the Senate Standing Committee on Legal and Constitutional Affairs.[50]

1991 and the Introduction of Section 592

On 1 January 1991, the Commonwealth introduced a new body of legislation, to put the regulation of company takeovers, securities and the futures industry on as much of a national footing as possible. The centrepiece of the legislative package was the Corporations Law, contained in Part 13 of the Corporations Act 1989 (Cth). The new s 592 of the Corporations Law dealt with insolvent trading and was drafted in similar terms to its predecessor.[51]

The Explanatory Memorandum which accompanied the Corporations Bill 1988, indicated that the intention of s 592[52] was to place greater responsibility on persons who were directors and managers at the time that debts that could not be repaid were incurred by the company, and to expose such persons to personal liability to creditors for the payment of any such debts the company incurred.[53] The provision also contained two statutory

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46. Companies Bill 1981, Explanatory Memorandum at para 1219.
47. United Kingdom, *A Revised Framework for Insolvency Law*, HMSO London (1984) Cmnd 9175, para 52.
48. Harmer Report, supra n 13 at 125.
49. Ibid.
50. Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties; Report on the Social and Fiduciary Duties and Obligations of Company Directors*, 1989 (Cooney Report) at 77.
51. There were minor grammatical changes to the wording of s 592 in comparison to s 556. The wording of s 592 was changed to the past tense. Under s 592(2) "if" was changed to "where", "incurs" was changed to "incurred". The word "is" in s 556(1)(c) became "was" under s 592(1)(c). The penalty clauses were moved to Schedule 3.
52. Section 592(1) [Liability for debts etc.] "Where:
    (a) a company has incurred a debt;
    (b) immediately before the time when the debt was incurred:
        (i) there were reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or
        (ii) there were reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and
    (c) the company was, at the time when the debt was incurred, or becomes at a later time, a company to which this section applies;
    any person who was a director of the company, or took part in the management of the company, at the time when the debt was incurred contravenes this sub-section and the company and that person or, if there are two or more such persons, those persons are jointly and severally liable for payment of the debt."
53. Corporations Bill 1988, Explanatory Memorandum Vol 2 at 474–5.

defences in s 592(2) in identical terms to s 556(2).[54] Although a creditor could bring proceedings against a director under s 592 for the recovery of the debt, the company itself only had standing to bring an action where a director was convicted of fraudulent conduct under s 592(6).

Like its predecessor, the operation of s 592 attracted criticism. It was perceived that the civil and criminal elements operated so that criminal prosecution was a prerequisite for civil action by the liquidator. The defences gave rise to technical arguments that frustrated the operation of the provisions. The provisions caused inequity among unsecured creditors as they could only be utilised by individual creditors and gave rise to a multiplicity of actions. Moreover, proving insolvency at the time a particular debt was incurred was fraught with difficulties.[55] Much has been written about the inadequacies and inconsistencies of s 556 and s 557 of the Companies Code and s 592 and s 593 of the Corporations Law.[56]

The Continuing Case for Law Reform: The Harmer and Cooney Reports

The inadequacies of s 556 were identified by the Australian Law Reform Commission (ALRC) in its General Insolvency Inquiry[57] (The Harmer Report) and the Senate Standing Committee on Legal and Constitutional Affairs in its report into the duties and obligations of company directors[58] (The Cooney Report).

The ALRC considered s 556 of the Companies Code, but because its successor (s 592 of the Corporations Law) was is in the same terms, its Report is equally applicable to that provision. The Report was very detailed and examined how both statute and common law had attempted to make directors responsible for their actions in relation to insolvent trading. It set out the deficiencies of the insolvent trading provisions, and appropriate remedies for creditors when a company is insolvent. It considered s 556 to be fundamentally flawed, in that it focused on incurring debts whilst insolvent, instead of encouraging directors of companies in financial difficulty to initiate appropriate insolvency administration.

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54. Section 592(2) provided:
"(a) that the debt was incurred without the person's express or implied authority; or
(b) that at the time when the debt was incurred the person did not have reasonable cause to expect:
(i) that the company would not be able to pay all its debts as and when they became due; or
(ii) that, if the company incurred the debt, it would not be able to pay all its debts as and when they became due."

55. Explanatory Memorandum, supra n 53 at 212–17 and 474–5.

56. For example: A Herzberg, "Insolvent Trading — Civil Liability of Company Officers under Insolvent Trading Provisions" (1991) 9 *Company and Securities Law Journal* 285 and see his earlier article "Current Developments Legal and Administrative" (1985) 3 *Company and Securities Law Journal* 202. Also R Baxt, "Companies — Liability of Directors for the Debts of a Company — Extent to Which There is Absence of Liability if They Take no Part in the Company's day-to-day Involvements" (1988) 62 *Australian Law Journal*, 643 and see his other article "Guarantees and Section 592, Corporations Law: the Dynamics of Debt" (1992) 21 *Australian Business Law Review* 212.

57. Harmer Report, supra n 13.

58. Cooney Report, supra n 50.

Problems with the insolvent trading provisions

The ALRC pointed out that up until the introduction of s 556, legal proceedings to enforce the insolvent trading provisions were lengthy and costly,[59] and there were very few successful criminal prosecutions against directors and fewer instances of civil recovery.[60] Although the Report conceded that the introduction of s 556 in 1981 was a positive step in providing a civil remedy independent of any criminal conviction, it nevertheless considered that the reforms did not go far enough and major flaws in the provisions still existed.

The ALRC identified a number of specific problems contained in s 556 which may be summarised as follow:[61]

(a) section 556 contained both civil and criminal elements in the one section;
(b) the provisions failed to provide that a liquidator with standing could bring an action for the benefit of all creditors;
(c) the benefit of civil liability was given to the creditor who could afford to take legal action;
(d) section 556 allowed multiplicity of actions by creditors and was costly in procedure and inefficient; and
(e) the section contained a number of deficiencies, pointed out in decisions such as *Australia Pty Ltd* v *Watt*,[62] *Metal Manufacturers* v *Lewis*[63] and *3M Australia Pty Ltd* v *Kemish*.[64]

In considering the deficiencies of the insolvent trading provision, the ALRC was of the view that, at no stage since the introduction of the insolvent trading provisions in Australia had the provisions been in a form appropriate for giving creditors a suitable remedy, and there was a clear need for further reform.[65] In particular, the responsibility of a director had never been expressed as a positive duty owed to the company to prevent insolvent trading. In the opinion of the ALRC, the real failing of s 556 was in its language, because a company was permitted to trade up to a point where, objectively viewed, the company was unable to pay all its debts as they fell due.[66] The provision was perceived to be so inadequate that the ALRC recommended its repeal and the enactment of a new provision which would permit all creditors to share equally in the sums recovered. This was intended to promote the principle of equal sharing in insolvency.[67]

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59. Harmer Report, supra n 13 at 124.
60. Ibid.
61. Ibid at 125.
62. (1984) 2 ACLC 621.
63. (1986) 4 ACLC 739.
64. (1986) 10 ACLR 371.
65. Harmer Report, supra n 13 at 124.
66. Ibid at 125.
67. Ibid.

Recommendations for reform

The main features of the ALRC's recommendations for restructuring s 556 are outlined as follows:[68]

(a) There should be a duty imposed on directors to prevent the company engaging in insolvent trading.
(b) A breach of liability should give rise to civil liability only. There should be no criminal liability.
(c) Insolvent trading involves:
  (i) the incurring of debts when circumstances of insolvency in relation to a company exist; and
  (ii) the subsequent winding-up of the company.
(d) Circumstances of insolvency exist when there are reasonable grounds for suspecting that a company is unable to pay its debts.
(e) Action for breach of the duty to prevent insolvent trading should be brought by the company through the liquidator or, if the court grants leave, through a creditor.
(f) Proof of the existence of circumstances of insolvency should be assisted by three presumptions:
  (i) a presumption of inability to pay debts where an examination of the assets and liabilities of the company indicate that the company is insolvent;
  (ii) a presumption that circumstances of insolvency exist where proper and adequate accounting records detailing the company's financial affairs are, for whatever reason, not available to the liquidator; and
  (iii) a presumption that circumstances of insolvency, once established, exist at a particular time within 12 months preceding the commencement of the winding-up and continue to exist.
(g) To escape liability for insolvent trading, a director of a company should be able to rely on one of three defences:
  (i) the director had reasonable grounds to expect that the company would be able to pay its debts from its own resources;
  (ii) the director took reasonable steps to minimise the possible loss to creditors;
  (iii) the director was not able for good reasons, to participate in the management of the company at the relevant time.
(h) The first defence should be established if a competent and reliable person had responsibility for providing directors with sufficient information to prevent the company from engaging in insolvent trading and discharged that responsibility.
  (i) The second of these defences should be established if the director endeavoured to prevent the insolvent trading or endeavoured to place the company under a form of administration in insolvency.
(j) If a director is found liable for insolvent trading then the amount of liability should be determined by the court and measured by reference to the loss or damage sustained by the creditors.

68. Ibid at 126–7.

(k) The sum recovered should be applied for the benefit of all unsecured creditors.
(l) The liability should only be imposed on directors and not on senior management.

The ALRC was of the view that the implementation of these changes as outlined above would create a positive duty on the part of directors, and would further prevent the company from engaging in insolvent trading. It is therefore important to consider each of these recommendations in detail.

1. The duty

The ALRC, in considering the formulation of the obligation of directors to creditors, found it necessary to impose a duty on directors to prevent the company from "engaging in insolvent trading", which involved the incurring of a debt by a company when circumstances of insolvency existed, and the company is subsequently wound-up. The rationale for imposing this duty was to remove attention away from incurring a debt or debts and direct attention to the directors' responsibility for the overall financial management of the company.[69] The duty is expressed by the ALRC as being owed to the company even though a breach of the duty would adversely affect creditors.[70] In the opinion of the ALRC, this view was consistent with the decision in *Kinsela* v *Russell Kinsela Pty Ltd* (in liq)[71] which indicated that the duties directors owe to a company involve a consideration of the creditors' interests once the company becomes insolvent.[72]

Whilst the recommendation of a duty was a considerable advance, the proposed minor amendments to the wording in s 556(1) meant that the same flaws contained in the provision remained. For example, difficulties that the courts experienced with the phrases, "incurs a debt" and "reasonable grounds", remained as a result of the ALRC recommendations and in fact have been incorporated in the current s 588G(1). A detailed analysis of the courts' difficulties was singularly lacking in relation to these issues. In relation to the words, "incurs a debt" there was no consideration given by the ALRC to the point in time the debt is incurred. The issue is important in relation to obligations to creditors who supply goods, lease repayments or other instalments payments[73] and negligence[74] cases.

A second issue concerns the ALRC recommendation to substitute the word "suspect" for "expect" in s 556(1) in order to highlight the responsibilities of directors to creditors. It was considered that the test for directors to should be "reasonable grounds for suspecting" that the company is unable to pay its debts, rather than "reasonable grounds to expect".

69. Ibid at 128.
70. Ibid.
71. (1986) 10 ACLR 395.
72. Ibid.
73. *Jein Pty Ltd* v *Johnson* (1987) 5 ACLC 463. See also A Herzberg "Insolvent Trading" (1991) 9 *Company and Securities Law Journal* 285 at 292.
74. *Briggs* v *James Hardie & Co Pty Ltd* (1989) 7 ACLC 841.

The ALRC was of the view that this change in wording imposed a higher standard of care upon directors to avoid insolvent trading.[75]

2. Removal of criminal liability

The ALRC also recommended that breach of the duty to prevent insolvent trading should only give rise to civil liability and that criminal liability should not be retained.[76] This recommendation was based upon the policy consideration that the civil law should play a greater role and the criminal law a lesser role in insolvency administration. It was considered the retention of criminal liability would discourage risk-taking which was an important factor in promoting economic growth.[77] This same view was also accepted in the Cooney Report.[78] It is surprising that the Corporate Law Reform Act 1992 (Cth) did not adopt these recommendations. The current s 588G(3) has both civil and criminal sanctions.[79]

3. Presumptions of insolvency

The current provisions contained in s 588E that deal with presumptions do not encompass all the recommendations contained in ALRC Report. They depart from the recommendations on several major points. First, the ALRC Report presumed insolvency on balance sheet asset liabilities ratio, absence of accounting records and failure to return unsecured creditors more than 50 cents in the dollar. The ALRC Report also presumed insolvency in the immediate period prior to the commencement of the winding-up. However, the new legislation defines insolvency in the negative and the definition is contained in s 95A of the Corporations Law.[80] It is doubted that this definition will overcome all of the problems pointed out in *Hawkins* v *Bank of China*[81] and a precise and more detailed definition would have been of more assistance. Second, the ALRC Report took the view that there should be a presumption of insolvency at some time prior to the commencement of a formal insolvency administration. The ALRC considered that a presumption of insolvency during this short period would reduce the cost of reconstructing the company's financial picture.[82]

The Government rejected this approach and took the view that the potential benefit which it offered did not justify the element of retrospective liability.[83] As a compromise the

75. Harmer Report supra n 13 at 129.
76. Ibid, Vol 2 para 323.
77. Ibid.
78. Like the Harmer Report, the Cooney Report was of the opinion that criminal sanctions did not assist the creditor. Cooney Report, supra n 50 at 78–81.
79. Sections 588G(3) and 1317E.
80. Corporations Law s 95A(1) "[When a person is solvent] A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable."
s 95A(2) "[Insolvent person not solvent] A person who is not solvent is insolvent."
81. (1992) 10 ACLC 588.
82. Corporate Law Reform Bill (1992), Explanatory Memorandum at para 1018.
83. Ibid at para 1019.

new s 588E presumes insolvency if it can be proved that the company was insolvent at a particular time during the twelve months ending on the "relation — back day".[84] However, s 588E does reflect the ALRC recommendation of a presumption of insolvency where inadequate accounting records existed or where no records had been kept in a manner required by s 286 of the Law.[85]

Although the new provisions did not adopt all the ALRC recommendations, they are still a very positive practical step for both liquidators and creditors in determining insolvent trading by a company. They have removed a number of the considerable difficulties that confronted creditors and have made the liquidator's task easier where company documents are missing or destroyed.

4. The defences

The ALRC recommended that the defences in s 556(2) should be replaced altogether. The first proposed defence was where a director had *reasonable grounds to expect that the company would be able to pay all its debts from its own resources*.[86] This proposed defence was only marginally different from that under s 556. In the ALRC's view this general defence would exonerate a director if he or she took a responsible role in the management of the company.[87] Further, the words "from its own resources" are significant. The ALRC had in mind a situation whereby a company is technically insolvent, but its association with a parent company and its access to the parent company's financial resources, might not make it insolvent for purposes of s 556. Accordingly, the ALRC took the view that access to another company's financial resources should be ignored by the courts for the purposes of determining the financial position of a company. This defence was not adopted in the form recommended as the current s 588G(2) provides a defence where the director had *reasonable grounds to expect solvency*.

The second defence proposed by the ALRC was where a director at the time of, or within a reasonable time after, becoming aware that the company was engaging in insolvent trading, took steps to minimise the loss to creditors, by either taking action to prevent the company engaging in insolvent trading or placing the company in a form of administration in insolvency.[88] This recommendation was based on s 214(3) of the United Kingdom Insolvency Act (1986) and is now contained in s 588H(5).

The final defence proposed was where a director did not participate in the management of the company as a result of illness or other sufficient cause. The ALRC was of the opinion that it was not appropriate to find a director liable for insolvent trading where the director was not in a position to influence the management of the financial affairs of the

84. s 588E(2); "Relation — back day" is defined in s 9(1).
85. s 588E(4); note that s 588E(4) does not apply to a contravention that is minor or technical [s 588E(5)], or to the destruction of documents by a person other than director [588E(6)].
86. Harmer Report, supra n 13 at 136.
87. Ibid.
88. Ibid at 138.

company at the relevant time.[89] This recommendation was also adopted and is now contained in s 588H(4).

5. Proceedings to be brought by liquidator

A liquidator had no standing to bring proceedings under s 556.[90] The ALRC was of the view that since s 556 only applied to a company in winding-up, the liquidator is the appropriate person to determine if an action should be brought.[91] The standing of the liquidator is now contained in s 588M(2). The liquidator has additional powers in compensation recovery proceedings under s 588M(3) and penalty applications under s 588J(2). However, the ALRC was conscious that liquidators are sometimes reluctant to commence proceedings and therefore conceded that there should be provision for the court to make orders allowing creditors to bring an action. Creditors only have secondary standing and can only bring proceedings with the consent of the liquidator[92] or with leave of the court.[93] Creditors secondary standing is now contained in s 588M(3) and, as will be discussed later in this chapter, may lead to some unsatisfactory results.

6. Introduction of the principle of equal sharing

Another concern of the ALRC was that the civil liability regime advantaged a creditor with the resources to fund an action against a director and there was no equal sharing in the insolvency.[94] To remedy this, the ALRC proposed that the amount received by the company from a director for breach of the duty to prevent insolvent trading be applied for distribution in the winding-up. It was further proposed that the amount recovered only be for distribution among unsecured creditors because insolvent trading, in the ALRC's opinion, will have the greatest impact on them.[95]

It is clear that the current provisions in s 588M(3) and ss 588R–588U go much further than what was recommended by the ALRC.[96] The provisions allow for compensation claims to be brought by the liquidator within six years after the beginning of the winding-up.[97]

7. Liability for directors only

Section 556(1), and its successor (s 592(1)) imposed liability on any person who was a director of the company, or who took part in the management of the company at the time

89. Ibid at 139.
90. *Ross McConnell Kitchen & Co Pty Ltd* v *Ross* (1980) 3 ACLC 326.
91. Harmer Report, supra n 13.
92. Section 588R.
93. Section 588T.
94. Harmer Report, supra n 13 at 125.
95. Ibid at 141.
96. Corporate Law Reform Bill 1992, Explanatory Memorandum at para 1106.
97. Section 588M(4).

the relevant debt was incurred. Although the ALRC was minded of the fact that often it is the responsibility of senior managers to inform the board of the financial position of the company, it was in their view appropriate that only those persons who are entrusted with the overall management of the company should have the burden of the liability. The ALRC therefore recommended that senior management not be liable for insolvent trading.[98] There were a number of early cases where managers had been held liable.[99]

This recommendation was appropriate because it is directors who have the responsibility and duty to oversee the management of the company. The definition of directors in s 9 of the Corporations Law is wide enough to encompass those who act as shadow, or de facto directors. The current legislation adopted the recommendations of the ALRC in this regard.[100]

8. Liability of holding company for insolvent trading by subsidiary

Many European countries allow for the extension of a subsidiary company's insolvency proceedings to include the parent.[101] Australia had no similar provision and the separate entity principle operated unfairly against creditors where the business activity of a company had been controlled or influenced by a related company.

The ALRC recommended that in certain circumstances companies be liable for the debts or liabilities of related companies.[102] However, the ALRC recommendations and its draft legislation[103] were significantly different from the provisions adopted by the

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98. Harmer Report, supra n 13 at 143.
99. *3M Australia Pty Ltd* v *Kemish* (1986) 10 ACLR 371 and *Hussein* v *Good* (1990) 1 ACSR 710.
100. Section 588G(1).
101. P Blumberg, *The Law of Corporate Groups* (1985) at 627.
102. Harmer Report, supra n 13 at 147.
103. Ibid at Vol 2, D13:

The ALRC draft legislation provided:

"Liability of a company for the debts or liabilities of a related company

D13.(1) On the application of the liquidator of a company that is being wound up in insolvency, the Court may, if it is satisfied that it is just, order that a company that is or has been a related company shall pay to the liquidator the whole or part of the amount of a debt or liability of the first-mentioned company that is an admissible claim in the winding up.

(2) In deciding whether it is just to make an order under subsection (1), the matters to which the Court shall have regard include —

(a) the extent to which the related company took part in the management of the company;
(b) the conduct of the related company towards the creditors of the company generally and to the creditor to which the debt or liability relates;
(c) the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related company; and
(d) any other relevant matters.

(3) An order under this section may be subject to conditions.

(4) An order shall not be made under this section if the only ground for making the order is that creditors of the company have relied on the fact that another company is or has been a related company of the company."

government in the current legislation.[104] The ALRC provisions were drafted in wide terms so as to give discretion to the court to order a related company to pay the liquidator all or part of the amount which is an admissible claim in the winding-up.[105]

However, the provision contained in s 588V[106] is directly comparable to the test imposed on directors in s 588G. The liquidator of the subsidiary is permitted to initiate civil proceedings against the holding company to recover for the benefit of unsecured creditors or for loss or damage suffered by creditors as a result of the holding company's contravention of s 588V.[107] The four defences[108] mirror those in s 588G.

Section 588V is based on an amended version of the ALRC recommendations to allow the corporate veil to be pierced in certain circumstances, when the business activities of a company have been directed and controlled by another company. However, one commentator has observed that s 588V may lead to fewer proceedings under s 588G being initiated, because the liquidator may prefer to engage s 588V and direct attention at the holding company that possesses the capital, and perhaps allow subsidiary directors to walk away.[109]

1992 to Present: The Introduction of Section 588G

The ALRC and the Cooney Reports pick up the majority of the inadequacies of s 556 and its successor (s 592(1)) and many of their recommendations were contained in the Corporate Law Reform Act 1992. This Act came into effect on 24 June 1993 and it introduced significant changes with the insertion of Parts 5.7B and 9.4B into the Corporations Law to replace s 592 and other provisions. This new regime introduced important provisions for liquidators and, in some circumstances creditors, to pursue directors for insolvent trading. Of particular importance was the creation of a new statutory duty in s 588G, which imposes on directors a duty to prevent a company from incurring a debt where the company is insolvent. The ambit of this provision is considered in the next part of this chapter.

However, as has been already shown, there are parts of this new legislation that have deviated in important respects from the recommendations that were central to the philosophy of the ALRC and Cooney Reports. The new provisions have introduced some difficulties of their own in addressing delinquent director behaviour. These difficulties will also be explored in the next part of this chapter.

104. Division 5 of Part 5.7B of the Corporations Law.
105. Corporate Law Reform Bill 1992, Explanatory Memorandum, at para 1124.
106. Section 588V(2) provides that a corporation that contravenes the section is not guilty of an offence.
107. Section 588X; see also Corporate Law Reform Bill 1992, Explanatory Memorandum, at para 1128.
108. Section 588W.
109. A Herzberg, "Insolvent Trading Down Under" in J Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (1994) at 517–18.

Part Two

The Ambit of Section 588G

Introduction

The liability imposed on directors in the case of debts incurred by an insolvent company from 24 June 1993 is determined by s 588G. This section replaced s 592. For any case to be successful under s 588G, the plaintiff must establish that the company is insolvent and is unable to pay its debts as they become due at the time when it incurs a debt or the company is insolvent because the debt has been incurred. Recent judicial decisions closely consider the financial records and circumstances giving rise to the inability to pay the debt or debts of the company. Judges appear to be taking a commercially realistic approach to insolvent trading issues.[110] However, the operation of the section is dependent upon the interpretation of "insolvent" contained in s 95A. Under s 588G, a director will only be liable for debts if there were reasonable grounds for suspecting that the company was insolvent or would become insolvent.

A close analysis of the wording of s 588G will be undertaken, which is assisted by consideration of some of the predecessor's wording such as "incurs a debt" and "reasonable grounds" that are repeated in the new provision. The analysis will especially focus on the key word "suspecting" and a comparison drawn with the concept of "expectation" in the former provisions. This part will also analyse the new meaning of director, as the insolvent trading provision no longer includes "a person who took part in the management" of a corporation. Consideration will also be given to the new definition of solvency and what issues a court may take into account when determining the insolvency of a company.

A recent amendment to s 588G was made by the Corporate Law Economic Reform Program Act 1999. It removed the criminal consequences of breaching s 588G from Part 9.4B of the Corporations Law and introduced a simplified criminal offence under a new provision contained in s 588G(3).

Section 588G

Section 588G imposes a duty on directors not to have the company of which they are a director trade while insolvent. Subsection (1) states the requirements:

> (a) a person is a *director* of a company at the time when the company *incurs a debt*;
>
> (b) the company is insolvent at that time, or becomes insolvent by *incurring* that debt, or by incurring at that time debts including that debt;

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110. A representative example of recent decisions on s 588G includes *Starguard Security Systems P/L* v *Goldie* (1994) 13 ACSR 805; *Metropolitan Fire Services Pty Ltd* v *Miller (*1997) 23 ACSR 699; *Quick* v *Stoland Pty Ltd* (1998) 29 ACSR 130; and *Muller* v *Dana Australia Pty Ltd* [1998] VSCA 30 Unreported Supreme Court of Victoria — Court of Appeal (27 August, 1998).

(c) at that time, there are *reasonable grounds for suspecting* that the company is *insolvent*, or would so become insolvent, as the case may be; and

(d) that time is at or after the commencement of this Part. (emphasis added)

The actual duty is imposed by virtue of subsection (2) which provides that, "if a director fails to prevent the company from incurring the debt", the director will contravene the section if:

(a) the person is aware at that time that there are such grounds for so *suspecting*; or

(b) a *reasonable person in a like position* in a company in the company's circumstances would be so aware. (emphasis added)

It was considered by the Commonwealth Parliament that the duty "will prevent directors from avoiding liability for insolvent trading by deliberately refusing to take any part in the management of the company".[111] The amendments were introduced at a time when courts were refocussing the former provisions on creditors' rights and taking a stricter approach towards duties of directors to creditors.[112]

Who is a 'Director'?

The meaning of director is contained in s 9 of the Law. A director is:

(a) a person who:

(i) is appointed to the position of a director; or

(ii) is appointed to the position of an alternate director and is acting in that capacity; regardless of the name that is given to their position; and

(b) unless the contrary intention appears, a person who is not validly appointed as a director if:

(i) they act in the position of a director; or

(ii) the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes.

Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity or the person's business relationship with the directors or the company or body.

The latter part of s 9 provides an exemption to professional persons who give advice in the proper performance of their professional capacity or business relationship.

Section 588G differs from its predecessor because the liability excludes those "who took part in the management of the company", which were the words used in the old s 592. The former provision required a determination, when it was not always easy, of when a person was said to be managing a corporation.[113] An understanding of the position of the

111. Commonwealth, Hansard, House of Representatives, Second Reading Speech, Corporate Law Reform Bill 1992 No 15, 3 November 1992 at 2401. (Second reading speech.)

112. *Statewide Tobacco Services* v *Morley* (1993) 1 VR 423 and *Commonwealth Bank of Australia* v *Friedrich* (1990) 5 ACSR 115; *Group Four Industries* v *Brosnan* (1992) 8 ACSR 463.

113. *Re Hanlon Homes Pty Ltd (in liq)* (1987) 5 ACLC 459 defined company; also note s 9(1) Corporations Law for definition of "company".

person was important because it had a bearing on those who gave advice in relation to the management affairs of the company.[114] There were a number of attempts to broaden the meaning of the section to include those acting in an official capacity, such as a receiver or manager, but such attempts were unsuccessful.[115]

What is the Ambit of the Definition?

De facto director

The s 9 definition includes persons who act in the position of a director, whether they are validly appointed to act in that position or not. Therefore, anyone who takes on the responsibilities or functions in the company expected of a director may be considered a "de facto director" and be liable under s 588G. In this regard, persons who play a key role in a company, although they do not consider themselves directors, may be caught by the provision.

Shadow director

The definition of director also extends to shadow directors as s 9 includes a person in accordance with whose instructions or wishes the directors of the company are accustomed to act.[116] It is unclear how the court will interpret instructions or wishes. The wording in this section has ramifications for advisers, financial institutions, corporate insolvency consultants in "work outs" and the boards of holding companies. Although s 9 gives an exemption to those who give advice in a professional capacity or business relationship, it is conceivable that *advice* may lead to *instructions* by a professional, financial institution or holding company. This may occur where directors of an ailing company become accustomed to act and take instructions or directions to initiate corrective measures to avoid insolvency in an attempt to turn the company around. It appears that s 9 will be invoked, for example, if a consultant appointed by a financial institution effectively controls the company and the incumbent board "rubber stamps" decisions without independent consideration.

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114. *Holpitt Pty Ltd* v *Swaab* (1991) 105 ALR 421. In this case, Burchett J had to consider whether Mr Swaab, the company solicitor and secretary, was a person who took part in the management of the company for the purposes of s 592. Burchett J did not attach a loose meaning to these words and found that Mr Swaab's position was not within the ambit of the section. His Honour considered that the words in the context used imposed a criminal liability including imprisonment. In so finding, he considered that the rationale of the section must be that the person to whom the section is targeted is an offender, because of the significance of his role in the company which incurred the debt. The language of the section, in His Honour's view, could not be stretched to that of an outside professional giving advice. Only those people whose management role may be likened to that of a director could conceivably come within the phrase "took part in the management of a company". However, a different interpretation was found in *Australia Pty Ltd* v *Kemish* (1986) 4 ACLC 185, where an accountant was found to have taken part in the management of a company under s 556(1)(c).

115. *Fliway Transport Pty Ltd* v *Soper* (1989) 7 ACLC 129; (1991) 105 ALR 421.

116. For an in-depth consideration of the law in this area, see M Markovic "The Law of Shadow Directorships" (1996) 6 *Australian Journal of Corporate Law* 323.

The overlap between advice and direction and instruction

The definition of shadow director appears to contemplate a difference between *advice*, which is usually communicated at a distance, and *instruction* which implies involvement in the affairs of the company.

Concern has been raised whether or not advice in certain circumstances can amount to "instruction". The English decision of *Re Tasbian Ltd (No 3)*[117] shows the danger in the possible overlap between professional advice on the one hand and direction and instruction on the other. In that case, a chartered accountant and "company doctor" was appointed as a consultant to Tasbian Ltd by a finance company. When he was appointed, Tasbian had losses of £800,000 in three years of trading. The consultant resigned prior to the company being placed in receivership with a deficiency of £1,394,000.

Prior to the receivership, Tasbian had set up "Hartbrook", another company, and transferred all the Tasbian employees to Hartbrook with an arrangement whereby they were sub-contracted back to Tasbian. Hartbrook went into liquidation and had incurred large tax and national insurance liabilities. The consultant had played a key role in Tasbian, which included monitoring its trading, control of bank accounts and reducing the operations of Hartbrook. The court held there was sufficient evidence to find the consultant was a shadow or de facto director. Under the former provision (s 592), Australian courts have sometimes imposed liability on professionals who have extended their role into management.[118] It is clear that financial institutions may be particularly at risk if liquidators can establish that the board was accustomed to acting on their instructions.[119]

Another area of perceived risk is in inter-company relationships.[120] In *Standard Chartered Bank of Australia Ltd* v *Antico*,[121] the court considered whether one company had taken part in the management of a second company so that it was a shadow director of the second company (and therefore liable under former s 556 for the insolvent trading of the second company). The court decided that in circumstances where there was "actual control" of the second company's management decisions by the first company, and where the second company's board accepted that control, then the first company was a shadow director for the purposes of s 556. However, the power to appoint or remove directors does not of itself make a company a shadow director of another company.[122]

For a company to be caught by s 9 would require evidence that the second company was accustomed to act on the first company's instructions or directions. This may depend

117. [1992] BCC 358.

118. *3M Australia Pty Ltd* v *Kemish* (1986) 4 ACLC 185.

119. G Soyrota, "Insolvent Trading: Hidden Risks for Accountants and Banks Participating in 'Work Outs'" (1993) 23 *University of Western Australia Law Review* 329 at 334. See also *Kuwait Asia Bank EC* v *National Mutual Life Nominees Ltd* [1990] 3 All ER 404, where it was held that two directors on the board appointed by the bank were not agents of the bank, as the appointees only constituted two out of the five directors on the board. In this case there was no allegation that the bank's appointees were accustomed to act on the direction or instruction of the bank and in those circumstances the bank was not a shadow director.

120. Section 588V.

121. (1995) 13 ACLC 1, 381.

122. Ibid at 1, 437.

on how the directions or instructions were given to the ailing companies board, as in *Dairy Containers Ltd* v *NZI Bank*,[123] where the emphasis was on the form or content of identifiable instructions or directions. The acceptance of the first company's decisions by the second company, without careful consideration, may be sufficient to attract liability under s 588G.[124] Such evidence would amount to the second company's affairs effectively being run by the first company.

The above analysis has shown that the s 9 definition of director is far-reaching and great care will have to be taken by corporate advisers, financial institutions and others to give advice as opposed to directions and instructions on which a board becomes accustomed to act.

Incurs a Debt

A central element of s 588G(1) is that the company incurs a debt. This phrase in the context of 588G is important because it marks the point in time when solvency of the company is judged. There is no definition of "debt" or "incurs" in the law and reliance will be placed on judicial interpretation. The cases have focused on what legal obligation constitutes a debt and what liabilities and obligations amount to the incurring of a debt.[125] The authorities have developed categories of circumstances which have led to inconsistencies in the application of the phrase. Recently, several principles have emerged to give directors and their advisers guidance.

A debt has been defined as an obligation that is obtainable for a liquid sum and includes a contingent liability.[126] The words "incurs" and "debt" were considered by Gleeson C J in *Hawkins* v *Bank of China* where His Honour stated:[127]

> The words "incurs" and "debt" are not words of precise and inflexible denotation . . . the word "incurs" takes its meaning from its context and is apt to describe, in an appropriate case, the undertaking of an engagement to pay a sum of money at a future time, even if the engagement is conditional and the amount involved uncertain.

For a "debt" to exist there appears to be a requirement of a positive act on the part of the company to bring it into existence.[128] Where the company has not taken positive action to incur the "debt" and it has been imposed, as in the case of an award of damages, it may not constitute a debt for the purposes of s 588G.[129] The word "incurs" implies the

123. *Dairy Containers Ltd* v *NZI Bank Ltd; Dairy Containers Ltd* v *Auditor General (*1995) 7 NZ CLC 260 at 783. See also *Re Hyrodam (Corby) Ltd* [1974] 2 BCLC 180.

124. Markovic, supra, n 116 at 340.

125. J Mosley, "Insolvent Trading: What Is a Debt and When Is One Incurred?" (1996) 4 *Insolvency Law Journal* 155.

126. *Hawkins* v *Bank of China* (1992) 7 ACSR 349 at 358 per (Gleeson C J and Sheller J A).

127. Ibid at 357–8.

128. *Castrisios* v *McManus* (1991) 9 ACLC 287.

129. *Jelin Pty Ltd* v *Johnson* (1987) 5 ACLC 463.

undertaking of an engagement, to pay a sum of money in the future, even if the engagement is conditional and the amount uncertain.[130]

The phrase "incurs a debt" is confined to debts which the company incurs voluntarily, and only contractual obligations including payment of money and contingent liabilities will fall within its scope.[131] Past decisions have indicated that it does not apply to creditors in a number of circumstances. The words have raised difficulties where companies have entered into commercial transactions such as guarantees and leases. Such instances have raised complex issues of contingent liabilities and contractual obligations involving a consideration of the point in time the debt was incurred. One commentator suggests that the use of the expression in former s 556 frustrated the purpose of the insolvent trading provisions, as the provisions should have encouraged company directors to take early steps to tackle emerging difficulties or promptly take voluntary administration procedures.[132] Some members of the judiciary have indicated that the words are not precise or flexible,[133] while others have thought the words are apt.[134]

The courts have determined that the expression requires consideration from the point of view of commercial reality,[135] insisting on a flexible approach to the expression.[136] Although the retention of the expression "incurs a debt" in the past led to some inconsistencies and anomalous results,[137] the courts are prepared to interpret the expression in a way that is practical to commerce.

Judicial analysis of "incurs a debt"

Most of the judicial consideration of "incurs a debt" has been in relation to former s 556. A major problem for the courts in interpreting the insolvent trading provisions was that the elements of the provision were directed to a point in time, rather than to the overall circumstances of the trading.[138] This was reflected in a number of decisions.[139] One of the

130. *Hawkins* v *Bank of China* (1992) 7 ACSR 349 at 358 per Gleeson CJ and Sheller JA.

131. Ibid. Note that in *Hussein* v *Good* (1990) 8 ACLC 390 it was held that "incurring a debt" did not include a contingent liability. See also R C Williams, "Fraudulent Trading" (1986) 4 *Companies and Securities Law Journal* 14 at 23.

132. Herzberg, supra n 56 at 295.

133. *Hawkins* v *Bank of China* (1992) 10 ACLC 588 (Gleeson C J and Sheller J A).See also *Quick* v *Stoland Pty Ltd* (1998) 29 ACSR 130.

134. *Hawkins* v *Bank of China* (1992) 10 ACLC 588 at 599 (Kirby P).

135. *Standard Chartered Bank* v *Antico* (1995) 18 ACSR 1 at 55. See also *Quick* v *Stoland Pty Ltd* (1998) 29 ACSR 130.

136. *Hawkins* v *Bank of China* (1992) 10 ACLC 588.

137. *Metal Manufacturers* v *Lewis* (1988) 13 NSWR 315.

138. The decision of Justice Rogers in *Australia Pty Ltd* v *Watt*; *NEC Home Electronics Australia Pty Ltd* v *White* (1984) 2 ACLC 621, was one of the first to point out that the mini code, as he referred to ss 556, 557 and 558, exhibited difficulties in interpretation. However, he thought the words of s 556 were clear, and that the section was available to a "creditor who can make out the facts required to be proved to enliven the section". In His Honour's opinion, s 556(1) established both criminal and civil liability where a debt is incurred without reasonable grounds for payment.

139. *Halpern Nominees Pty Ltd* v *Martin* (1986) 4 ACLC 393; *John Graham Reprographics* v *Steffens* (1987) 5 ACLC 904; *Hussein* v *Good* (1990) 7 ACSR 710.

failings of the courts' interpretation of the elements in former s 556(1)(a) was the number of decisions which relied upon the interpretation placed on its predecessor, s 303(3), even though the language was different. In *Shapowloff* v *Dunn*,[140] the High Court preferred to look at when the liability arose, not when the debt was computed, in considering when the debt was contracted.[141] In the circumstances of that case the debt was contracted by the company on the date the broker bought the shares. This narrow approach was carried over to s 556(1)(a) with some justification.[142]

However, little consideration was given to the fact that s 303(3) provided for the *contracting of a debt* as opposed to *incurs a debt* in s 556(1), suggesting a different legislative purpose. It has been asserted by some commentators that *incurs a debt* is confined to debts which a company incurs voluntarily, and involves the payment of money — only contractual obligations fall within its scope.[143]

It has been successfully asserted that no course of action for a debt can arise until such time as delivery of the goods is made. In *Hussein* v *Good*[144] it was held that the debt is incurred when goods are delivered and the payment is due. However, a debt has been found not to be incurred where money is accepted and goods are not supplied, because in those circumstances the person has an action for damages for breach of contract.[145] In relation to the delivery of goods, in *Hussein* the court focused on the point of time the company becomes committed to the debt. In the case of delivery of goods, the court will look at the company's solvency at the time the debt was contracted. As a consequence, the use of the term *incurs a debt* in s 556(1) and s 592(1) did not apply to pre-contractual negotiations but only to contracts entered into for payment. This is also borne out in *3M Australia Pty Ltd* v *Kemish*,[146] where Foster J was of the opinion that, for a plaintiff to successfully rely on s 556(1), he or she had to establish the existence of facts at the time of incurring the debt.[147] A similar approach was taken by Connolly J in *John Graham Reprographics Pty Ltd* v *Steffens*,[148] where His Honour decided that period interest on the outstanding balance of a trading account was a debt incurred at the time when the terms of the account were agreed upon, not each month when the interest accrued.

In *Jelin Pty Ltd* v *Johnson*,[149] a judgment for damages for misleading or deceptive conduct did not constitute the "incurring of a debt" for the purposes of s 556. This was considered to be an event which was beyond the control of directors. The court

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140. (1981) 148 CLR 72.
141. Ibid at 78 (Stephen J).
142. In *Australia Pty Ltd* v *Watt*; *NEC Home Electronics Australia Pty Ltd* v *White* (1985) 3 ACLC 324, Rogers J did not see the need to refer to s 303(3) as he considered s 556(1) to be self-contained.
143. R C Williams, "Fraudulent Trading" (1986) 4 *Company and Securities Law Journal* 14 at 23; considered by A Herzberg, "Insolvent Trading" (1991) 9 *Company and Securities Law Journal* 285 at 292.
144. (1990) 8 ACLC 390. See also *Hamilton* v *Abbott* (1980) 5 ACLR 390.
145. *Reed International Books Australia Pty Ltd (t/as Butterworths)* v *King & Prior Pty Ltd* (1993) 11 ACLC 935.
146. (1986) 10 ACLR 371.
147. Ibid at 377.
148. (1987) 5 ACLC 904; see also *Catrisios* v *McManus* (1991) 9 ACLC 287 and *BL Lange & Co* v *Bird* (1991) 9 ACLC 1,015.
149. (1987) 5 ACLC 463.

recognised that in order for a company to incur a debt, it required a positive act on the part of the company. A similar approach was taken in *Castrisios* v *McManus*; *McManus* v *Castrisios*,[150] where the requirement of a positive act on behalf of a company precluded the finding that the incurring of sales tax by a company amounted to incurring a debt. The reasoning behind this decision was that sales tax is a consequence of the contractual agreement between the wholesaler and the person to whom they sell. It does not give rise to a debtor/creditor relationship.[151]

The difficulties of interpreting the phrase "incurs a debt" were considered at length in *Russell Halpern Nominees Pty Ltd* v *Martin*.[152] In this case the debt was incurred when the directors entered into the lease, not on each rent day. The court was of the view that this was the only logical result, otherwise if a company were to fall on bad times it might mean that directors would incur a debt on each rent day, a proposition that was unacceptable.[153]

The difficulty with the decision in *Halpern Nominees* was that it could lead to an illogical result of a company, being in a good financial position when it entered into the lease, then falling on bad times some time later, not being able to pay the rent, and escaping liability. This restricted the application of s 556(1) to rare circumstances where the company, at the time of entering into the agreement, was unable to pay its debts as they fell due. The problem with the words "incurs a debt" therefore meant that the financial position of an ailing company was directed to a point in time, rather than a consideration of its circumstances objectively. Creditors were required to point to some positive act of contracting the debt, which unnecessarily restricted the ambit of the provision. The problem was further compounded by the decision of Southwell J in *Hussein* v *Good*,[154] who held that the ambiguity in the meaning of *incurs a debt* limited the concept of debt to exclude contingent debts.

The result of decisions such as *Russell Halpern* and *Hussein* diluted the legislative impact of the provisions. They allowed a situation to arise where directors or managers of companies could purchase goods when they were solvent and avoid personal liability if the goods were delivered, some time later, at a point when the company was in financial difficulties. As one commentator has put it, this did not promote the purpose of the legislation which was to encourage "directors of insolvent companies to cease trading and invoke some form of insolvency administration".[155] The reliance upon predecessor sections by

150. (1991) 9 ACLC 287. Cox J decided not to follow *Shapowloff* v *Dunn* (1981) 148 CLR 72 and *Australia* v *Kemish* (1986) 10 ACLR 371. The obligation to pay sales tax was not "incurring a debt" within the meaning of 556(1)(a) because the sales tax legislation recognised the difference between tax and debt.

151. Ibid at 296.

152. (1986) 4 ACLR 393.

153. In *Rema Industries and Services* v *Coad* (1992) 10 ACLC 530 at 536, Lockhart J noted that, 'the time when a debt is 'incurred' will vary from case to case, depending principally upon the terms of the agreement between the parties, expressed or implied".

154. (1990) 7 ACSR 710.

155. A Herzberg, "Insolvent Trading – Civil Liability of Company Officers under Insolvent Trading Provisions" (1991) 9 *Company and Securities Law Journal* 285 at 295. See also A Herzberg, "Duty to Prevent Insolvent Trading" in J P G Lessing and J F Corkery (eds), *Corporate Insolvency Law* (1995) at 8, 23.

the judiciary led to a narrow application of the provision thereby causing a less than satisfactory operation of s 556(1)(a).

It was not until *Hawkins* v *Bank of China*[156] that the phrase "incurs a debt" was given flexibility. This case concerned whether or not the giving of a guarantee constituted the *incurring of a debt* under s 556(1) of the Companies Code (NSW). In this case, the words were applied in a practical manner consistent with their statutory purpose. In departing from *Hussein*, their Honours decided that *debt* under s 556(1) included a contingent liability. Of major importance were the comments of Kirby P, who stated that it was the intention of parliament that s 556 would increase and not limit the obligations imposed upon officers of a company.[157] His Honour went on to state:

> The expression "incurs a debt" in s 556(1) is, in isolation, entirely apt to describe an act on the part of a corporation whereby it renders itself liable to pay a sum of money in the future as a debt. The act of "incurring" happens when the corporation so acts as to expose itself contractually to an obligation to make a future payment of a sum of money as a debt. The mere fact that such sum of money will only be paid upon a future contingency does not make the assumption of the obligation any less "incurring" a "debt".[158]

As a consequence of this reasoning, the court in *Hawkins* found no difficulty in holding that a debt for the purposes of s 556(1)(a) was incurred when the company entered into the guarantee under which it was obliged to pay a liquidated amount contingent upon demand following default.

Decisions that followed *Hawkins* also considered the meaning of "incurs a debt". In *Rema Industries and Services Pty Ltd* v *Coad; Re Taspac Thermoforming Pty Ltd,*[159] Lockhart J was of the view that when a debt is incurred will vary from case to case and depend upon expressed or implied agreements between the parties. In *Leigh-Mardon Pty Ltd* v *Wawn,*[160] Hodgson J was of the opinion that there was no hard and fast rule that a company incurs a debt at the time when goods are delivered to the company, and not at any earlier time.[161] His reasoning appears more flexible than *Hawkins*, finding that the debt in question was not incurred on delivery of the goods, but at the last time when the orders could have been cancelled without rendering the company liable for substantial damages. His approach is important because it clearly shows that, like *Hawkins*, there was a shift in focus away from a narrow interpretation to a flexible approach, which considered the financial position of the company in the light of commercial reality.[162]

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156. (1992) 10 ACLC 588.
157. Ibid at 599.
158. Ibid at 598.
159. (1992) 7 ACSR 251.
160. (1995) 17 ACSR 741.
161. Ibid at 749.
162. In *New England Agricultural Traders Pty Ltd* v *Adams* (1994) ATPR 42 at 707, Whitlam J held that where a number of debts are the subject of proceedings under s 592(1), the court is required to consider the circumstances existing before the incurring of each debt. See also *Opac Pty Ltd* v *Coxhead* (1994) Federal Court of Australia, Lockhart J, unreported, 14 August 1995.

Further support for this new judicial outlook is found in *Standard Chartered Bank* v *Antico*,[163] where Hodgson J was of the opinion that "a company incurs a debt when, by its choice, it does or omits something which, as a matter of substance and commercial reality, renders it liable for a debt for which it otherwise would not have been liable".[164] The relevant question facing the court was whether the continuing of a finance facility amounted to incurring a debt at the time of renegotiation. His Honour found that the receiver of financial accommodation under a bill acceptance and discount facility, does not "incur a debt" on each roll over of bills or extension of the facility, where the principal amount of the financial accommodation remains outstanding. Therefore, His Honour found that a debt is incurred in respect of interest when the company enters into a new agreement, where roll over of the bills or an extension of the facility arises. What emerges from this decision is that financing does amount to incurring of a debt under s 556 where there is a new agreement or an extension of the finance facility. Accordingly, at the time of refinancing, a director must examine the company's financial position to determine the company's ability to repay the interest and principal.

Reasonable Grounds for Suspecting

Even if a company is insolvent, before a director becomes liable under s 588G, it must be established that there were *reasonable grounds to suspect* that the company was insolvent or would become insolvent.[165] Under s 588G, the test requires that whatever is "suspected" must be based on reasonable grounds and imports into this section an objective test for suspicion. The enquiry whether there are reasonable grounds to expect that the company will not be able to pay its debt when due is a factual one to be decided in light of all the circumstances. The decisions to date have indicated that this is to be decided as a matter of commercial reality and requires a consideration of the company's entire financial condition including assets, liabilities, cash, money, loans and its ability to raise finance.

To date, there are only a few authoritative judicial considerations of the term in the context of s 588G.[166] Former s 592(1)(b) contained the expression "reasonable grounds to expect". The change in language was a result of a recommendation by the ALRC.[167] It was thought that this change of wording from "expect" to "suspect" would increase potential liability, thus encouraging directors to be more rigorous in considering the company's financial affairs and, where appropriate, initiate insolvency administration. The difference in the meaning of "expect" and "suspect" is borne out in *3M Australia Pty Ltd* v *Kemish*,[168] where it was observed that the word "expecting" is very different to

163. (1995) 18 ACSR 1.

164. Ibid at 57.

165. Section 588G(1)(c).

166. *Stargard Security Systems* v *Goldie* (1994) 13 ACSR 805. This case concerned a chamber summons for summary judgment and the court considered whether there was a defence under s588H(2). See also *Metropolitan Fire Services Pty Ltd* v *Miller* (1997) 23 ACSR 699; *Quick* v *Stoland Pty Ltd* (1998) ACSR 130 and *Muller v Dana Australia Pty Ltd* [1998] VSCA 30 (27 August, 1998).

167. Harmer Report, supra n 13, para 287.

168. (1986) 4 ACLC 185.

"suspecting', and was synonymous with "predicting".[169] The meaning of "suspicion" was also considered in *Queensland Bacon Pty Ltd* v *Rees*,[170] in the context of the variable preference provisions of s 95 of Bankruptcy Act (1924–1960) (Cth), where Kitto J observed:

> In the first place, the precise force of the word "suspect" needs to be noticed. A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust, amounting to "a slight opinion, but without sufficient evidence", as Chambers' Dictionary expresses it. Consequently, a reason to suspect that a fact exists is more than a reason to consider or look into the possibility of its existence. The notion which "reason to suspect" expresses in subsection (4) is, I think, of something which in all the circumstances would create in the mind of a reasonable person in the position of the payee an actual apprehension or fear that the situation of the payer is in actual fact that which the subsection describes — a mistrust of the payer's ability to pay his debts as they become due and of the effect which acceptance of the payment would have as between the payee and the other creditors.[171]

A helpful guide to the interpretation of "reasonable grounds to suspect" is provided by Einfeld J in *Metropolitan Fire Services Pty Ltd* v *Miller*. In this case, His Honour recognised the application of an objective test in assessing reasonableness and said:

> Irrespective of how the test is formulated, it is one of objectively reasonable grounds, which must be judged by the standard appropriate to a director of ordinary competence . . . Questions of knowledge of and participation in the incurring of the relevant debt are now relegated to the status of factual matters which may arise should the director seek to establish one of the statutory defences afforded by the legislation. The establishment of liability is therefore not contingent on elements personal to the respondents.[172]

Although it has not been completely decided what meaning will be given to "suspect" in the context of s 588G, it is clear there is now a higher standard of care expected of directors. There is good reason to assume the judiciary will interpret "suspect" in a way that will make directors more accountable.[173]

However, the introduction of the word "suspect" is not without criticism, as some commentators have questioned its effectiveness[174] and alleged that it shifts the balance towards protecting creditors by promoting a risk-adverse culture.[175] It has also been criticised on the basis that it is not a commercial term and directors should not be expected to make important business decisions on grounds of suspicion.[176] These criticisms may

169. Ibid at 192.
170. (1965) 115 CLR 266.
171. Ibid at 301.
172. *Metropolitan Fire Services Pty Ltd* v *Miller* (1997) 23 ACSR 609 at 704.
173. N Coburn, 'When a Director Suspects Insolvency: The New Insolvent Trading Provisions' (1996) 5 *Corporation Law Bulletin* 74.
174. R P Austin, 'The Corporate Law Reform Bill — Its Effect on Liability Holding Company Debts of Subsidiary' (1992) 6 *Corporation Law Bulletin* 103.
175. J Dabner, 'Trading Whilst Insolvent — A Case for Individual Creditor Rights Against Directors' (1993) 17 *University of New South Wales Law Journal* 562.
176. Ibid.

prejudge the operation of the word in the context of s 588G. There is little basis to suggest that the word "suspect" has over-reached its mark so as to place entrepreneurship at risk.

Failure to Prevent the Incurring of Debt: Section 588G(2)

In order for personal liability to be imposed upon a director for breach of s 588G, not only must s 588G(1) be satisfied but s 588G(2) must also.

Section 588G(2) is contravened if a director fails to prevent the company the incurring the debt in circumstances where:

- the director was aware at the time there were such grounds for suspecting that the company is insolvent, or would become insolvent by incurring the debt; or
- a reasonable person in a like position in a company in the company's circumstances would have been aware.

Paragraph (a) of s 588G(2) is subjective and requires a director to be aware that there were grounds for suspecting insolvency. Paragraph (b) is objective and requires an assessment of whether or not a reasonable person in a like position in that company's circumstances would become aware.

Therefore, in order to be liable under s 588G, the director does not have to be aware at the time the company incurs the debt that there are reasonable grounds for suspecting the company is insolvent or would become insolvent. But there must be facts and circumstances that point to the fact that the director should have been aware. The phrase "in a like position", will enable the court to look at any special expertise held by the individual director and the size and functions of the company.[177]

It appears that paragraph (a) of s 588G(2) is superfluous and its subjective element is inconsistent with the objective elements in s 588G(1). It is envisaged that most liquidators would not proceed under paragraph (a) of s 588G(2), but would instead ask the court to consider the financial information and circumstances and seek to apply the test in s 588G(2)(b); that is, whether or not a reasonable person in a like position in the company had grounds for suspecting insolvency.

Section 588G (3) Criminal Offence

Section 588G (3) contains a criminal offence for contravening 588G in circumstances of dishonesty. The Corporate Law Economic Reform Program Act 1999 (CLERP), which commenced operation on 13 March 2000, removed the criminal consequences of breaching s 588G previously contained in s 1317FA of Part 9.4B of the Corporations Law. Former s 1317FA had made it an offence to contravene a civil penalty section where a person did so knowingly, intentionally or recklessly, or dishonestly intending to gain an advantage, or intending to deceive or defraud.

177. Corporate Law Reform Bill 1992, Explanatory Memorandum, para 39.

As a result of the CLERP Act, the criminal consequences of breaching s 588G are now contained in s 588G (3). A director commits an offence if he or she suspected the company to be insolvent and dishonestly failed to prevent the company incurring the debt.

The new provision is very different from s 1317FA which was complex and required a range of mental elements to be proved. The new s 588G(3)(d) refers only to a person acting dishonestly in failing to prevent the company incurring the debt. The term "dishonestly" is defined by a developed body of criminal legal authorities.[178]

Under the former criminal provision (s 1317FA), the court had the choice of imposing a civil penalty order where a criminal prosecution failed. Parliament has now taken away this option. Under the new s 588G(3), where a criminal prosecution has failed, ASIC will have to commence fresh proceedings to obtain a civil penalty order. The new Part 9.4B only deals with the civil consequences of contravening a civil penalty section.

The Definition of Solvency

The definition of insolvency is integral to the workings of s 588G and the possible consequences that can result. Section 95A defines solvency. Subsection (1) provides a "person is solvent if and only if, the person is able to pay all the persons debts as and when they become due and payable". The provision then explains in subsection (2) that a person who is not solvent is insolvent. By s 85A, *person* is defined to include a "body corporate" as well as an individual. Therefore, insolvency is expressed as the inability of a company to pay its debts as and when they become due and payable. The section suggests that a cash flow test is to be applied when determining a company's ability to pay its debts.[179]

The definition introduced in s 95A does not represent a significant departure from the traditional definition of insolvency contained in s 122(1) of the Bankruptcy Act (Cth) 1966, which provides for insolvency in circumstances where a person "is unable to pay his debts as they became due from his own money". The definition of insolvency contained in the 1992 draft legislation included (in addition to the words in s 95A(1)) the expression "from the person's own money". The Explanatory Paper indicates that this expression did not exclude liquid funds to which the company has access through borrowing or mortgaging or selling assets within a reasonable period.[180] However, the words *from the person's own money* were excluded from final legislation. It appears unlikely that the change from the draft to final legislation is a substantial amendment given the Explanatory Memorandum did not comment specifically on the change. Because the new solvency definition uses similar wording to that contained in s 122(1) of the Bankruptcy Act (Cth), it is likely that the courts will use authority in relation to s 122(1) to give meaning to s 95A.[181] This is

178. For example see: *R* v *Brow* [1981] VR 783, *R* v *Harvey* [1993] 2 Qd R 389, *R* v *Bonollo* [1981] VR 633, *R* v *Love* [1989] 17 NSWLR 608 and *R* v *Gosh* [1982] QB 1053.
179. A Keay, "The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations" (1995) 21 *Monash University Law Review* 305 at 307.
180. Corporate Law Reform Bill 1992, Exposure Draft Legislation and Explanatory Paper, para 571.
181. For an analysis of s 122(1) of the Bankruptcy Act, see D Fernon (ed), *Bankruptcy Law & Practice* at [122.1.05].

supported by the one reported decision to date on s 588G, which considered authorities that had analysed s 122(1) of the Bankruptcy Act to determine the ambit of s 95A.[182]

One of the oldest Australian decisions to consider insolvency is *Bank of Australasia* v *Hall*.[183] This decision indicated that the test of solvency, the ability to pay debts as they fell due, was not a simple mechanical test of assets over liabilities. Griffiths C J said:

> It was suggested, but the argument was not pressed, that the debtor's affairs should be regarded from the point of view of a balance sheet of assets and liabilities. This is not what the statute says . . . The question is not whether the debtor would be able, if the time were given him, to pay his debts out of his assets but whether he is presently able to do so with moneys actually available.[184]

In *Rees* v *Bank of New South Wales*,[185] solvency was not determined solely by cash on hand but included other factors such as the ability of a person to raise finance through the selling or mortgaging of assets. Barwick C J said:

> It is quite true that a trader, to remain solvent, does not need to have ready cash by him to cover his commitments as they fall due for payment, and that in determining whether he can pay his debts as they become due regard must be had to his realisable assets. The extent to which their existence will prevent a conclusion of insolvency will depend on a number of surrounding circumstances, one of which must be the nature of the assets and in the case of a trader, the nature of his business.[186]

In *Sandell* v *Porter*,[187] insolvency did not mean a temporary cash crisis but required a consideration of all of the debtor's circumstances. In Barwick CJ's view, "the conclusion of insolvency ought to be clear from a debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity".[188] In so stating, His Honour pointed out that insolvency was the debtor's inability to utilise cash resources through the command of his assets. This view was reiterated in *Hymix Concrete Pty Ltd Limited* v *Garrity* where Jacobs J said "a temporary lack of liquidity must be distinguished from an endemic shortage of working capital whereby liquidity can only be restored by a successful outcome of business ventures in which existing capital has been deployed".[189]

There is also authority to indicate that the test of insolvency excludes asset realisation programs, where the debtor has to sell part of a business in order to pay creditors.[190] The element of time and the debtor's ability to met the due date for payment is a factor that has been taken into consideration.[191] The possibility of future trading profitability is not

182. *Stargard Security Systems Pty Ltd* v *Goldie* (1994) 13 ACSR 805 at 811
183. (1907) 4 CLR 1514. See also Re *Newark Pty Ltd (in liq)* (1993) 1 Qld 409 at 413.
184. Ibid at 1528.
185. (1964) 111 CLR 210.
186. Ibid at 218.
187. (1966) 115 CLR 666.
188. Ibid at 670.
189. (1977) 13 ALR 321 at 328.
190. *Re Timbatec Pty Limited* (1974) 24 FLR 30 at 36.
191. *Expo International Pty Ltd* v *Chant* [1979] 2 NSWLR 820 at 839.

relevant to the issue of inability to pay debts,[192] although one commentator points out that the use of the word "all" requires the director to forecast the company's financial position into the future.[193]

In *Dunn* v *Shapowloff*, Mahoney J interpreted the words "ability to pay" by applying a commercial reality test and said:

> What will constitute ability to pay must be determined in a realistic way by reference to the facts of each case after taking into consideration, inter alia, the company's assets and liabilities and the nature of them and the nature and circumstances of the company's activities.[194]

Such considerations include the company's ability to borrow. O'Bryan J in *Heide* v *Lester*,[195] in considering a company's ability to pay took into account all credit and cash resources available to the company.

Section 95A was also considered by Master Bredmeyer in *Stargard Security Systems Pty Ltd* v *Goldie*[196] in relation to an application for summary judgment for the defendant to pay compensation for loss and damage because of a breach of s 588G. In assessing whether the company was insolvent, the Master had regard to the earlier authorities that considered s 122(1) of the Bankruptcy Act. Consideration was given to the average weekly cash flow of the company prior to the incurrence of the debt and also to weekly cash flow predictions and expectation of sales and returns of the product. The Master was of the view that "in assessing solvency or insolvency, it is relevant to look not only at the company's likely income, but also at the company's likely debts".[197]

One of the most recent decisions on s 95A is by Einfeld J in *Metropolitan Fire Services Pty Ltd* v *Miller*.[198] In this case, His Honour said that is was necessary to consider the whole of the company's resources, including its credit resources. Part of this determination may include taking into account the time extended to the company to pay its creditors and the time it will receive payment of its debts.[199] In *Quick* v *Stoland Pty Ltd*,[200] another decision which considered s 95A, the court pointed to a number of relevant issues for determining whether a company is insolvent:

- all of the company's debts as at the relevant time in order to determine when those debts were due and payable;

192. *Sheahan* v *Hertz Australia Pty Ltd* (1994) 14 ACSR 209. However, profit forecasts have been taken into consideration. See *TNT Channel 9* v *Scotney* (1995) 17 ACSR 116 and *Stargard Security Systems Pty Ltd* v *Goldie* (1994) 13 ACSR 805.
193. S Pollard, "Fear and Loathing in the Boardroom: Directors Confront New Insolvent Trading Provisions" (1994) 22 *Australian Business Law Review* 392 at 403.
194. (1978) ACLC 40–451 at 30, 147.
195. (1990) 3 ACSR 159 at 165.
196. (1994) 13 ACSR 805.
197. Ibid at 814. See also *Leslie* v *Howship Holdings Pty Ltd* (1997) 15 ACLC 459 and *In the Matter of Simionato Holdings Pty Ltd* (1997) 15 ACLC 477.
198. (1997) 23 ACSR 699.
199. Ibid at 703.
200. (1998) 29 ACSR 130.

- all of the company's assets as at that time in order to determine the extent to which those assets were liquid or realisable within a time frame that would allow each of the debts to be paid;
- expected cashflow from the business by deducting from projected future sales the cash expenses which would be necessary to generate those sales; and
- arrangements between the company and prospective lenders, such as its bankers and shareholders, in order to determine its liquidity, realisable assets and cashflow.[201]

In a recent unreported decision,[202] the court considered the terms of the company's overdraft facility; the company's failure to pay trade creditors according to the terms of trading; the company's inability to provide funds to cover cheques of even modest amounts; the company's failure to meet a series of demands from creditors accompanied by threats of legal action; and its inability to meet essential services such as insurance, electricity and telephone.

When is a Debt "Due and Payable"?

The word "due" has been interpreted according to its ordinary usage and means payable.[203] In *3M Australia Pty Ltd* v *Kemish*, Foster J said:

> I am satisfied that a debt does not necessarily become due . . . upon the date originally stipulated for payment. I consider it proper to take into account arrangements made by the company with the creditor for extended time for payment, even if where such arrangements would not be contractually binding upon the creditor.[204]

Accordingly, a debt does not necessarily become due on the date stipulated for its payment, as the court in assessing solvency can take into consideration any extensions of time permitted by a creditor.[205] However, as pointed out in *Calzaturificio Zenith Pty Ltd (in liq)* v *NSW Leather and Trading Co Pty Ltd*,[206] it is necessary to make an appropriate calculation to decide when creditors have to be paid and the debts are likely to be received in order to decide whether the company is able to pay its debts as they fall due.

In considering an extension of trading terms, the due time for payment may be where the parties have agreed to vary the contract.[207] In deciding the due date, the courts have taken account of arrangements with creditors and the course of dealings between the

201. Ibid.

202. *Mullenger* v *Dana Australia Pty Ltd* [1998] VSCA 30, unreported Supreme Court of Victoria, 27 August 1998.

203. *Carrier Air Conditioning* v *Kurda* (1993) 11 ACSR 247 at 254 and *Pioneer Concrete Pty Ltd* v *Ellston* (1995) 10 ACLR 289 at 301. For a consideration of the application of "due and payable" under other statutes, see *Cort* v *Winter* (1844) Coll 320 at 321, 322 (per knight Bruce V-C); *Re Stockton Malleable Iron Co* (1875) 2 CH D 101 at 103; *Re Airedale Garage Co Ltd; Anglo South American Bank Ltd* v *Airedale Garage Co* [1933] 1 Ch 64 at 78–9 (Per Lord Hanworth MR).

204. (1986) 10 ACLR 371 at 378.

205. *Pioneer Concrete (Vic)* v *Stule* (1996) 14 ACLC 534. This case followed *Re Newark Pty Ltd (in liq)* (1991) 6 ACSR 255 in preference to *Carrier Air Conditioning* v *Kurda* (1993) 11 ACSR 247.

206. [1970] VR 605.

207. *Re Newark Pty Ltd (in liq)* (1991) 6 ACSR 255 and *Calzaturificio Zenith Pty Ltd (in liq)* v *NSW Leather and Trading Co Pty Ltd* [1970] VR 605.

parties.[208] Where there are no trading terms agreed, the court may look to the custom of the industry.[209] Several recent authorities have indicated that a debt is due when the relevant contract says it is due, subject to any agreements or considerations which make it reasonable to regard the debt as not being due.[210]

In summary, the assessment of insolvency depends on the circumstances of the company. It is apparent that s 95A invokes a cash flow test. The determination of a company's ability to pay all its debts as and when they become due and payable is a question of fact to be decided as a matter of commercial reality in the light of all the circumstances. The court is likely to consider "the company's financial position in its entirety including activities, assets, liabilities, cash, money which it could procure by sale or on the security of its assets, and its ability to obtain financial assistance by way of loan or subscription for share capita".[211]

Having now reviewed the elements of s 588G, the next step in this analysis is to consider the defences available to a director who has breached the s 588G prohibition. The s 588H defences are considered in the next part of this chapter.

Part Three

The Defences to Insolvent Trading

Introduction

The defences contained in s 588H of the Corporations Law introduce both new wording and new defences into the insolvent trading provisions. There are four defences under section 588H. In summary, these are as follows:

(i) where the director had reasonable grounds to expect that the company was solvent at the time the debt was incurred (s 588H(2));
(ii) where the director relied on information from a competent and reliable person responsible for providing information about the company's solvency (s 588H (3));
(iii) where the director was ill or not involved in the management of the company for some other good reason (s 588H(4)); and
(iv) where the director took reasonable steps to prevent the incurring of the debt (ss 588H(5) and (6)).

Because the new defences reuse some of the language contained in the previous provisions (s 566 and s 592) this part will at times consider how the courts interpreted the old provisions to assist the analysis in relation to the new defences.

208. *Australia Pty Ltd* v *Kemish* (1986) 10 ACLR 371 at 378.

209. *Re Newark Pty Ltd (in liq)* (1991) 6 ACSR 255. See also *ASIC* v *Lawless*, Magistrates Court, Hobart, Magistrate Mr Hill, unreported 19 December 1995, 8. In this case the prosecution accepted the custom of 60-day payment in the printing industry.

210. *Sycotex Pty Ltd* v *Baseler* (1994) 122 ALR 531; *Chartered Bank* v *Antico* (1995) 18 ACSR 1 at 73.

211. *Standard Chartered Bank* v *Antico* (1995) 18 ACSR 1 at 71. See also *Metropolitan Fire Services Pty Ltd* v *Miller* (1997) 23 ACSR 699.

Reasonable Grounds to Expect Solvency: 588H(2)

The first defence contained in s 588H(2) is drawn from former s 592(2)(b) and provides:

> 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.

Former s 592(2)(b) absolved a director or manager of a company from liability if they did not have *reasonable cause to expect* that the company would not be able to pay all its debts when they fell due, or if the company incurred the debt in question it would not be able to pay all its debts as they fell due.

There were arguably several classes of identifiable judicial approaches to former s 592(2)(b), which resulted in a conflict as to the circumstances of the availability of the defence. The first approach was that of Carruthers J in *Pioneer Concrete Pty Ltd* v *Ellston*,[212] which adopted the statements of Wilson J in *Shapowloff* v *Dunn*.[213] The second identifiable approach was that of Foster J in *3M Australia Pty Ltd* v *Kemish*,[214] which was developed by Hodgson J in *Metal Manufacturers* v *Lewis*.[215] The third was the decision of Ormiston J in *Statewide Tobacco Services Ltd* v *Morley*,[216] followed by Tadgell J in *Commonwealth Bank* v *Friedrich*.[217] The argument will be developed that the inadequacies of s 592(2)(b) were borne out in the number of decisions which attempted to reconcile the policy assumptions with the provision. This part will argue that one of the main failings of the courts was an inability to grasp that the provisions should have been read in conjunction with the directors' responsibilities contained in other parts of the legislation.

The liberal approach

In *Pioneer Concrete*[218] Carruthers J considered the operation of the defences under s 556(2)(b), and that the words "reasonable cause to expect" required a blending of subjective and objective considerations. In doing so he relied heavily on the decision of Wilson J of the High Court in Shapowloff.[219] Carruthers J observed the change in language from "reasonable grounds to expect" in subsection 1(b) to "reasonable cause to expect" in

212. (1985) 10 ACLR 289.
213. (1981) 148 CLR 72.
214. (1986) 10 ACLR 371.
215. (1986) 11 ACLR 122.
216. (1990) 8 ACLC 827.
217. (1991) 5 ACSR 115.
218. (1985) 10 ACLR 289.
219. (1981) 148 CLR 72. Wilson J said: "The prosecution must prove beyond reasonable doubt that at the same time of contracting the debt, the defendant himself had no expectation, reasonably grounded in the whole of the circumstances then existing as he knew them of being able to pay the debt. It will be seen that the test involves a blending of subjective and objective considerations. The test of reason imports an objective standard, but it is to be applied to the facts as known to the defendant."

subsection (2)(b) and held that a defendant relying on subsection 2(b) had to prove at the time each debt was incurred that: "he had no cause reasonably grounded in the whole of the circumstances then existing as he knew them to expect that the company would not be able to pay all its debts as and when they became due or that if the company incurred that debt it would not be able to pay all its debts as and when they fell due."[220]

In blending subjective and objective considerations he found on the facts before him that the company could not have hoped to pay all its debts as they fell due and in the circumstances the director was personally liable for the debts. By contrast, Hodgson J in *Metal Manufacturers*[221] was critical of this approach. In his view, it did not concentrate sufficiently on the wording of s 556(2)(b), which was significantly different to the old s 303(3) of the Companies Act 1961, and there had been no attempt by Carruthers J to consider the meaning of the ordinary language contained in the provision.

Despite Hodgson J's observations, Connolly J, in *John Graham Reprographics Pty Ltd* v *Steffens*,[222] took the same approach as Carruthers J. Interestingly enough, there was a crucial difference. Connolly J referred to the test as "an objective standard that is to be applied to the facts as known to the defendant".[223] In applying this principle, he considered the prospects of the bank advancing money to the defendant, and the financial state of affairs of the company in the light of the defendant's knowledge. In view of these considerations he concluded that the company's ability to pay all its debts as they fell due was no more than "a pious expectation".[224]

Further acceptance of the approach in *Pioneer Concrete* is found in the decision of O'Bryan J in *Heide Pty Ltd t/a Farmhouse Smallgoods* v *Lester*[225] who determined that the view of Carruthers J in *Pioneer Concrete* was a succinct and an appropriate approach to follow.[226] In following *Pioneer Concrete*, His Honour found that: "a recent history of the company's financial performance provided no reasonable ground for a director to expect that the company might suddenly find sufficient cash resources to eliminate its debts already due and payable . . . the question must be asked whether the defendants had reasonable cause to expect the matters set out in sub clause (i) or (ii) of subsection (1)."[227]

In considering the facts before him O'Bryan took into account the defendants' actions at the time, and in particular a scheme they had embarked upon to free their privately owned property from the bank at the expense of trade creditors. In the light of all these considerations, His Honour was of the opinion that the defendants had no confidence in the viability of the company, and any hope of paying all the company's debts as they fell due was "unjustified optimism".

220. *Pioneer Concrete Pty Ltd* v *Ellston* (1985) 10 ACLR 289 at 301.
221. (1986) 11 ACLR 122.
222. (1987) 5 ACLC 904.
223. Ibid at 911.
224. Ibid.
225. (1990) 8 ACLC 958.
226. Ibid at 964.
227. Ibid at 967.

Emergence of the narrow approach

The importance of *3M Australia Pty Ltd* v *Kemish*[228] is that it was considered in *Metal Manufacturers*[229] by Hodgson J who adopted a different approach toward the interpretation of s 556(2)(b). Therefore, *Metal Manufacturers* must be considered in the light of the decision of Foster J in *Kemish*. In *Kemish*, Foster J thought the correct approach was that taken by Wilson J in *Shapowloff*[230] but developed his own unique line of enquiry. Foster J considered that whether or not there were *reasonable grounds to expect* that the company would not be able to pay all its debts depended on the director's knowledge at the relevant time and the grounds of expectation considered objectively. His Honour said:

> (a) whether the defendant on the balance of probabilities had in fact no "cause to expect" that the company would not be able to pay all its debts as they fell due, such an answer to this enquiry would depend upon the defendant's own state of knowledge at the time and his managerial past within the company.
>
> (b) the next step is to inquire whether this ignorance or failure to properly interpret the "grounds" of expectation to pay the debts was objectively reasonable. This would depend upon the degree to which a person was themselves obligated to inform themselves of the financial position of the company, and also dependant upon their state of health at the time of incurring the debt or their absence from the company at the relevant time.[231]

His Honour also envisaged that in deciding whether a defendant had *reasonable cause to expect*, the court might also have regard to some circumstances not known to the defendant, if their ignorance was not objectively reasonable.

Although, Hodgson J in *Metal Manufacturers*[232] agreed with the substance of Foster J's decision, he considered that it might be read as placing too much of a burden on a defendant. In particular, Hodgson J pointed out that in former s 303(3) the onus was on the prosecution to establish that a person did not have *reasonable grounds to expect* the company would be able to pay its debts as they fell due. In s 556(2)(b) the onus shifted to the defendant. In analysing the defences, Hodgson J considered that the words "reasonable cause to expect" imported circumstances actually known to the defendant, and circumstances which the defendant ought to know, having regard to his position in the company.[233] This was his objective standard of reasonableness. Given this definition of "reasonable cause to expect" he was of the opinion, unlike Foster J, that the best approach to the provision was to ask if the defendant proved that he did not have *reasonable cause to expect* that the company would be unable to pay its debts as they fell due.[234]

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228. (1986) 10 ACLR 371.
229. (1986) 11 ACLR 122.
230. (1981) 148 CLR 72 at 81.
231. *3M Australia Pty Ltd* v *Kemish* (1986) 4 ACLC 192–3.
232. (1986) 11 ACLR 122.
233. Ibid at 129.
234. Ibid at 130.

There are two points to be made in relation to these decisions. First, it is interesting that despite some discernible differences between the approach of Carruthers J in *Pioneer Concrete* and that of Foster J in *Kemish*,[235] both decisions found that no defence was available to the directors or managers in the circumstances. The second point to emerge is that both Carruthers J and Foster J considered that the authorities in relation to s 303(3) and s 374C of the Companies Act applied with equal force to the construction of s 556(2)(b), pointing out that the major difference was that under s 556(2)(b) the defendant bore the onus of proof. Both judges also considered and accepted the applicability of the reasoning in *Shapowloff*[236] to s 556.

Highlighting directors' responsibilities

The third identifiable approach is that of Ormiston J in *Statewide Tobacco Services Ltd* v *Morley*,[237] who was of the opinion that a defence under s 556(2)(b) would only be made out if the director was able to prove that he or she had no *reasonable cause* to believe that the company was insolvent. The expectation in the paragraph related in part to the enquiry that a director or manager should make about the company's solvency.[238]

In taking this approach, His Honour found that the defence in paragraph (b) was general and as the paragraph was written in the negative, the ability of a company to pay its debts as and when they became due was a question of *reasonable cause to expect*, directed at the financial position of the company generally.[239] The conclusions reached by Ormiston J are, to a large extent, similar to those reached by Kirby P in the NSW Court of Appeal decision in *Metal Manufacturers* v *Lewis*, several years earlier.[240] The test that Ormiston J adopted for s 556(2)(b) was a much wider version of the Hodgson J approach at first instance in *Metal Manufacturers*.[241] Ormiston J put less weight on what a director knows and placed greater emphasis on what he or she reasonably ought to have known in relation to the ability of the company to pay its debts. Like Kirby P, Ormiston J considered that the legislature, by enacting amendments to the insolvent trading provisions, had required directors to act with greater responsibility than they had been required to do under the previous legislation. The decision of Ormiston J was subsequently approved by the Full Court of the Supreme Court of Victoria.[242]

The difficulties of paragraph (b) were also considered by Tadgell J in *Commonwealth Bank of Australia* v *Friedrich*.[243] Eise was the Honorary and part time Chairman of the National Safety Council of Australia, Victorian Division (NSC). Friedrich was the Chief

235. (1986) 10 ACLR 371.
236. (1981) 148 CLR 72.
237. (1990) 8 ACLC 827.
238. Ibid.
239. Ibid.
240. (1988) 13 ACLR 357.
241. (1986) 11 ACLR 122.
242. *Statewide Tobacco Services Ltd* v *Morley* (1992) 8 ACSR 305.
243. (1991) 9 ACLC 946.

Executive Officer. The State Bank of Victoria (subsequently acquired by the Commonwealth Bank) lent over $97 million to the NSC. Because of fraudulent activities on the part of Friedrich, the NSC accounts showed excess assets over liabilities. The NSC accounts were the subject of qualified auditors reports. The auditors did not express an opinion on the large number of assets of the company held in containers supposedly full of safety equipment. Those assets did not exist.

Eise and another director signed off on the company's accounts which were purported to have been approved at a board meeting. Eise had not read the qualified auditors accounts, nor had the board considered the company's accounts. Eise sought to avail himself of the defence under s 556(2)(b) as he did not suspect or know of the fraudulent conduct by Friedrich.

In finding that Eise could not rely upon the defence contained in s 556(2)(b), Tadgell J decided that "reasonable cause to expect" meant that the court considered what the defendant knew together with what he ought reasonably to have known.[244] In doing so he accepted the approach of Ormiston J[245] and Kirby P[246] and considered paragraph (b) objectively. He distinguished *Shapowloff* on the basis that that decision had considered s 303(3) of the uniform code and was not relevant to s 556.

Tadgell J directed his attention to the matters personal to the defendant. He took into account the circumstances the director found himself in at the time when the debt was incurred. In applying this test, Eise had not informed himself of the contents of the 1986 and 1987 accounts and the audit reports that would have alerted him to important matters. In particular, Eise could have taken immediate steps to verify the amounts of trade debtors and unqualified assets.[247] His Honour alluded to the fact that basic enquiries were not made that may have put Eise on notice about the fraud and observed that once verification was attempted, the fraud was detected within three days.[248]

Tadgell's J constructive knowledge approach was followed by the Full Court of South Australia in *Group Four Industries Pty Ltd* v *Brosnan*.[249] In this case, the Full Court stated that *reasonable grounds to expect* is to be considered against the background of the duties and responsibilities that the Law imposes on a director requiring each director to have an active interest in the company. This approach has been followed by other courts.[250]

Addressing the inadequacies

The development of the law in relation to s 556(2)(b) and s 592(2)(b) shows that the courts have sometimes had difficulties coming to terms with the intention and policy of the

244. Ibid at 1005.
245. *Statewide Tobacco Services Ltd* v *Morley* (1990) 8 ACLC 827.
246. *Metal Manufacturers Ltd* v *Lewis* (1988) 13 ACLR 357.
247. (1991) 9 ACLC 946 at 1005.
248. Ibid at 1006.
249. (1992) 8 ACSR 463.
250. *Leigh-Mardon Pty Ltd* v *Wawn* (1995) 17 ACSR 741 at 751.

provisions. This has partly arisen because of the different emphasis put on the provisions in earlier decisions.[251] The shortcoming of these early authorities is that they failed to appreciate that "reasonable cause to expect" in paragraph (b) should have been read against the background of the statutory duties imposed upon directors; an oversight picked up by more recent decisions.[252]

In light of obligations imposed by directors under the Law, the decisions in *Morley* and *Friedrich* were a minor advance and did no more than expose directors to what was already a requirement of the company legislation. The earlier decisions had failed to recognise an implied duty on the part of directors not to trade whilst insolvent and also did not emphasise that directors had obligations to creditors. One might have thought that it was a relatively basic responsibility for a director to know or have some idea about the company's accounts, and not to rely upon self-imposed ignorance.

The issue of the company's finances is at the heart of the company's very existence. For many years the Law has required the company to keep accounts,[253] directors to sign off on them and attest to solvency[254] and lay the accounts before the general meeting.[255] It was imperative for a director, in relation to duties of care and diligence, to know and understand the company's accounts.[256] Given these responsibilities it seems apparent that in relation to ss 556 and 592 and the policy underpinning those provisions, there is a duty upon a director to understand the company's financial position. When these matters are considered, the advances made by *Morley* and *Friedrich* were modest.

The current provision

This defence in s 588H(2) requires a person to have an expectation of solvency. The defence retains the word "expect" from the earlier provisions which makes the cases on the earlier provisions applicable.[257]

A distinguishing feature of the defence is that it contains the words "reasonable cause" rather than the former words "reasonable grounds" which were in s 592(2)(b). This accepts the argument put forward in a number of cases[258] that the words "reasonable grounds admits some flexibility in relation to subjective considerations, whereas "reasonable cause to expect" suggests that directors consider the company's finances in the future and predict an outcome.[259]

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251. *Metal Manufacturers* v *Lewis* (1986) 11 ACLR 122; *Pioneer Concrete Pty Ltd* v *Ellston* (1985) 10 ACLR 289; *John Graham Reprographics Pty Ltd* v *Steffens*; *Heide Pty Ltd (t/as Farmhouse Smallgoods)* v *Lester* (1990) 8 ACLC 958; and *3M Australia Pty Ltd* v *Kemish* (1986) 10 ACLR 371.
252. *Commonwealth Bank of Australia* v *Friedrich* (1991) 9 ACLC 949; and *Group Four Industries Ltd* v *Brosnan* (1992) 8 ACSR 463.
253. Section 286(1) Corporations Law.
254. Section 295 Corporations Law.
255. Section 250R Corporations Law.
256. Section 180(1) Corporations Law.
257. *3M Australia Pty Ltd* v *Kemish* (1986) 4 ACLC 178 at 192; *Commonwealth Bank of Australia* v *Friedrich* (1991) 9 ACLC 946 at 956.
258. *Dunn* v *Shapowloff* (1978) 2 NSW LR 235 at 244 (Mahoney J A).
259. *3M Australia Pty Ltd* v *Kemish* (1986) 4 ACLC 178 at 192.

Earlier cases will assist in determining what the standard of reasonableness should be in the context of s 588H(2). It is likely that the standard to be applied is the degree of competence and care expected of a director in the relevant position.[260] A possible weakness of the defence in s 588G(2) is borne out in Ormiston J's decision in Morley,[261] where in interpreting "reasonable grounds to expect" in s 556(2)(b), His Honour expected directors to take responsibility in relation to the financial affairs of the company, but not play an investigative role unless they were put on enquiry.[262] The use of the word "cause" suggests that a director would not have to make enquiries about solvency if there was no cause, but only form a view if the information came to the director. Therefore, the use of the word "cause" in the context of s 588H(2) suggests that a director must have some grounds, reason or motive for action.

A recent case which considered s 588H(2) does not go into any great detail in analysing this defence, however, the court examined the financial circumstances of the company and the directors conduct in the circumstances of the insolvency.[263] The court was of the view that there were facts known to the defendant about the financial affairs of the company that prevented the director in the circumstances from having reasonable grounds to expect solvency of the company.

Reliance on Another: s 588H(3)

The *reliance on other person* defence recognises the size of many companies and allows a director to establish, on reasonable grounds, a defence if he or she expected that the company was solvent by relying on information from a competent and reliable subordinate, responsible for providing information about the solvency of the company. This defence orginated in a recommendation of the ALRC.[264]

Section 588H(3) provides:

> Without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when the debt was incurred, the person:
>
> (a) had reasonable grounds to believe, and did believe:
>
> (i) that a competent and reliable person (**"the other person")** was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and
>
> (ii) that the other person was fulfilling that responsibility; and
>
> (b) expected, on the basis of information provided to the first-mentioned person by the other person, 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.

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260. *Commonwealth Bank of Australia* v *Friedrich* (1991) 5 ACSR 115 at 126; and *Standard Chartered Bank* v *Antico* (1995) 18 ACSR 1 at 74–5.

261. *Statewide Tobacco Services* v *Morley* (1990) 2 ACSR 405.

262. Ibid at 431.

263. *Fabric Dyeworks (Australia) Pty Ltd* v *Behaharon*, Unreported Supreme Court of Victoria — Court of Appeal, May 1998 — BC9802051.

264. Harmer Report, supra n 13 at Chap 5, Vol 2 para 306.

It was considered by the ALRC that this defence may encourage a proper system of financial management. The focus on the defence is not that the person is competent or reliable, but whether there were reasonable grounds to believe that was the case.[265] It is suggested by some commentators that, while it is not stated, it requires a director to take a partially active role in the company by ensuring the creation of proper procedures and delegations,[266] and operates to place a higher standard on directors.[267]

In *Capricorn Society Ltd* v *Linke*,[268] directors were able to avoid liability on the basis that they had made regular enquiries about the financial position of the company and were given positive reports by an active director who they relied upon, and they were not involved in the day to day management of the business.

It is not clear what enquiries should be made of a person's competence. It appears that a person may be competent yet dishonest, and where the director has no reason to expect the dishonesty then the directors might be able to establish a defence under subsection (3).

Under the defence, it would appear that a director's responsibility in a large or small company would be limited to asking for and receiving financial figures on a regular basis, and if there are no factors to arouse suspicion, then a director would be taken to have acted reasonably in relying on the other person. Ormiston J[269] commented in relation to the insolvent trading provisions:

> Directors cannot be required to make their own further investigations or to "audit" the accounts provided, unless they have particular responsibilities or expertise, and they can only be required to seek more information if the company's accounts, together with any other information from the company's executives put them on inquiry.[270]

In recent years the failure of directors to make proper enquiries when all seemed "above board" has led to some catastrophic results.[271] It may not be sufficient for a director to merely obtain information, as there are cases which suggest that a director must also enquire into the basis of the information received.[272] The defence may therefore be interpreted with an emphasis on appropriate enquiries.

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265. Ibid para 307.
266. R Baxt, "New Insolvent Trading Rules for Directors" (1993) 9 *Company Director* 12.
267. Pollard, supra n 194 at 407.
268. (1995) 17 ACSR 101.
269. *Statewide Tobacco Services* v *Morley* (1990) 2 ACSR 405.
270. Ibid at 431.
271. *Daniels* v *Anderson; Hooke* v *Daniels; Daniels* v *AWA Ltd* (1995) 16 ACSR 607 (AWA case); G P Stapledon, "The AWA Case and the Availability to Auditors of the Defence of Contributory Negligence" (1995) 13 *Company and Securities Law Journal* 513; J Rawsley, *Going for Broke, Nick Leeson and the Collapse of Barings Bank* (1995).
272. *Commonwealth Bank of Australia* v *Friedrich* (1990) 5 ACSR 115.

Illness or Other Good Reason: s 588H(4)

A director may avoid liability under s 588H(4) if the director was not in a position to influence the financial affairs of a company at the relevant time.[273] Section 588(4) provides:

> If the person was a director of the company at the time when the debt was incurred, it is a defence if it is proved that, because of illness or for some other good reason, he or she did not take part at that time in the management of the company.

A possible interpretation of this defence is that it presupposes that if a director is involved in the operation of the company, then the person is absolved of liability, if it can be established that at the relevant time the *debt was incurred*, the person was ill or had a good excuse for not being involved. Even if the defence is interpreted differently, it will open a "Pandora's box" as the words "ill" or "for some other good reason" have very wide meanings. An illness may involve any number of contingencies.[274] One is hopeful that the words are to be interpreted in the light of a director acting diligently.[275] It has been argued that the defence will prove too difficult to rely upon[276] and that it does not advance the legislative purpose.[277]

One commentator makes the point that the defence seems to assume that had the director participated in management at the relevant time, either the debt would not have been incurred or steps would have been taken to minimise the harm.[278]

Reasonable Steps to Prevent Incurring a Debt: s 588H(4)

Section 588H(4) provides:

> It is a defence if it is proved that the person took all reasonable steps to prevent the company from incurring the debt.

The policy behind this defence is to reward responsible directors and encourage those who recognise that the company is in financial difficulties and take steps to cease trading or initiate appropriate insolvency administration to minimise possible loss to creditors.[279] The defence is based on s 214(3) of the United Kingdom Insolvency Act (1986) which only absolves directors from liability for wrongful trading where every step has been taken to minimise potential loss to the company's creditors.

273. Harmer Report, supra n 13 at Chap 5, para 312.
274. G Monsterrat, "Commonwealth v Christopher Skase: A matter of Life or Death or a Nomination for an Oscar?"(1995) 18 *University of New South Wales Law Review* 502.
275. Corporate Law Reform Bill 1992, Explanatory Memorandum, para 1086.
276. Pollard, supra n 212 at 407
277. A Herzberg, "Insolvent Trading Down Under" in J Ziegel (ed), *Current Developments in International and Comparative Corporate Insolvency Law* (1994) at 510.
278. Ibid.
279. Harmer Report, supra n 13 at Chap 5, Vol 2 para 310; see also 436A(1) Corporations Law.

However, unlike its British counterpart, the defence is assisted by pointing to elements that establish *reasonableness*[280] and gives consideration to action taken to appoint an administrator. The court may consider when that action was taken and the result of the director's action in appointing an administrator. Other reasonable steps would include informing the creditor that credit should not be advanced and resignation if other directors wish to continue to trade.

The section ties in with both Part 5.3A that encourages the appointment of an administrator[281] if directors think there is a likelihood of insolvency and also the discretion given to the court to consider the actions of a director in relation to the imposition of a civil penalty.[282]

This defence is in line with the legislative purpose to encourage directors to take responsibility when the company is in difficult financial circumstances, and to absolve them from liability if they have acted diligently and were unable to prevent the incurring of the debt. The defence recognises the efforts of honest directors who react quickly when the company finds itself in financial difficulties, and encourages voluntary administration.

Sections 1317S and 1318

Under s 1317S, where proceedings are brought against a director to pay compensation because of a breach of s 588G and it appears to the court that the director has, or may have, contravened s 588G but that:

> (i) the director acted honestly; and
>
> (ii) having regard to all the circumstances of the case, the director ought fairly to be excused for the contravention,
>
> the court may relieve the director either wholly or partly from liability because of the contravention.

Section 1317S was introduced by the Corporate Law Economic Reform Program Act 1999 and came into operation on 13 March 2000. It addressed conflicting interpretations of courts as to whether s 1318 was available to directors in relation to breaches of the insolvent trading provisions.

Under s 1318(1) the court has power to relieve a person from liability in civil proceedings for negligence, default, breach of trust or breach of duty, where the person has acted honestly and, having regard to all the circumstances of the case, the person ought fairly to

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280. Section 588H(6) [Elements proving reasonableness]

"In determining whether a defence under subsection (5) has been proved, the matters to which regard is to be had include, but are not limited to:

(a) any action the person took with a view to appointing an administrator of the company; and

(b) when that action was taken; and

(c) the results of that action."

281. Section 436A(1)(a).

282. Section 1317S.

be excused. It was held by Tadgell J in *Commonwealth Bank* v *Friedrich*[283] that company officers could not rely upon s 1318(1) in proceedings brought under former s 556. A contrary view was taken by Bryson J in *Bans Pty Ltd* v *Ling*.[284] In *Standard Chartered Bank of Australia Ltd* v *Antico*[285] Hodgson J favoured the view of Tadgell J. The basis of his reasoning was that s 556 imposed a liability for a debt, which did not involve a "default" or "breach of duty".

However, one commentator[286] has pointed out that although this reasoning is applicable to former ss 556 and 592, s 588G has been worded differently to s 592 and "one would assume that the defendants will be able to rely on s 1318(1) as an additional defence to those provided under s 588H of the Corporations Law."[287]

This concludes our analysis of the defences to a s 588G action. The next part of the chapter describes the parties that may take action for a breach of s 588G and the possible civil and criminal consequences of such a breach.

Part Four

Litigation

Proceedings by Liquidator

One of the major reforms introduced by the 1993 insolvent trading provisions is that the liquidator has the primary right of action to bring proceedings under s 588M. The intention of this provision is to ensure equal sharing between creditors in the winding-up.[288] It is also intended to avoid a multiplicity of actions being commenced against a director by several unsecured creditors. However, the liquidator is only able to take action upon the winding-up of the company where the debt was wholly or partly unsecured or when loss or damage was suffered. The liquidator must be careful to avoid double recovery[289] and give priority to unsecured creditors in certain instances.[290]

A liquidator can recover from a director irrespective of the director being convicted or being subject to a civil penalty order.[291] The liquidator will only take action where there are sufficient funds to pay for the costs of such proceedings and an opinion of the relative chances of success will no doubt come into consideration. The possibility of an order for

283. (1991) 5 ACSR 115.
284. (1995) 13 ACLC 524.
285. (1995) 18 ACSR 1.
286. M Hyland, "Insolvent Trading: Does s 1318 apply?" (1996) 34 *Law Society Journal* 44.
287. Ibid at 45.
288. Harmer, supra n 13 at Chap 5 n 1, Vol 2 para 315.
289. Section 588N.
290. Section 588Y(1).
291. Section 588M(1)(e) and (f).

costs against a liquidator is a very relevant factor where any action is taken against a director.

Proceedings by Creditors: Section 588R

A creditor of a company being wound-up has only a secondary right to bring proceedings against a director with the written consent of the company's liquidator under s 588R.

The creditor must give the liquidator notice of intention to sue when the company begins to be wound-up.[292] The creditor must have the leave of the court to begin proceedings under s 588M if the liquidator does not consent to the creditor bringing proceedings after three months of receipt of the notice.[293] However, if the liquidator, within three months of receiving the notice, indicates to the creditor that proceedings should not be taken against a director, reasons must be given and the creditor must file the liquidator's reasons with the court. The amount recoverable is restricted to loss and damage suffered by the creditor,[294] which would usually be equal to the debt due.

It has been suggested that the greatest failing of the 1993 insolvent trading provisions was the taking away of the creditors primary right to sue.[295] There is an argument that the advancement of the principle of equal sharing does not justify the removal of the primary right from creditors. There are a number of situations where liquidators have taken years to commence action and have, in some instances, dragged their feet in liquidations.[296] In addition, the new provisions presuppose liquidation. The creditor is required to wait until the company is wound-up, and it is not always the case, especially with small companies, that they are put into liquidation. Sometimes they are deregistered. In the case of deregistration, creditors cannot compel the payment of company funds without a court order, nor are they entitled to make a claim on the unclaimed monies account administered by ASIC pursuant to s 577(4) of the Corporations Law. Although a creditor is entitled to make an application to ASIC under s 1341(2) of the Corporations Law, the critical issue is whether they have a legal or equitable interest in the monies. The general rule is that an application by creditors for payment out of the fund will be refused.[297] The only remedy for a creditor is to seek reinstatement of the company or wind-up the company, both of which involve additional expense.

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292. Section 588S.
293. Section 588T(3)
294. Section 588M(3).
295. J Dabner, "Trading Whilst Insolvent is a Case for Individual Creditors Rights Against Directors" (1994) 17 *University of New South Wales Law Journal* 547 at 566.
296. *United Tool & Dye Makers Pty Ltd (in liq)* v *J* V *Marine Motors Pty Ltd* (1992) 1 VR 266. In this case it took the liquidator four years to institute proceedings for the return of a boat from a third party.
297. *Caratti* v *NCSC* (1984) 2 ACLC 790 at 793 where Pidgeon J stated: "If contributories as such wish the proceeds as on a dissolution then their appropriate remedy would appear to be to restore the company to the Register and then to appoint a liquidator to distribute it in a way contemplated by the Act and to pay out priorities as stated in the Act."

The new provisions also take away the incentive of creditors to pursue insolvent traders, as any successful recovery requires the court to pay the company compensation equal to the amount of loss or damage.[298]

The most recent decision to interpret the operation of 588R(1) is *Quick* v *Stoland Pty Ltd*.[299] In this case the court interpreted the words "proceedings" to mean, at the very least, any process by which a claim under s 588M is made in a court of competent jurisdiction. It would also include a claim made by way of amendment to existing proceedings. In this case the director argued that the s 588M proceedings had begun without the consent of the liquidator as required by s 588R. However, the court looked at the object of the legislation and allowed the creditor to pursue the action after the liquidator's consent had been received at the stage when proceedings had already commenced.

Compensation: Sections 588M–T

Once there has been a finding that a director has contravened the statutory duty under s 588G, the court may order compensation to the company or creditor equal to the amount of the loss or damage.[300] Compensation may be awarded on a hearing or proceeding in respect of a civil penalty or criminal contravention,[301] or when the liquidator or creditor[302] institutes proceedings. Section 588J(2) provides for a liquidator to intervene and seek compensation in proceedings connected with a civil penalty action, in which circumstances the liquidator may have a right to be heard.

Unlike proceedings under former s 592 in which a creditor was only able to recover the amount of the debt,[303] the liquidator or creditor can recover *loss or damage* arising from the company's insolvency. This leaves the question of quantum of damages uncertain. It is anticipated that the loss suffered will include consequential loss. The intention of this provision is to go further than the payment of the debt in former s 592, and can take into account the benefit that the company obtained.[304] The operation of the section is different to that of former s 592 which made directors liable only to the creditor that initiated the proceedings. By contrast, the new provisions empower the court to pay the company compensation.

One commentator has pointed out that these provisions are unnecessarily complex and confusing.[305] It is interesting to note that the court will have to consider at what point in time a secured creditor suffers loss or damages in relation to a debt. Under s 588T the

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298. Section 588J(1).
299. (1998) 29 ACSR 130
300. Sections 588J(1), 588K and 588M. Note that under s 588K a criminal court may order compensation to be paid to the company.
301. Section 588M.
302. Sections 588M and 588R.
303. In *Geraldton Building Pty Ltd* v *Woodmore*, Master Bredmeyer, 18 September 1992, SC(WA) (No 155/1992), the Master decided that incurring liability for damages does not constitute the incurring of a debt.
304. Harmer Report, supra n 13 at Chap 5, Vol 2, para 317.
305. Herzberg, supra n 278 at 514.

extent of a director's liability for loss and damage is left uncertain. It is possible under the provisions that a director can be liable for an amount more than the debt. The ALRC suggests that the liability is one that will require careful consideration of the facts in each case.[306]

A recent decision involving consideration of s 588M is *Quick* v *Stoland Pty Ltd*.[307] This case described the operation of s 588M as follows:

> Where a director of a company is liable to pay the debts that were incurred by that company in consequence of the application of s588G, those debts are recoverable by the liquidator (s 588M(2)) or by the creditor (s 588M(3)). If the debts are recovered by liquidator they will form part of the estate of the company that is available for distribution among its creditors and contributories. If recovered by the creditor they will be retained by him or her.

The judgment makes it clear that a director cannot be the subject of competing claims and it is for the liquidator to determine whether proceedings are brought with the exception that a creditor can apply to the court to bring proceedings if the liquidator's consent is not forthcoming.

Presumptions — Tools to Assist Creditors, Liquidators and ASIC

The ALRC criticised former s 592 for failing to address practical difficulties faced by creditors in establishing solvency at the time the debt was incurred. The 1993 insolvent trading provisions address these concerns and assist the party trying to establish circumstances of insolvency by introducing presumptions of insolvency in s 588E.

A liquidator or creditor will be assisted where a company is shown to be insolvent at a particular time within twelve months prior to the "relation back day" which is the date of the commencement of the winding-up. There is also a presumption of insolvency (s 588E(4)) where adequate financial records are not kept or the records fail to correctly record and explain the company's transactions, or its financial position during the relevant period.

Relation back day

The presumptions operate to facilitate liquidators, creditors and ASIC establishing insolvency at a particular point in time. Section 588E(2) provides that the presumptions apply to a *recovery proceeding.*

"Recovery proceeding" is defined in s 588E(1) to include proceedings for a contravention of s 588G, s 588M (recovery of compensation for loss resulting from insolvent trading) and s 588W (recovery from holding company for insolvent trading by subsidiary). Section 588E(3) allows the presumption to be made that if a company has been proven to be insolvent on a particular date during the 12 months prior to the relation back date, then

306. Harmer Report, supra n 13 at Chap 5, Vol 2, para 318.
307. (1998) 29 ACSR 130.

the company is insolvent from that time until the relation back date. This presumption has the effect that once the liquidator proves insolvency at a point in time, insolvency after that point in time is presumed.

Inadequate accounts

Section 588E(4) provides that a presumption of insolvency will arise where the company has failed to keep adequate financial records as required by s 286. The presumption will not arise if it can be shown that the contravention was due to the destruction of records outside the director's control.[308] The presumption does not apply if the failure to keep financial records is only minor or technical.[309] This presumption is a significant step forward for liquidators and creditors. It was recognised by the ALRC that the absence of books of account made it difficult to reconstruct the financial position of a company and therefore determine whether it had been engaging in insolvent trading at the relevant time.

It may be argued that s 588E does not go far enough. This is because insolvency usually exists prior to the commencement of a formal insolvent administration. Creditors under former s 592 were put to the expense of reconstructing a picture of the company's financial affairs. To overcome this, the ALRC proposal presumed a company to be insolvent during the 90 days before the winding-up commenced. This retrospective approach would have been more practical for liquidators and creditors. However, the government was of the view that any potential benefit that would be derived from this approach did not justify the element of retrospective liability which it would impose.[310] By not adopting the ALRC recommendation, liquidators and creditors will still be put to considerable expense in establishing an insolvent profile of the company unable to pay its debts if the presumptions are inapplicable. The crucial time for establishing insolvency will always be the time prior to the commencement of the winding-up.[311]

Notwithstanding this criticism, the presumptions are beneficial as they go some way to overcoming the problems in former s 592 and its predecessor, which required a person to establish insolvency at the time the debt was *incurred*.

Civil Contravention of s 588G

Contravention of s 588G will attract the civil liability provisions of the Corporations Law.

On a declaration by a court of breach of s 588G, ASIC may seek under the civil penalty provisions a pecuniary penalty order, a disqualification order or a compensation order. A company may also seek a compensation order but not a pecuniary penalty order or a

308. Section 588E(6).
309. Section 588E(5).
310. Corporate Law Reform Bill 1992, Explanatory Memorandum, para 1019.
311. J Schultz, "Liability of Directors for Corporate Insolvency" (1993) 5 *Bond Law Review* 191 at 200 arguing that the government should not have rejected the ALRC recommendation. See also Herzberg, supra n 278 at 506.

disqualification order. No-one but ASIC or a company damaged by the contravention may seek these orders.[312]

The court proceedings are civil proceedings in terms of the application of rules of evidence and procedure.[313] This means that there must be proof on the balance of probabilities that there has been a contravention of a civil penalty provision rather than proof beyond reasonable doubt.

Pecuniary penalty order

Where a court has declared a breach of s 588G, the court may order a director to pay a pecuniary penalty of up to $200,000 if the contravention:

- materially prejudices the interests of the company or its members; or
- materially prejudices the company's ability to pay its creditors; or
- is serious.[314]

Disqualification order

Where a court has found a breach by a director of s 588G, the court may also disqualify that person from managing companies for a period that the court considers appropriate if the court is satisfied that the disqualification is justified. In determining whether the disqualification is justified, the court may have regard to:

- the director's conduct in relation to the management, business or property of any company; and
- any other matters that the court considers appropriate.[315]

Compensation order

If a director has contravened s 588G and damage has resulted from the contravention, then the court may order the director to compensate the company for damage suffered by it. The damage suffered by the company for the purposes of making a compensation order includes any profits made by the person resulting from the contravention.[316]

Criminal Penalties

A director who breaches s 588G commits an offence and can be subject to criminal penalties if the director's failure to prevent the company from incurring the debt (which led to

312. Section 1317J.
313. Section 1317L.
314. Section 1317G.
315. Section 206C.
316. Section 1317H.

insolvency) was dishonest.[317] A director who has acted in this manner may be fined up to $200,000 or imprisoned for up to five years or both.[318]

Criminal proceedings may be started against a director for contravention of s 588G regardless of whether:

- a pecuniary penalty order;
- a compensation order; or
- a disqualification order;

has been made against the director.

Part Five

Insolvent Trading and Enforcement

Introduction

ASIC is the key statutory body responsible for the regulation of insolvent trading. Part of its charter is to "take whatever action it can take, and is necessary, in order to enforce and give effect to the national scheme laws".[319] The intention of this part of the chapter is to give a general overview of the regulation of insolvent trading and consider how ASIC carries out its regulatory functions and which enforcement and preservative powers are open to ASIC to protect shareholders, creditors and investors to ensure compliance with the Corporations Law.

Recent research has highlighted the effect of insolvent trading, indicating that at least 36 percent of the small- to medium-enterprise community is harmed by other businesses involved in insolvent trading.[320] Therefore, rigorous law enforcement in this area has become a necessity. It has been recognised by insolvency practitioners that there is an emergence of a business culture that views the non-payment of debt as leading to economic damage with flow on results for all companies.

How does ASIC enforce the Law in relation to insolvent trading? One strategy has been the establishment of a small business program as part of its national enforcement strategy to target phoenix companies and insolvent activities. The program contained specialist lawyers, accountants and investigators. Its purpose was to promote compliance with the Corporations Law and minimise loss to creditors through public education, surveillance of high-risk companies, administrative remedies and enforcement action. However, as a result of recent Government funding cuts to ASIC in the June 2000 budget

317. Section 588G(3).
318. Schedule 3.
319. Section 1(2)(g) Australian Securities and Investments Commission Act, 1989.
320. ASIC Research Paper 95/01, 11.

the Small Business Program was discontinued. The insolvent trading investigations are now handled by general investigative units throughout ASIC.

Public Education and Enforcement

Research

ASIC has undertaken research with the objective of providing material upon which it could make informed decisions in targeting insolvent trading. An ASIC report has enabled it to detect early warning indicators of insolvency.[321] The report focuses on examples of insolvency and concerns of the small- to medium-sized enterprises sector.

The statistical and quantitative findings of the report point to a general need for many directors, especially in small- and medium-sized companies, to more clearly understand their responsibilities. The report indicates that 36 per cent of small- to medium-sized companies have been financially harmed by insolvent trading activities by other companies and over 62 percent of people interviewed believed that insolvent trading was relevant to their business. The issue is also significant from an ASIC enforcement perspective, as insolvent trading accounts for 24 percent of all the complaints received.

From a practical point of view, the study made two interesting points. First, the cause of insolvent trading for small to medium companies appears to be under-capitalisation upon commencement and through their trading history. Secondly, the legal and accounting tests of insolvency are difficult to apply due to the highlyprofessional judgment required.[322] One of the report's policy recommendations was that ASIC should target educational activities as opposed to prosecutions to ensure compliance with the insolvent trading provisions.[323]

Community awareness

To assist people being informed about insolvent trading and other problem areas in the securities industry, ASIC has run an education campaign, introduced a "hot-line" information service and made available printed material on numerous areas of the Corporations Law.[324] Community awareness remains important since recent information indicates that only five percent of respondents in the small- to medium-sized business sector thought insolvent trading was illegal.[325]

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321. ASIC Media Release, 96/22.
322. Ibid.
323. Ibid.
324. For example, see: ASIC, "Don't get burned: How to avoid shonky operators, phoenix companies and fly by nights". ASIC Information Sheet 35 ASIC, *External Administrations*, Information Book (June 1995); and ASIC, *Don't Kiss Your Money Goodbye: How to Choose a Financial Adviser*, Information Book (1992).
325. ASIC Research Paper 95/01, 11.

Surveillance

ASIC surveillance strategy relating to insolvent trading activity, besides creating awareness of director obligations, seeks to detect and deter contravention of the insolvent trading provisions. Surveillance may involve ASIC officers requesting and obtaining books and records through the service of notices, making inquiries into company activities and seeking budget forecasts and explanations about financial statements.

Where there are unpaid inter-company loans or transactions, ASIC may request the company to prepare full financial statements and interview the company's accountant or auditor to determine solvency. There have been many instances where ASIC has expressed particular concerns following surveillance, and directors have then sought specialist advice to remedy internal financial problems.

Overview of ASIC investigative powers

The powers available to ASIC in the investigation of criminal offences apply to the investigation of a civil penalty contravention including the insolvent trading provisions. This is because of s 13(1)(a) of the Australian Securities and Investments Commission Act (1989) (ASIC Law). Accordingly, an investigation into a contravention of a civil penalty provision allows ASIC to use its coercive powers. Before exercising its general investigative powers, ASIC must *suspect* a contravention of a national scheme law.[326] Upon forming a suspicion on reasonable grounds, it may direct persons to attend an examination before an inspector[327] and/or produce books and records relating to the affairs of the company.[328]

In relation to questions asked at an examination, privilege against self-incrimination is extended to examinees who are subject to a proceeding for the imposition of a penalty. An examinee's lawyer may attend the examination. After the examination the inspector may require the examinee to read and sign the record of interview. A copy of the transcript may be given to the examinee, if the request is made in writing. Any admission made in an examination cannot be used against that person in subsequent criminal proceedings or proceedings for the imposition of a penalty, which would include civil penalty orders.[329] However, this exclusion does not apply in circumstances where the examinee makes a false statement or makes any false statement in the signing of the record of interview.[330]

In relation to the penalty provisions, ASIC can require under s1317R any person other than the alleged contravener or their legal representative to provide all reasonable assistance in connection with the application for a civil penalty order or criminal proceedings for an offence against the Law.

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326. Section 13 ASIC Law.
327. Section 19 ASIC Law
328. Sections 29, 30 and 31 ASIC Law.
329. Section 68 ASIC Law.
330. Section 68(3)(c) and (d) ASIC Law.

Enforceable undertakings

ASIC has power to obtain enforceable undertakings from persons who may have breached the Law. The power is contained in s 93AA of the ASIC Law. As a result of these provisions, ASIC can obtain an undertaking from a person to cease the conduct of concern to ASIC. This undertaking is a public document and does not disqualify ASIC from taking other criminal or civil proceedings in the future.

Deciding between civil or criminal enforcement

Although there is no formal ASIC policy regarding the circumstances in which ASIC/DPP will commence civil or criminal remedies in relation to insolvent trading, the DPP and ASIC have settled prosecution guidelines.[331]

In making a decision, ASIC/DPP weighs up a number of competing factors, which involve a determination of the occurrence of criminal dishonesty. The type of issues that may be considered are whether or not the mental element of dishonesty in s 588G(3) can be proved. Moreover, the contravention of a civil penalty provision need only be proven on the balance of probabilities, although the test for penalty provisions may require a higher standard, which has been considered as being somewhere between the balance of probabilities and beyond reasonable doubt.[332] ASIC may take the advice of the DPP that the matter may be better suited to civil remedy relief. Civil penalty proceedings would seem to be appropriate for the honest but careless director. On the other hand, criminal proceedings may be initiated in circumstances where there was dishonesty. From an operational point of view, the obtaining of "protective orders" such as a disqualification of a director is very important to ASIC to ensure the concerned conduct is discontinued.

Preserving property: s 1323

ASIC can seek relief to prevent or contain damage to corporate or individual assets through preservative actions.

ASIC or an aggrieved person can petition the court for an order under s 1323 of the Corporations Law, in circumstances where an investigation is being carried out, a prosecution is initiated, or civil proceedings have begun, where there is an alleged contravention of the Corporations Law. Under this provision, ASIC can obtain orders to provide for the freezing or transfer of money, securities or other property. Property of a person includes property that is beneficially held including through a trust, by nominee or fiduciary arrangement.[333] This type of relief is similar to a Mareva injunction and can be obtained ex parte and directed against the assets of a respondent or defendant.

331. Guidelines For the Working Arrangements Between the Australian Securities and Investments Commission and the Director of Public Prosecutions for the Investigation and Prosecution of Serious Wrong Doing (December 1992).
332. *Briginshaw* v *Briginshaw* (1938) 60 CLR 335.
333. Section 1323(2A).

Section 50 of the ASIC Law enables ASIC to commence an action on behalf a plaintiff company which would also enable ASIC to apply for a Mareva injunction.[334] ASIC uses this provision in circumstances where there is evidence to suggest a possible or intended dissipation, transfer, or removal of assets by a person or company, which requires the preservation of those assets until relevant interests can be determined.

ASIC may also apply for the appointment or interim appointment of a receiver/manager or a receiver or trustee over property of a company.[335] Although this is a useful power, it has been used by the courts with caution as it has far-reaching consequences for the administration of the company and possible devaluation of the company's assets. The courts have only granted such relief where the evidence suggests a serious fraud or the likely dissipation of assets which would otherwise be available to satisfy relevant liabilities.[336]

Other powers under s 1323 include the ability of the court to obtain a defendant's passport and order him or her not to leave the jurisdiction. In these circumstances, ASIC must demonstrate a nexus between the order sought and the necessity to protect the value of any claimant's rights as against the defendant.[337]

In the above circumstances, ASIC has the advantage of not being required to give an undertaking as to damages.[338] Court orders under the provision may operate for a specific period or may be subject to a further order.

Section 1324

This provision allows ASIC to apply for a statutory injunction to require compliance with the Corporations Law. ASIC would apply for such relief in circumstances where it suspects a person has or proposes to engage in conduct that constitutes or would constitute a contravention of the Corporations Law.[339] The provision also applies if the contravention in question affects the interests of a creditor or a shareholder if the insolvency of the company is an element of the contravention.

Section 1324 provides that on the application of ASIC or an any person whose interests are affected, the court may grant an injunction or interim injunction requiring an act to be done. The order can be made whether or not it is clear to the court that the person intends to engage in the subject conduct or the person or company is intending to refuse or failing to do an act.[340] These injunctions may be granted without the need to establish a continuity of misconduct. In considering the application, the court has to balance, on the

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334. For a practical application, see ASIC Media Release 98.
335. Section 1323(1)(h).
336. *Beach Petroleum NL* v *Johnson* (1986) 11 ACLR 566 at 571; *Bond Brewing Holdings Ltd* v *National Australia Bank Ltd* (1990) 1 ACSR 445.
337. *Connell* v *NCSC* (1989) 1 ACSR 193.
338. Section 246 ASIC Law and see *Beach Petroleum NL* v *Johnson* (1992) 9 ACSR 404 at 412.
339. Section 1324(1).
340. Section 1324(2), 1324(6) & 1324(7).

one hand, the public interest of preventing the wrongdoing and, on the other hand, the company having its commercial interests interfered with.

The advantage of this relief is that it can be obtained without ASIC having to prove continuity of misconduct or an imminent damage of substantial harm.[341] In determining whether or not to use its discretionary powers, ASIC will take all relevant circumstances into account.[342] Although, ASIC is not required to give an undertaking as to damages,[343] the lack of a damages undertaking is a material consideration for the court in determining and considering the application.[344]

Assistance given to liquidators

Where the liquidator has no funds and has demonstrated that all reasonable steps have been taken or has attempted to obtain the books, records and property of the company, ASIC, in limited circumstances has assisted liquidators to obtain a s 530C warrant from a court to obtain relevant records or company property. The liquidator might ask ASIC to assist in circumstances where it is essential for the liquidator to trace the whereabouts of missing money or assets of a company. Section 530C of the Corporations Law allows the court to issue a warrant on application of a liquidator or provisional liquidator where there is sufficient evidence to indicate that the controllers of the company have concealed or removed property of the company. ASIC, as part of its liquidators' program, has specific criteria in giving assistance, involving issues of public interest, essential furtherance of administration, lack of funds available, and availability of ASIC staff.

Conclusion

The current prohibition on insolvent trading is the end product of a long and at times imperfect process. While s 588G is undoubtedly an improvement on its predecessors, a number of the ALRC recommendations were not included in the current provisions. Nonetheless, law reform should always be regarded as a continuing rather than finite development. For ASIC, the insolvent trading provisions are a key part of its mandate to regulate the corporate sector in the interests of the broader community. Public education, enforcement and surveillance of these provisions will continue as one of the major areas of ASIC activity.

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341. Section 1324(6) and (7).
342. *ASIC* v *Sackley* (1991) 4 ACSR 739 at 747.
343. Section 1324(8).
344. *CAC* v *Lombard Nash International Pty Ltd* (1986) 11 ACCR 566.

Chapter 5

The Recovery of Employee Entitlements in Insolvency

David B Noakes*

Introduction

The rise in the number of corporate insolvencies in which employee entitlements are left unpaid has been a significant problem and a focus of law reform proposals for some time. On a number of occasions, employees have been unable to recover significant amounts in unpaid wages and other entitlements following the insolvency of their employer. The Federal Government recently enacted changes to the Corporations Law ("the Law"), contained in the Corporations Law Amendment (Employee Entitlements) Act 2000 (Cth) ("the Act"). The amendments introduced by the Act are designed to address the issue of the loss of employee entitlements upon the insolvency of the employer (the "employment situation").

The Act seeks to do this by widening the scope for the prosecution of directors who breach the prohibition on insolvent trading. The Act also introduces a new offence targeting agreements and transactions entered into with the intention of avoiding the payment of employee entitlements upon the insolvency of the employer.

However, despite the fact that the express object of the Act is the protection of employees, the amendments in practice do little to assist employees whilst at the same time failing to recognise the primary responsibility that employers have in meeting their employees' entitlements. Aspects of the Act also have wider implications that seek to over-zealously punish the directors of the insolvent company. In particular, the extension of director liability for insolvent trading to include entering into an uncommercial transaction will have general application to all uncommercial transactions and is not restricted to transactions in relation to employee entitlements.[1] Further, in commercial practice, the amendments are unlikely to be either an effective deterrent or a practical avenue to recover employee entitlements. Thus, the amendments over-reach in areas where they are not required, but fail to provide a remedy in situations where they would be appropriate.

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1. See Explanatory Memorandum to the Corporations Law Amendment (Employee Entitlements) Bill 2000 (Cth), [10] (the "Explanatory Memorandum").

This chapter conducts a preliminary explanation of the employment situation in Australia, which will allow the reforms contained in the Act to be examined in context. The chapter will then examine the legislative history that led to the passage of the Act in the federal Parliament. The amendments contained in the Act will then be considered in detail. The amendments have encountered significant criticism, and this part of the chapter will provide possible solutions to the problems raised, as well as drawing attention to some alternative approaches. The chapter will conclude that, in seeking to address the problem of unpaid employee entitlements in insolvency, the Federal Government has failed to provide a comprehensive legislative solution that properly considers the needs of employers and employees alike.

The Employment Situation

For some time now, Australia has been considering a number of options for law reform to address the complex problems that arise in corporate group insolvencies.[2] In 1993, O'Donovan wrote:

> One of the recurring features of recent company failures in Australia and overseas has been the use of complex group structures to conceal the flow of funds within the group and to subvert directors' duties. These structures have been used to disguise assets stripping and to prolong insolvent trading.[3]

Since then, schemes designed to avoid group liabilities in insolvency have become even more intricate and difficult to prosecute. The intervening years have also witnessed a discouraging rise in the phenomenon of the "phoenix company", whereby one company fails and transfers its remaining assets to a new company that is operated by the same persons.

At the same time, corporate groups are now a common occurrence, with business operating through a complex structure of groups of companies being the typical form of large modern corporate organisations.[4] The majority of large Australian companies are part of a group, a recent study finding that 89 percent of the companies surveyed had at least one controlled entity, and, on average, each company had 28 controlled entities.[5]

A recent phenomenon in Australia has been the use of complex corporate strategies to avoid obligations to pay employee entitlements on insolvency or liquidation of a

2. For a discussion of recent proposals for reform and a comparison with the overseas regulatory experience see J Farrar, "Corporate Group Insolvencies, Reform and the United States Experience" (2000) 8 *Insolvency Law Journal* 148.
3. J O'Donovan, "Grouped Therapies for Group Insolvencies", in M Gillooly (ed), *The Law Relating to Corporate Groups* (1993) at 46.
4. T Hadden, *The Control of Corporate Groups* (1983) at 1.
5. See I Ramsay and G Stapledon, "Corporate Groups in Australia" (2001) 29 *Australian Business Law Review* (forthcoming). The authors examined 415 of the Top 500 companies (measured by market capitalisation) listed on the Australian Stock Exchange, as at 28 November 1997. A "controlled entity" under the Corporations Law is a broadly defined concept that includes not only subsidiaries (where one company owns over 50 percent of the shares in another) but also other entities that are under effective control: Corporations Law, s 50AA (effective 13 March 2000). See also s 259E.

company. The employment situation first came to prominence in Australia during the waterfront dispute in 1998 between Patrick Stevedores and the Maritime Union of Australia. The Patrick group of companies undertook a corporate restructure of the group towards the end of 1997 which resulted in different group companies conducting the stevedoring business, holding assets, and employing and supplying labour. The dismissal of the entire workforce when the "employer companies" entered voluntary administration was the first time that Australian courts had examined a restructure allegedly designed to avoid obligations owed to employees, upon one or more group companies becoming insolvent. The corporate strategy allegedly employed by Patrick to dismiss the MUA employees and the lack of available remedies were the source of much academic debate.[6]

Since then, Australia has witnessed a series of high-profile corporate insolvencies that have left employees without their entitlements. In 1998, 267 workers lost their jobs when their employer, Cobar Mines Pty Ltd, went into liquidation. Cobar's parent company refused to pay the $10.5 million in holiday, long service and retrenchment entitlements owed to workers. In December 1998, the national companies regulator, the Australian Securities and Investments Commission (ASIC) concluded an investigation into the liquidation of Cobar, resulting in the employees being paid almost all their entitlements.[7] Similarly, in June 1999, the Oakdale coalmine near Camden in NSW was closed, 125 employees were dismissed and $6.3 million in entitlements was left unpaid. The Federal Government's solution to the Oakdale insolvency was to use the coal industry long-service leave fund to pay the moneys owed to the workers. In January 2000, the textile and clothing manufacturer National Textiles Limited entered voluntary administration, leaving 314 employees owed $11.1 million in accumulated entitlements. A subsequent investigation by ASIC resulted in no charges being laid against the directors, despite evidence that the company had been under-capitalised since 1996 and was operating with a net deficiency in group assets of $52 million.[8]

Finally, in November 2000, receivers were appointed to the national manufacturing group, Steel Tank and Pipe (STP), leaving 150 employees owed up to $3.3 million in entitlements. The STP insolvency is notable for the allegation that it followed a corporate

6. See generally G Orr, "Conspiracy on the Waterfront" (1998) 11 *Australian Journal of Labour Law* 159; R Baxt and T Lane, "Developments in Relation to Corporate Groups and the Responsibilities of Directors – Some Insights and New Directions" (1998) 16 *Company and Securities Law Journal* 628; D Kingsford Smith, J Riley and L Aitken, "Unveiling the Waterfront: Corporate Veil, Directors' Duties and Voluntary Administration" (1998) 10 *Butterworths Corporation Law Bulletin* [172], 7; P Darvas, "Employees Rights and Entitlements and Insolvency: Regulatory Rationale, Legal Issues and Proposed Solutions" (1999) 17 *Company and Securities Law Journal* 103; D Noakes, "Dogs on the Wharves: Corporate Groups and the Waterfront Dispute" (1999) 11 *Australian Journal of Corporate Law* 27; D Noakes, "Reform to the Law of Corporate Groups in Australia to Protect Employees" (2000) 34 *University of British Columbia Law Review* (forthcoming).

7. Australian Securities and Investments Commission, "ASIC Brokers $6.5m Cobar Settlement", *Press Release* (7 December 1998).

8. Report to Creditors by the Voluntary Administrator of National Textiles Limited (Receiver and Manager appointed) (Administrator appointed) (ACN 056 983 432) (14 February 2000), 52. For an analysis of the National Textiles insolvency see D Noakes, "Corporate Groups and the Duties of Directors: Protecting the Employee or the Insolvent Employer?" (2001) 29 *Australian Business Law Review* (forthcoming).

restructure which had the effect of placing the workers jobs and entitlements in a perilous position. According to press reports, STP is alleged to have set up assetless companies to employ the majority of the employees, with separate companies owning the assets. The STP insolvency bears a striking similarity to the waterfront dispute (discussed above), where the corporate restructure to place workers within shelf companies was alleged to have been done in order to make it easier to dismiss the employees.

All of the above examples of the employment situation have involved the operation of corporate groups. Corporate groups have been a particular feature of the employment situation due to the fundamental principle in corporate law that a company has a separate legal personality from that of its shareholders. Therefore, the limited liability available to each group company provides the mechanism whereby it is possible to manipulate the structure of the group to avoid legal liability for a particular course of action, such as by transferring assets amongst several group companies to ensure that assets are removed from the reach of employees.

The History of the Act

Ministerial Council for Corporations

Amendments to the Law to address the employment situation were first canvassed in July 1999 by the Federal Treasurer and the Ministerial Council for Corporations (MINCO), which considered the introduction of criminal or civil liability for company directors for failure to recover employee debt in insolvency. The Treasurer and MINCO recommended the introduction of measures to:

- strengthen the existing prohibition against insolvent trading, so that directors would be in breach of the Law if they entered into an uncommercial transaction which led to the company's insolvency; and
- introduce a new offence to prevent directors from entering into arrangements or transactions that avoided payment of employee entitlements.

The proposal would have created "a civil or criminal penalty, specifically designed to prevent the misuse of company structures by directors to avoid payment of employee entitlements."[9] According to one commentator, in order for a director to avoid a penalty under this proposal, the test for wages could be satisfied where the company had successfully "quarantined" the money from claims to other creditors, in the event of insolvency.[10] Similarly, the test for redundancy payments could be met where a director had made reasonable quantification of, and provision for, redundancy payments in the event of insolvency.[11]

9. See the Hon Jeff Shaw QC, MLC "The Protection of Employee Entitlements" (Paper presented at the Australian Centre for Industrial Relations Research and Training Conference, "Re-thinking Collective and Individual Rights at Work: A Reflection and Outlook", Sydney, 16 July 1999) 3.
10. Ibid at 11.
11. Redundancy payments are a special case, as an employee is not entitled to a redundancy payment unless termination of their employment occurs in specific circumstances: ibid at 12.

The Ministerial Discussion Paper

In August 1999, the Federal Minister for Employment, Workplace Relations and Small Business, the Hon Peter Reith MP, released a Ministerial Discussion Paper addressing the loss of employee entitlements upon employer insolvency.[12] The Discussion Paper proposed either the introduction of a capped safety-net scheme to be jointly funded by the state and federal governments through revenue raised from payroll tax, or the introduction of a compulsory insurance scheme to guarantee employees a proportion of their lost entitlements.[13] On 8 February 2000, Mr Reith announced that the scheme had been approved by the government.[14] The scheme is currently operating as an interim measure (with $55 million in funding) and is being administered by the Department of Employment, Workplace Relations and Small Business.[15]

The Discussion Paper also referred to the proposal by MINCO to amend the Law, and noted:

> The Coalition Government believes that these changes together will provide a strong incentive for directors to behave responsibly without impacting on genuine entrepreneurial activity. They will impose a much stronger legislative framework to protect employees in a manner which the great majority of employers, who are committed to meeting their obligations, will accept as necessary.[16]

Parliamentary Joint Statutory Committee on Corporations and Securities

The Corporations Law Amendment (Employee Entitlements) Bill 2000 (Cth) ("the Bill") was introduced into the House of Representatives on 17 February 2000, and was read for a second time and passed on 15 March 2000. The Bill sought to introduce the two proposals endorsed by MINCO and the Federal Government.

On 8 March 2000, the Senate referred the Bill to the Parliamentary Joint Statutory Committee on Corporations and Securities ("the Committee") to report on 6 April 2000. The Committee was established under s 241 of the Australian Securities and Investments Commission Act 1989 (Cth). Its statutory duties include inquiring into the operation of the Corporations Law, or of any other law that appears to affect significantly the operation of the Corporations Law. The Committee invited written submissions on the proposals in the Bill and conducted a public hearing on 5 April 2000.

On 10 April 2000, the Committee published its Report on the Bill ("the Report"). The Report recommended that the Bill should be passed. However, on 10 May 2000, the

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12. The Hon Peter Reith MP, "The Protection of Employee Entitlements in the Event of Employer Insolvency", Ministerial Discussion Paper (August 1999).
13. Ibid at [34].
14. See The Hon Peter Reith MP, "National Scheme to Protect Employee Entitlements", *Press Release* (8 February 2000).
15. It is beyond the scope of this article to discuss the operation of the scheme. See discussion by C Hammond, "Insolvent Companies and Employees: The Government's Year 2000 Solutions" (2000) 8 *Insolvency Law Journal* 86, 88–90.
16. The Hon Peter Reith MP, supra n 12 at [32].

non-Government parties in the Senate sent the Bill back to the House in an amended form. The amendment sought to introduce court-sanctioned contribution orders against related companies of the insolvent employer, as an additional reform to address the loss of employee entitlements.[17] This would involve giving a court the discretion to make contribution orders in certain circumstances, thereby transferring the obligations of insolvent companies to pay employee entitlements to related companies that are solvent. On 7 June 2000, the House of Representatives rejected the proposed contribution order amendments and sent the Bill back to the Senate. On 26 June 2000, the Labor Party did not insist on the amendment in the Senate and accordingly, the Bill was passed in its original form. The Bill commenced upon the granting of assent by the Governor-General on 30 June 2000.

Liability for Insolvent Trading and Uncommercial Transactions

Directors to be personally liable for uncommercial transactions

Creditors (including employees) who are left out of pocket following the insolvency of an Australian company are able to seek recovery from the directors if the directors allowed the company to trade when it was insolvent.[18] As the Explanatory Memorandum notes:

> Section 588G is directed at protecting the rights of creditors, and provides that a director of a company which *incurs a debt* when it is insolvent, or becomes insolvent by incurring the debt, contravenes a civil penalty provision. Civil penalties and criminal sanctions may flow from a breach of the duty not to engage in insolvent trading, including director's personal liability for the debts incurred. However, s 588G does not cover the situation where a company confers a financial benefit on another party rather than incurring a debt.[19]

In addition, creditors already benefit under the Law from provisions aimed at the avoidance of uncommercial transactions.[20] However, the coverage provided by the Law in this respect is not comprehensive. The Explanatory Memorandum notes that "[t]here is currently no duty on directors not to engage in a non-debt uncommercial transaction where the company is or becomes insolvent, and no penalty for doing so."[21]

Therefore, the first amendment to the Law deems that a company incurs a debt for the purpose of the insolvent trading provisions when it enters into an uncommercial transaction, thereby extending the current duty of directors not to engage in insolvent trading.

However, as Hammond has noted, deeming something which is not otherwise a debt as a debt is problematic, and may require remedial legislation in order to clarify the legislative intent.[22] In its present form, the new provision may be read down to apply only to those

17. For a discussion of contribution orders in the context of the employment situation, see D Noakes, "Dogs on the Wharves: Corporate Groups and the Waterfront Dispute", supra n 6 at 53–61.
18. Corporations Law, ss 588M, 588R–588U.
19. Explanatory Memorandum, supra n 1 at [6].
20. Corporations Law, ss 588FA–FJ. See H A J Ford, R P Austin and I M Ramsay, *Ford's Principles of Corporations Law* (9th ed, 1999) at [27.220].
21. Explanatory Memorandum, supra n 1 at [8].
22. See Hammond, supra n 15 at 91–2.

uncommercial transactions which are taken to constitute the incurring of a debt involving some form of outflow of money or value from the company.[23] This is obviously not the legislative intent of the provision, as evidenced by the Explanatory Memorandum.

Under the new provision, liability for directors will arise at the time that the company enters into an uncommercial transaction (other than one ordered by a court or directed by a prescribed agency).[24] As is the case with the other insolvent trading provisions, directors will be able to rely upon certain defences, including where the director reasonably believed that the company was solvent at the time of the transaction.

Under the new provision, a transaction will be deemed "uncommercial" in accordance with s 588FB of the Law. This section provides that a transaction is "uncommercial" if a reasonable person in the company's circumstances would not have entered into the transaction having regard to:

- the benefits, if any, to the company in entering the transaction;
- the detriment to the company of entering the transaction;
- the respective benefits to other parties to the transaction as a result of entering into it; and
- any other relevant matter.

Under s 588FB, a transaction may also be deemed to be uncommercial even though a creditor of a company is a party to the transaction.

The Explanatory Memorandum to the Corporate Law Reform Bill 1992 (Cth),[25] which introduced s 588FB (as part of the new Part 5.7B), stated:

> The provision is specifically aimed at preventing companies disposing of assets or other resources through transactions which resulted in the recipients receiving a gift or obtaining a bargain of such magnitude that it could not be explained by normal commercial practice.[26]

The Explanatory Memorandum to the Corporate Law Reform Bill also stated that the provision is aimed at transactions where "the consideration is nominal or trivial or lacks a 'commercial quality'".[27]

Recent cases on the definition of "uncommercial transaction" in s 588FB have adopted a purposive interpretation,[28] referring to the aims of the section as outlined above.

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23. Ibid at 92.
24. See Corporations Law, ss 588G(1A)(7). The Explanatory Memorandum notes that the proceeds of an uncommercial transaction that a company is ordered to enter into by the court would be available for distribution to creditors, but the director(s) involved would not be liable under this subsection for complying with the order. The Explanatory Memorandum also notes that the amendment provides the scope to specify in the regulations relevant agencies which may make orders or directions that will not fall within the scope of the duty: see Explanatory Memorandum, supra n 1 at [9].
25. Commonwealth, Explanatory Memorandum to the *Corporate Law Reform Bill* 1992 (Cth).
26. Ibid at [1044].
27. Ibid.
28. In accordance with s 109H of the Corporations Law, which provides that:
    "In the interpretation of a provision of this Law, a construction that would promote the purpose or object underlying the Law (whether that purpose or object is expressly stated in the Law or not) is to be preferred to a construction that would not promote that purpose or object."

The Full Federal Court, in *Demondrille Nominees Pty Ltd* v *Shirlaw*,[29] stated that the object of the section is to prevent a reduction in the assets of the company that is being wound up by certain "transactions at under-value" entered into within a specified period prior to insolvency.[30] Young J, in *McDonald* v *Hanselmann*,[31] considered that "the test when dealing with situations where there is a sale at an under-value by a company about to be wound up is whether there was a bargain of such magnitude that it could not be explained by normal commercial practice".[32] Young J also noted that the purpose of the provision was "mainly to stop transactions to related entities or to relatives".[33]

Austin J, in the recent case of *Lewis* v *Cook*,[34] referred to the above decisions on s 588FB and concluded:

> The section was intended to emphasise the objective nature of the inquiry – not an inquiry into what the particular company might have done, but rather into whether a reasonable person would have not entered into the transaction. However, although the inquiry is objective, the Court must have regard to "the company's circumstances" — which includes the state of knowledge of the company when it enters into the transaction.[35]

Austin J also referred to the Full Federal Court decision in *Tosich Construction Pty Ltd (in liq)* v *Tosich*,[36] and stated that "[w]here the transaction is entered into or authorised by the board of directors, as here, the section requires an assessment of the state of knowledge of the directors . . ."[37]

The courts will be likely to refer to these interpretations of "uncommercial transaction" when applying the new provision in s 588G. However, the uncommercial transaction provisions were not designed to be used as part of a mechanism to penalise directors, particularly given that decisions under the new provision will presumably be based on an assessment of the director's state of knowledge of the company's circumstances at the time of the transaction. Nevertheless, directors should be aware that they may be penalised under this new provision for entering into a transaction in good faith and with due diligence which may not be uncommercial at that time, but which later turns out to be uncommercial with the benefit of hindsight.[38]

Prior to this amendment, a company that entered into an uncommercial transaction did so at the risk that the transaction would be deemed void in the event of the liquidation of the company. However, the risks of such transactions have been increased as the

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29. (1997) 25 ACSR 535.
30. Ibid at 548.
31. (1998) 28 ACSR 49 at 53.
32. Ibid. Young J was picking up the language of the Full Federal Court in *Demondrille Nominees Pty Ltd* v *Shirlaw* (1997) 25 ACSR 535 at 548, who, in turn, were echoing the words of the Explanatory Memorandum to the Corporate Law Reform Bill, supra n 26.
33. Ibid.
34. (2000) 18 ACLC 490.
35. Ibid at 497.
36. (1997) 15 ACLC 1,402.
37. *Lewis* v *Cook* (2000) 18 ACLC 490 at 497.
38. Mr Ian Dunlop, Hansard, *Reference: Corporations Law Amendment (Employee Entitlements) Bill 2000*, Parliamentary Joint Statutory Committee on Corporations and Securities Committee (5 April 2000) CS 1.

amendment introduces a new duty on directors not to engage in an uncommercial transaction where the company is insolvent, or becomes insolvent, as a result of that transaction. In addition, directors will not only be guilty of a breach of the Law, they may also be personally liable to employees for compensation.

By extending the remedies for recovering uncommercial transactions to the personal assets of directors, the amendment has sought to address the situation of the dissipation of a company's assets at undervalue prior to insolvency. The Explanatory Memorandum notes:

> The inclusion of uncommercial transactions in s 588G(1A) has implications for the protection of employee entitlements, the prosecution of directors involved in "phoenix" activity and recovery actions by liquidators for the benefit of creditors generally.[39]

The Hon Joe Hockey MP, the Federal Minister for Financial Services and Regulation, stated that the amendment would "ensure that directors don't use asset stripping techniques to avoid paying employees their proper entitlements".[40] However, the extension of director liability for insolvent trading to include entering into an uncommercial transaction creates an extremely broad and onerous provision that will include circumstances that do not involve any outflow of money or value. It is also important to note that the inclusion of uncommercial transactions will have general application to all uncommercial transactions and is not restricted to dealings in relation to employee entitlements.[41] In addition, the extension of the uncommercial transaction provision to s 588G would include payments made by a company to a creditor. Therefore, a director may be liable for making a payment to a creditor that is later deemed to be "uncommercial".

The amendments will not address a situation where there was no insolvent trading and no uncommercial transaction entered into. In this way, a transfer of assets away from the company for an uncommercial consideration would not be caught by the provision where the transfer did not lead to insolvency or occur whilst the company was in fact insolvent. Given the advantages of voluntary administration, as soon as the threat of insolvency is raised, a prudent course by a director would be to place the company under administration and thereby avoid the risk of insolvent trading. At the very least, voluntary administrations have been estimated to result in a delay in liquidation proceedings of two years.[42]

It may also be extremely difficult and costly in practice to prove that any given transaction was in fact "uncommercial". For example, in the National Textiles insolvency the payment of a guarantee fee by National Textiles to a related party was closely examined by the Administrator, who concluded that to the extent, if any, the payment was excessive, a right of action for recovery may exist. However, the Administrator noted that

39. Explanatory Memorandum, supra n 1 at [9].
40. The Hon Joe Hockey MP, "More Protection for Workers' Entitlements", *Press Release* (28 June 2000).
41. See Explanatory Memorandum, supra n 1at 10.
42. A 1995 estimate from the National Enforcement Co-ordination Office of the then Australian Securities Commission. See H Bird "The Problematic Nature of Civil Penalties in the Corporations Law" (1996) 14 *Company and Securities Law Journal* 405 at 423.

"[c]ommercially, I would consider it unlikely that on liquidation a liquidator would effect any recoveries from this source".[43]

The amendment is also diametrically opposed to the recent trend in corporate regulation towards a more "hands-off" approach to directors, typified by the introduction of the new statutory "business judgment rule".[44] The business judgment rule was introduced with the recent changes to the Law effective from 13 March 2000, and was seen as a response to the increased director responsibility resulting from the decision in the AWA case.[45] The new business judgment rule, applying to the duty of care and diligence, was designed to afford directors greater protection from liability in relation to their decisions made in good faith. Under the rule, the court is restricted to an assessment of the procedural aspect of the director's actions and cannot examine the merits of conduct of the director (as occasionally occurred under the previous regime).

The introduction of the rule is consistent with the established legal practice of courts in Australia and England not to interfere with a board's prerogative to make commercial decisions. The Privy Council in *Howard Smith Ltd* v *Ampol Petroleum Ltd*,[46] stated that:

> There is no appeal on the merits from management decisions to courts of law; nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.

Where directors make decisions in good faith which later turn out to be incorrect, the business judgment rule provides a measure of protection. Although the new rule does not apply in relation to the duty of directors to prevent insolvent trading,[47] this is inconsistent with, and demonstrates no understanding of, the need to allow corporations some flexibility in business judgment. Baxt recently noted the:

> . . . need to find a fine balance between a set of laws that will protect investors and others from unscrupulous operators (including directors), and a set of guidelines that enable directors

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43. Report to Creditors by the Voluntary Administrator of National Textiles Limited (Receiver and Manager appointed) (Administrator appointed) (ACN 056 983 432) (14 February 2000), 50.

44. Section 180(2) of the Corporations Law provides that:
"A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of [the statutory duty of care and diligence in s 180(1)], and their equivalent duties at common law and in equity, in respect of the judgment if they:
(a) make the judgment in good faith for a proper purpose; and
(b) do not have a material personal interest in the subject matter of the judgment; and
(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
(d) rationally believe that the judgment is in the best interests of the corporation.
The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold."

45. See *AWA Ltd* v *Daniels* (1992) 7 ACSR 759 and the appeal in *Daniels* v *Anderson* (1995) 16 ACSR 607. For a discussion of the case see J Cassidy, "Standards of Conduct and Standards of Review: Divergence of the Duty of Care in the United States and Australia" (2000) 28 *Australian Business Law Review* 180.

46. [1974] AC 821 at 832.

47. For a discussion of whether it should apply, see R Langford, "The New Statutory Business Judgment Rule: Should it Apply to the Duty to Prevent Insolvent Trading?" (1998) 16 *Company and Securities Law Journal* 533.

> to make decisions that sometimes may be a little risky but which involve the entrepreneurial spirit that is central to the continued development of our economy.[48]

Of the 11 submissions to the Committee that addressed the proposal to extend the insolvent trading provisions to include uncommercial transactions, only three (including the Treasury) were in support.[49] The Australian Institute of Company Directors and the Law Council of Australia both objected strongly to the proposal.[50] The decision of the Committee to nevertheless recommend its inclusion in the extension to s 588G was not an exercise in striking a "fine balance". The new provision will sanction directors in situations where it is inappropriate and will inhibit genuine entrepreneurial activity.

Directors to face civil and criminal penalties

The Explanatory Memorandum notes that imposition of director liability in the form of civil penalties may follow a breach of the new provision.[51] Directors who breach this duty may therefore also be personally liable to pay compensation under the civil penalty provisions of the Law. In circumstances where the failure to prevent the company incurring the debt was dishonest, offending directors may also be subject to criminal prosecution.[52]

However, if the imposition of civil penalties on directors does not serve to prevent the insolvency, it may also ultimately be unsuccessful in ensuring that employee obligations are met. As Daniels notes, "to achieve optimal penalties, the State is left with little choice but to increase the amount of resources expended on monitoring and enforcement in an effort to increase the probability of detection."[53]

A recent study on the use by ASIC of the civil penalty regime in the Law found that civil penalties had minimal worth as a deterrent and that enforcement was problematic, with ASIC often viewing the imposition of a civil penalty as a low priority when faced with attempting to recover funds from a failed enterprise.[54] The authors of the study note:

> Unsurprisingly, it is these very real, very pragmatic and very immediate priorities that direct which tools ASIC enforcement personnel use. There is understandable reluctance amongst ASIC enforcement professionals about the incidental time, complications and expense associated with civil penalties.[55]

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48. R Baxt, "Directors, you are at Risk!" (2000) 16 *Company Director* 46.
49. Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on the Corporations Law Amendment (Employee Entitlements) Bill 2000* (April 2000) at [3.3]–[3.20].
50. Ibid at [3.14]–[3.18].
51. Explanatory Memorandum, supra n 1 at [11].
52. Corporations Law, s 588G(3).
53. R Daniels, "Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance" (1995) 24 *Canadian Business Law Journal* 229 at 235.
54. G Gilligan, H Bird and I Ramsay, "Civil Penalties and the Enforcement of Directors' Duties" (1999) 22 *University of New South Wales Law Journal* 417 at 439.
55. Ibid.

The study found that in the six-year period from 1993, ASIC had commenced actions against only 10 individuals for contravention of 14 civil penalty provisions (only five of which related to contraventions of the insolvent trading provisions).[56]

In addition, ASIC is constrained by the level of funding and the amount of resources that can be directed towards any enforcement priority. The recent reduction in the ASIC budget from $137 million to $130 million will only exacerbate this problem.[57] As Gilligan, Bird and Ramsay note, ". . . no matter how efficiently existing resources are used, 'appropriate' matters are likely to slip through the enforcement net simply because of insufficient resources."[58]

In May 2000, the then ASIC chairman, Mr Alan Cameron, informed the Senate Economics Legislation Committee that funding restrictions would mean that ASIC would be forced to make difficult choices about the cases it pursued, and that there may be a consequential reduction in the number of cases on insolvent trading.[59]

The effectiveness of the extension of director's liability for insolvent trading can also be determined to some extent by the impact of the existing provisions. A recent survey of 126 directors of public companies and 212 directors of proprietary companies attempted to determine whether directors had sufficient knowledge and understanding of the elements of the offence to enable them to prevent insolvent trading.[60] The results indicated that 88 percent of public directors and 76 percent of proprietary directors could define insolvency, and 84 percent of public directors and 70 percent of proprietary directors could identify the key elements of the offence of trading whilst insolvent.[61] Whilst these results are encouraging, it is submitted that without maintaining and improving this level of director awareness, the effectiveness of the new provision as a deterrent may be lessened, and many uninformed directors may be caught by the new offence for "uncommercial transactions". In this respect, it is relevant to note that ASIC recently announced that, due to funding cuts, its small business program (providing, amongst other things, education for directors about their duties, especially on how to avoid insolvent trading) would cease to operate from 1 July 2000.[62]

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56. Ibid at 437.
57. See Australian Securities and Investments Commission, *Annual Report 1998/1999*, 66; and 25 *ASIC News* (May 2000) 1. *ASIC News* states:
"[ASIC's] workload has increased, we face newly emerging work including law reform and we received less from the Government than we asked for. As a result [ASIC] decided it was better to cut according to our priorities, than to make cuts across the board . . . We will focus our resources on supporting and enforcing honesty and fairness in financial reporting and market disclosure, retail sales and investment advice, superannuation and managed investments, and maintaining an accurate company database."
58. Gilligan, Bird and Ramsay, supra n 54 at 441.
59. Mr Alan Cameron, Hansard, *Consideration of Budget Estimates*, Senate Economics Legislation Committee (30 May 2000) at E134–E135.
60. B Mescher, "Company Directors' Knowledge of the Insolvent Trading Provisions" (1998) 6 *Insolvency Law Journal* 186.
61. Ibid at 196.
62. See Australian Securities and Investments Commission, *ASIC News*, supra n 57 at 1. *ASIC News* states:
"While [ASIC] will still investigate serious breaches of the law among small companies, investor and consumer protection must take a higher priority."

New Offence to Avoid Paying Employee Entitlements

Liability for an agreement or transaction to avoid entitlements

The second amendment to the Law introduces new Part 5.8A, prohibiting persons (not just directors) deliberately entering into agreements or transactions (whether formal or informal, oral or written, or with or without legal effect) with the intention of defeating the recovery of employee entitlements.

The new s 596AA defines entitlements as wages; superannuation contributions payable by the company; amounts due for injury compensation; leave entitlements; and retrenchment payments. The protection of entitlements under this new section does not include entitlements of employees who are or have been directors of the company or entitlements of their spouses or relatives. However, protection of entitlements will extend to both past and present employees of the company (and their dependants).

The new s 596AB[63] prohibits a person (which includes a body corporate such as a parent company)[64] from entering into an agreement or transaction (or a series of agreements and/or transactions) with the intention or part intention of:

- preventing the recovery of the entitlements of employees of a company; or
- significantly reducing the amount of the entitlements of employees of a company that can be recovered.

The Explanatory Memorandum notes:

> The object of this offence is to deter the misuse of company structures and of other schemes to avoid the payment of amounts to employees that they are entitled to prove for on liquidation of their employer.[65]

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63. Corporations Law, s 596AB provides:
"(1) A person must not enter into a relevant agreement or a transaction with the intention of, or with intentions that include the intention of:
(a) preventing the recovery of the entitlements of employees of a company; or
(b) significantly reducing the amount of the entitlements of employees of a company that can be recovered.
(2) Subsection (1) applies even if:
(a) the company is not a party to the agreement or transaction; or
(b) the agreement or transaction is approved by a court.
(3) A reference in this section to a relevant agreement or a transaction includes a reference to:
(a) a relevant agreement and a transaction; and
(b) a series or combination of:
(i) relevant agreements or transactions; or
(ii) relevant agreements; or
(iii) transactions.
(4) If a person contravenes this section by incurring a debt (within the meaning of section 588G), the incurring of the debt and the contravention are linked for the purposes of this Law."

64. Corporations Law, s 85A.

65. Explanatory Memorandum, supra n 1 at [18].

While the scope of this section is untested, liability may be established where the transaction is approved by a court, creditors or even the employees themselves.[66] Examples may include taking out a fixed charge over an asset or entering into a Deed of Company Arrangement (both of which have the potential to reduce the amounts available to employees).[67]

A breach of the new provision may result in a penalty of $100,000 or 10 years jail, or both.[68] Under the general principles of criminal law, persons who aid or abet a breach of this provision (such as financiers) would also be liable to a penalty.[69]

The difficulty of determining intention

The provisions have been drafted in order to prevent avoidance by arranging the prohibited transactions through non-related parties or by entering into other "behind-the-scenes" arrangements. However, the phrase "agreement or transaction" may exclude the situation where a unilateral step is taken by one party, such as the creation of an employer company with an unrealistically small asset base. The wording of the amendment may also not cover the situation where the intention to avoid employee entitlements is evidenced in a scheme.[70] The Hon Jeff Shaw QC MLC also submitted to the Committee that the qualification that the agreement or transaction must *significantly* reduce the amount of entitlements would be uncertain in effect and should be removed to avoid legal argument.[71]

Problems of interpretation are also likely to be encountered in determining what the subjective "intention" of a person was. Under s 596AB, persons will be liable even if the intention to prevent the payment of employee entitlements is only one of a number of reasons for entering into an agreement or transaction. It is submitted that such a provision may be easy to circumvent, as corporations may choose not to record their deliberate or "real" intention at any stage of a corporate restructure. Directors may successfully argue that ordinary commercial motives were behind an action that had the effect of denying employees their entitlements. Ultimately, the courts may need to resolve the question of whether the director was trying to avoid paying entitlements or whether the decision was aimed at growing the business and protecting jobs.

The real problem is that the new provisions require the court to determine whether the intention or part intention of a person in entering a particular agreement or transaction was

66. Submissions of the Law Council of Australia (Corporations Law Committee) and Mr Ian Parsonage. See Parliamentary Joint Statutory Committee on Corporations and Securities, supra n 49 at [3.30] and [3.31].
67. Ibid.
68. Corporations Law Sch 3.
69. Explanatory Memorandum, supra n 1 at [19].
70. Similar to the definition of "schemes" for tax avoidance in the Income Tax Assessment Act 1936 (Cth): Submission by the then NSW Attorney General and Minister for Industrial Relations (who subsequently resigned in June 2000), the Hon Jeff Shaw QC MLC: see Parliamentary Joint Statutory Committee on Corporations and Securities, supra n 49 at [3.24].
71. Ibid at [3.23].

to deliberately avoid paying employee entitlements, or whether the conduct was in fact reasonable in the circumstances. In practice, it would be difficult to prove that an asset disposition that occurred prior to a voluntary administration substantially constituted an agreement or transaction made with the intention of denying employees their entitlements. This would be particularly so where the disputed agreement or transaction could have been made months before the insolvency, possibly at full or near full commercial value, with the assets sold at a price reached by an independent valuer. For example, in the waterfront dispute, the valuation of the assets of the Patrick group companies involved in the restructure was done in accordance with a valuation conducted in late 1996 by the accounting firm then known as Price Waterhouse.

Should offenders face criminal or civil penalties?

The submission of Mr Shaw to the Committee stated that, in practice, there might be few successful prosecutions as the criminal standard of proof (combined with the necessity to prove intent) is a high hurdle.[72] Mr Shaw suggested that the new offence should instead be a civil penalty.

The threat of a criminal penalty may at least serve to ensure that directors make timely payments prior to insolvency.[73] In the situation of a corporate restructure designed to avoid employee obligations, the prospect of a criminal sanction may be the only factor that would militate against such a course of action in the mind of a director. It has been argued previously that sending one or two directors to jail for deliberately seeking to avoid paying employee entitlements would ensure that other directors would soon lose enthusiasm for the practice.[74] However, the problem with this ex post facto approach for the aggrieved employee is that the company is already insolvent and the prospects for recovering unpaid wages and entitlements do not improve markedly with the criminal punishment of directors.

Furthermore, unless the real or perceived threat of jail is a powerful deterrent to the conduct of a director, then this provision may not succeed in preventing undesirable conduct. There will not be a deterrent factor where directors believe they are unlikely to be prosecuted, based on the historical use of criminal sanctions by ASIC. A study of criminal proceedings brought by the then Australian Securities Commission during the years 1992 to 1995 under the insolvent trading provisions revealed a total of 17 prosecutions in the period.[75] The author of the study notes that: "[p]rosecution levels are a limited measure of a mechanism's success in securing regulatory compliance [as] [t]hey provide no measure

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72. Ibid at [3.22].
73. C Symes, "Do Not Dismiss the Employee as a Statutory Priority Creditor in Corporate Insolvency" (1998) 26 *Australian Business Law Review* 450 at 461.
74. J Burnside QC, in *The Australian Financial Review*, Sydney, 19 May 2000 at 34.
75. The prosecutions were in relation to the period 1 December 1991 to 30 June 1995. The insolvent trading provisions during this period were s 556 of the Companies Code and s 592 of the Corporations Law. See H Bird, supra n 42 at (1996) 14 *Company and Securities Law Journal* 405 at 422–3 and 425–6.

of its deterrent function.[76] Yet, the author raises questions about the "very low prosecution rates in the face of significant contravention reporting rates . . ."[77]

As an alternative to a criminal standard of proof, the Australian Council of Trade Unions and Mr Shaw submitted to the Committee that the preferable approach would be one of strict liability, such that the mere existence of an agreement or transaction that has the effect of reducing employee entitlements would give rise to an offence.[78] The director would then have the onus of relying on defences that:

- it was not their intention to avoid employee entitlements;
- they were not in a position to influence the conduct that led to the avoidance; or
- they exercised appropriate diligence to provide for entitlements.[79]

The Textile Clothing and Footwear Union of Australia also submitted to the Committee that because the offence must be proved beyond reasonable doubt, establishing intention would be nearly impossible and that therefore, the offence should be based on outcome, not intention.[80]

The Commonwealth Department of Treasury in its submission to the Committee considered that such a results-based approach would not be workable, because all expenditure can potentially reduce the amount of money available for employee entitlements and it would be unreasonable to make all persons involved guilty of an offence and liable to pay compensation.[81] The Treasury considered that, for such an approach to be workable, it would have to be limited to transactions where the company was already insolvent and must exclude third parties with no knowledge of the financial position of the company.[82]

As a compromise between the two opposing viewpoints, it may be better to incorporate some objective elements that can be examined when determining the offence. In this way, the court will examine the factual context and then introduce evidence of intention. Therefore, there would be no subjective test of intention unless the original results showed that employee entitlements were avoided.

However, given that this provision may give rise to a criminal penalty, it is submitted that a results-based approach that discards the presumption of innocence would be too draconian.

As an alternative approach to reversing the onus of proof, it may be better — as Mr Shaw suggested — to make a breach of the new provision a civil penalty, resulting in a test of contravention based on the balance of probabilities. Civil penalties themselves are already an important — albeit selectively used — sanction within the Law, allowing a court

76. Ibid at 405.
77. Ibid.
78. Submissions by the Australian Council of Trade Unions and the Hon Jeff Shaw QC MLC: see Parliamentary Joint Statutory Committee on Corporations and Securities, supra n 49 at [3.21] and [3.23].
79. Ibid at [3.21] and [3.23].
80. Submission by the Textile Clothing and Footwear Union of Australia, see ibid at [3.27].
81. Ibid at [3.50]–[3.51].
82. Ibid at [3.51].

to impose penalties up to $200,000 and make orders including disqualifying offenders from being involved in managing a corporation. In addition, because ASIC makes discretionary decisions as to which cases to pursue, a civil penalty may be favoured given that it will ordinarily be easier to prove. Furthermore, criminal penalties may still be imposed where the person contravenes the civil penalty dishonestly. Also, given that contravention of the provision is an essential precondition to an action for compensation whereas conviction for an offence is not (discussed below), the lower standard of proof would make it more effective than its present form and deter corporate opportunism.

Persons in contravention are liable to pay compensation for loss

It is important to realise that the company need not be insolvent at the time that the relevant agreement or transaction is entered into for the prohibition in s 596AB to apply, nor does the company have to become insolvent as a result of the transaction or agreement. However, the new s 596AC provides that a person who contravenes s 596AB is liable to pay compensation if the company is being wound up and the employees suffer loss because of the contravention.[83]

The new Part 5.8A allows a court to order persons in breach of the new offence to pay compensation to employees who have suffered loss or damage because of the agreements or transactions.[84] Persons will not be liable to pay compensation from double or multiple liability,[85] and actions for compensation under s 596AC do not preclude an action against a director for breach of any other duty under the Law (including a breach of directors' duties).[86]

Section 596AC(2) provides that the liquidator may stand in the shoes of the employees and recover an amount equal to the loss or damage as a debt due to the company. Where the liquidator decides not to take action within a specified time (or otherwise gives consent or fails to consent within a specified time), the new Part 5.8A will permit an employee to recover from directors, as a debt due to the employee, an amount equal to the loss or damage.[87] This will allow an employee to take action where currently under the Law they have limited rights to recover employee entitlements.

It is clearly stated in s 596AC(1) that "[t]he person is liable [to compensate for the loss] whether or not the person has been convicted of an offence in relation to the contravention."

In this respect, the proposal is practical, in that it does not require a criminal penalty before a civil remedy. This will ensure that compensation is payable even if the director has not been convicted of a criminal offence, and will mean that the lower civil standard of

83. Corporations Law, s 596AC.
84. Corporations Law, s 596AC(3).
85. Corporations Law, s 596AD.
86. Corporations Law, s 596AE.
87. Corporations Law, ss 596AF–596AI.

proof can be applied in compensation cases. Therefore, it would only be necessary for a court to be satisfied on the balance of probabilities of a breach of s 596AB in order to make an order for compensation.[88]

Problems of recovery of compensation

The imposition of liability for unpaid wages on directors may allow for the recovery of employee entitlements upon insolvency subject of course to the assets of the directors. In Canada, the federal government and most Provinces impose liability on directors for unpaid wages.[89] Certainly in Australia, civil liability of directors has been seen as one solution to preventing insolvent trading by companies.[90] However, as we have seen, the amendments contained in new Part 5.8A contain fundamental problems that may prevent the recovery of employee entitlements where directors breach s 596AB. Furthermore, the amendments only provide an avenue of remedy for employees where the company is insolvent and the liquidator has not already started proceedings. A more effective approach may therefore be to make directors liable for unpaid entitlements in all circumstances.

Ultimately, the availability of this legal remedy where employee entitlements have been avoided may be dependent upon a strong union or other group of employees with a legitimate and high-profile cause. Employees may otherwise be reluctant or simply unable to pay for costly litigation that is likely to involve a significant time-lag between the insolvency and any recovery. Furthermore, problems are likely to arise in relying upon liquidators to enforce these provisions, with liquidators unlikely to intervene due to limited resources and limited incentive. Liquidators at least have an obligation to consider the merits of any legal entitlement the company may have, and make a judgment as to whether the right should be pursued. However, if there are no assets with which to fund an action for recovery, then such an action will not proceed. Therefore, it is submitted that ASIC should also have the right to bring proceedings to recover employee entitlements on behalf of employees, given that ASIC intervention was successful in recovering entitlements for the Cobar workers (discussed above).

Nor will the amendments necessarily lead to the recovery of employee entitlements, because a director may avoid liability by limiting personal assets. However, although the recovery may exceed the personal assets of the director, there may still be significant costs for the director, including consequential loss of reputation, that may act as an effective deterrent.[91] Finally, the right of recovery is limited to where the company has entered

88. Explanatory Memorandum, supra n 1 at [25].
89. See, for example, s 119(1) of the Canada Business Corporations Act, and s 96 of the British Columbia Employment Standards Act [RSBC 1996] Chapter 113.
90. Civil penalties may be imposed on directors for allowing a company to incur debts whilst insolvent: Corporations Law, ss 588G, 1317E–1317S. S 452 of the Workplace Relations Act 1997 (Qld), provides that if a company commits an offence by failing to pay wages, directors may be jointly liable for any order made against the company.
91. Daniels, supra n 53 at 240.

liquidation, and it is submitted that the provision should also, as a minimum, extend to the situation where the company has entered into a Deed of Company Arrangement.

Conclusion

Where directors make good faith decisions that later turn out to be wrong, they should not be liable for the consequences unless they did not take appropriate care or did not comply with other duties imposed upon them by the law. However, the extension of directors' potential liability for insolvent trading may serve to deter talented individuals from accepting board positions. This result may be more detrimental to business than allowing a sensible degree of risk-taking within appropriate compliance guidelines.

Legislation designed to protect employee entitlements should be aimed at stopping the deliberate transfer of assets out of a corporation with the result that the corporation is unable to meet its obligations to employees, upon insolvency. However, the new Part 5.8A is unlikely to be either an effective deterrent or a practical remedy for the recovery of employee entitlements. The test will be whether the amendments have any real impact on the rise in asset-stripping and other forms of corporate opportunism that have continued to threaten employee entitlements.

Ultimately, corporate regulation in situations of insolvency or near-insolvency must strike a fine balance between allowing sufficient flexibility in business judgment coupled with appropriate and effective sanctions for improper corporate acts. However, the amendments to the Law discussed in this chapter are not an appropriate legislative response to the issue of protecting employee entitlements. The "broad-brush" nature of the amendments means that they are bound to be both over-inclusive and under-inclusive, in the sense that they will apply to situations where they should not, and yet not apply in practice to situations where legal sanctions would be appropriate.

Chapter 6

Why are there So Few Insolvent Trading Cases?

Abe Herzberg*

Introduction

The decision in *Metropolitan Fire Systems Pty Ltd* v *Miller*[1] was handed down in May 1997, almost four years after s 588G came into operation.[2] Since then, a small handful of insolvent trading cases have come before the courts, dealing only with peripheral issues.[3] It may seem surprising that there has been such a long gap between the enactment of the insolvent trading provisions and the first reported cases because the current provisions were deliberately designed to make it easier to recover compensation from directors than was formerly the case.[4] This may tend to suggest that there is something wrong with the current insolvent trading provisions, which makes liquidators reluctant to utilise them. This is of some concern because of the expanded role that has been assigned to s 588G.[5]

While there are a number of reasons why it has taken so long for the first s 588G cases to be handed down, the decisions in the reported cases indicate these have nothing to do with inherent deficiencies in the legislation. In this chapter I suggest that the most important reason for the dearth of s 588G cases is the increasing use of the Corporations

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1. (1997) 23 ACSR 699.
2. Section 588G, inserted into the Corporations Law by the Corporate Law Reform Act 1992 (Cth), applies to debts incurred by a company on or after 23 June 1993. Section 592(1) applies in respect of debts incurred before that date.
3. See, for example, *Quick* v *Stoland Pty Ltd* (1998) 29 ACSR 130, and *ASC* v *Forem Freeway Enterprises Pty Ltd* (1999) 17 ACLC 511 both of which are discussed below. See also *Kenna & Brown Pty Ltd* v *Kenna* (1999) 17 ACLC 1183, *Tourprint International Pty Ltd* v *Bott* (1999) 17 ACLC 1543 and *Powell* v *Tonkin* [2000] SASC 97, all of which were decided since this chapter was written.
4. See A Herzberg, "Duty to Prevent Insolvent Trading" in Lessing and Corkery (eds), *Corporate Insolvency Law*, Taxation & Corporate Research Centre, Bond University, 1995, for a comparison between the present and former insolvent trading provisions.
5. For example, as a result of amendments to the Corporations Law made by the First Corporate Law Simplification Act 1995, and the Company Law Review Act 1998, directors may contravene s 588G if a company engages in a share buy-back, pays a dividend, reduces share capital, redeems redeemable preference shares and provides financial assistance for the acquisition of its shares when there are reasonable grounds to suspect that the company is insolvent.

Law's voluntary administration scheme. This has meant that a significant number of companies in financial difficulties are not placed in liquidation which is an essential prerequisite for successful compensation claims against directors.[6] Instead, insolvent companies are increasingly placed in voluntary administration and then move to a deed of company arrangement.

A practical consequence of the popularity of voluntary administration and deeds of company arrangement is that those companies which are wound up are likely to be hopelessly insolvent with insufficient assets available for liquidators to fund a s 588G case against directors. Even if funds are available, it will not be commercially sensible to start s 588G cases against directors if they are themselves also insolvent. In such cases the Australian Securities and Investments Commission (ASIC) will be the only likely plaintiff to initiate insolvent trading cases.

This chapter is divided into four parts. First, I discuss a number of the reported cases, particularly, *Metropolitan Fire Systems Pty Ltd* v *Miller*. Secondly, after noting the popularity of voluntary administrations, I set out the various factors that influence directors to appoint an administrator as well as the reasons why creditors increasingly vote in favour of deeds of company arrangement. The third part of the chapter is based on the assumption that a company has been wound up in insolvency and I focus on the considerations that influence liquidators in deciding whether or not to start a s 588G case against directors. Finally, I examine ASIC's role in insolvent trading cases.

The Insolvent Trading Cases

Metropolitan Fire Systems Pty Ltd v *Miller*

The Federal Court decision of Einfeld J in *Metropolitan Fire Systems Pty Ltd* v *Miller*[7] is important for a number of reasons, not the least of which is that it is the first reported s 588G insolvent trading case.[8] It confirms that, like its predecessors,[9] directors will not be able to defend themselves against personal liability for breaching s 588G by asserting that they did not know the company was insolvent and relied on others to monitor the company's financial position.[10] The case is also noteworthy for the fact that the compensation claim was brought by a creditor and not the company's liquidator.

6. Corporations Law s 588M.
7. (1997) 23 ACSR 699.
8. This is the key section of the insolvent trading provisions of the Corporations Law. The insolvent trading provisions applicable to directors are set out in ss 588G–588U and s 588Y. Corporations Law ss 588V—588X contain equivalent provisions applicable to holding companies.
9. Section 592 of the Corporations Law and s 556 of the Companies Code.
10. *Morley* v *Statewide Tobacco Services Pty Ltd* (1992) 10 ACLC 1233 and *Group Four Industries Pty Ltd* v *Brosnan* (1992) 10 ACLC 1437.

1. The facts

Raydar Electrics Pty Ltd (Raydar), an electrical sub-contractor, was engaged by a head contractor to carry out all the electrical, fire and emergency warning systems work in the construction of the Clancy Auditorium at the University of New South Wales. Raymond Miller, a director of Raydar, subcontracted the installation of the fire systems to Metropolitan Fire Systems Pty Ltd (Metropolitan) for an agreed contract price of about $60,000. Of this amount, $10,000 was paid leaving a balance of about $50,000. Subsequently, one of Raydar's suppliers successfully applied for its liquidation on the insolvency ground. Metropolitan, with the consent of Raydar's liquidator, applied to the Federal Court for a declaration that Raydar's three directors had contravened s 588G by failing to prevent their company from incurring debts to Metropolitan amounting to about $50,000. Metropolitan claimed compensation for that sum from the directors under s 588M.

2. Application of s 588G

There are a number of conditions that must be satisfied before directors can be made liable under s 588M to pay compensation for loss resulting from insolvent trading. First, contravention of s 588G must be established.

(a) Company incurs a debt

A central element of s 588G is that the company incurs a debt.[11] This raises two interrelated questions. What is meant by the expression "incurs a debt" and when is a debt incurred? The timing question is significant because under s 588G(1)(b) the company must have been insolvent at the time the debt was incurred, or became insolvent by incurring that debt.

Neither of these questions were in dispute in Metropolitan Fire Systems. It was not disputed that Raydar incurred a debt, Metropolitan's claim being a liquidated debt for a specific sum ascertained by reference to the contract price for work done. It was also agreed that the debt was incurred at the time the contract was entered into.[12] Following *Hawkins* v *Bank of China*[13] and *Shepherd* v *ANZ Banking Group Ltd*,[14] Einfeld J held that s 588G(1)(b) applied even though the debt may have been contingent.[15] The contingency arose from evidence of an informal understanding that Raydar would not have to pay Metropolitan until it had received payment from the head contractor.

11. Corporations Law s 588G(1)(a).
12. The courts have been inconsistent in determining when a debt is incurred. See Noble, "When Does a Company Incur a Debt Under the Insolvent Trading Provision of the Corporations Law" (1994) 12 *Company and Securities Law Journal* 297 and Mosely, "Insolvent Trading: What is a Debt and When is One Incurred?" (1996) 4 *Insolvency Law Journal* 155.
13. (1992) 26 NSWLR 562.
14. (1996) 20 ACSR 81.
15. (1997) 23 ACSR 699 at 705.

While incurring any type of debt in the specified circumstances is an essential element in establishing a contravention of s 588G and the imposition of a civil penalty order or a criminal sanction, a director's liability to pay compensation under s 588M only arises if the debt is wholly or partly unsecured.[16] This was of some significance in *Metropolitan Fire Systems* because the directors argued that, the contract with Metropolitan contained a retention of title clause, its debt was wholly secured. Einfeld J rejected this argument.[17] He held that since any equipment and materials supplied by Metropolitan had physically merged with the Auditorium structure so as to become fixtures, the retention of title clause provided no security to Metropolitan. Further, Metropolitan had made no claim under the retention of title clause.

(b) Insolvency

Under s 588G(1)(b) Metropolitan was required to show that Raydar was insolvent at the time the debt was incurred.[18] There is a cash flow test of insolvency in s 95A. A company is insolvent if it is unable to pay all its debts as and when they fall due. Einfeld J adopted the test of solvency in *Heide Pty Ltd* v *Lester*[19] and stated:

> There is a necessity, therefore, to consider the whole of the company's resources, including its credit resources. In determining these resources, there is to be taken into account the time extended to the company to pay its creditors on the one hand and the time within which it will receive payment of its debts on the other.[20]

It was obvious to Einfeld J that at the time the Metropolitan debt was incurred, Raydar was in severe financial difficulties.

> Its creditors were demanding their money, and its major assets were all locked in as security for two major debts. Moreover, although Raydar was owed substantial amounts of money, it was not foreseeable that this money would be realised in the near future to enable creditor demands to be satisfied.[21]

Taking into account all the resources available to Raydar, including the unavailability of additional support from the directors, Einfeld J concluded that Raydar was unable to pay its debts as and when they fell due.

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16. Corporations Law s 588M(1)(c).
17. (1997) 23 ACSR 699 at 705.
18. The rebuttable presumption of insolvency in s 588E(4) where a company contravenes s 286 by failing to keep adequate financial records was not referred to in *Metropolitan Fire Systems* even though Einfeld J noted that Raydar's financial records were incomplete. This was one of the insolvent trading issues in *ASC* v *Forem Freeway Enterprises Pty Ltd* (unreported Federal Court 4 March 1999).
19. (1990) 3 ACSR 159 at 165.
20. (1997) 23 ACSR 699 at 702.
21. Ibid at 705.

(c) Reasonable grounds to suspect insolvency

Having concluded that Raydar was insolvent at the time the debt was incurred, s 588G(1)(c) then required Metropolitan to prove that there were reasonable grounds for suspecting this. According to Einfeld J the reference to "reasonable grounds" indicates that suspicions of insolvency are determined on objective criteria and judged by the standard appropriate to a director of ordinary competence.[22] The actual state of mind or knowledge of a director is not a relevant factor. According to Einfeld J, once reasonable grounds for suspecting insolvency are established under s 588G(1)(c), the inquiry then turns to s 588G(2) and whether the director is aware that such grounds exist[23] or alternatively whether a reasonable person in a like position in a company in the company's circumstances would be so aware.[24]

If this is the correct analysis of the relationship between ss 588G(1)(c) and 588G(2), it highlights an extremely cumbersome drafting style in the legislation. Applying Einfeld J's analysis a director contravenes s 588G if it can be shown that:

- the director is aware that a director of ordinary competence would have suspected the company's insolvency at the relevant time; or
- a reasonable director in a like position in the company's circumstances would have suspected that a director of ordinary competence would have suspected the company's insolvency.

Such drafting complexities did not trouble the court. Einfeld J concluded[25] that at the time the debt to Metropolitan was incurred a reasonable company director in the position of Raydar's directors would have or should have suspected, if not actually known, that Raydar was insolvent and unlikely to be able to trade out of its problems in the foreseeable future. He noted that the evidence indicated that:

- there were reasonable grounds to suspect that none or very little of the money owing to Raydar would be received in the short or medium term and that there were no other sources of large sums of money available to it;
- a reasonable director would have been aware that a major creditor intended to pursue legal proceedings against the company and that Raydar had shown a lack of commitment in defending the proceedings, the successful defence of which was critical to its financial survival;
- directors of ordinary competence would have made themselves aware that various creditors had served statutory demands and winding up applications on the company;
- a reasonable director would have suspected, given the poor track record of the head contractor as a debtor, that by taking up the project and incurring the further debt to Metropolitan, that Raydar was sinking even further into insolvency; and

22. Ibid at 703.
23. Corporations Law s 588G(2)(a).
24. Corporations Law s 588G(2)(b).
25. (1997) 23 ACSR 699 at 710.

- a reasonable director would have suspected that incurring the debt to Metropolitan would have compounded even further Raydar's by then chronic inability to pay its debts as and when they fell due.

3. *Section 588H defences*

Section 588H sets out four defences. Directors seeking to rely on the defences bear the onus of establishing them on the balance of probabilities. Only two of the four defences — ss 588H(2) and (3) — were considered in Metropolitan Fire Systems. The defences in ss 588H(4) and (5) were not at issue.

(a) Reasonable grounds to expect solvency

All three of Raydar's directors relied on the s 588H(2) defence arguing that they had reasonable grounds to expect that Raydar was solvent at the time the debt to Metropolitan was incurred. Einfeld J observed that:

> The grounds on which the director forms the view as to the company's solvency or otherwise must be reasonable. This implies an objective consideration of the grounds viewed against all the circumstances and not whether, when looked at from the point of view of the director in question, the grounds appear reasonable.[26]

Section 588H(2) refers to reasonable grounds to *expect* solvency whereas the focus of s 588G is on reasonable grounds to *suspect* insolvency. Einfeld J commented on the difference:

> From the cases in which the meaning of these words has been considered, it would appear that to "suspect" something requires a lower threshold of knowledge or awareness than to "expect" it: see a discussion on "to suspect" by Kitto J in *Queensland Bacon Pty Ltd* v *Rees*[27] and *3M Australia Pty Ltd* v *Kemish*.[28] The expectation must be differentiated from mere hope in order to satisfy this defence: *Dunn* v *Shapowloff*.[29] It implies a measure of confidence that the company is solvent. The directors must have reasonable grounds for regarding it as likely that the company would at the relevant date have been able to pay its debts as and when they fall due.

Einfeld J concluded that in the light of the evidence the directors could not rely on the s 588H(2) defence. There were various factors leading to that finding. There was no reason to believe that Raydar would receive significant finance in the short term. Its creditors had begun to take an increasingly aggressive attitude. Any optimism that the directors may have had regarding the company's future was based on hope rather than reasonable expectations.

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26. Ibid at 711.
27. (1966) 115 CLR 266 at 303.
28. (1986) 4 ACLC 185 at 192.
29. [1978] NSWLR 235.

(b) Reasonable reliance

Two of Raydar's three directors, Patricia Miller and Leonard Ewins, sought to rely on the defence in s 588H(3) — the delegation and reliance defence. Before considering the applicability of s 588H(3) to each of the directors Einfeld J remarked:[30]

> It is now settled that directors have a positive duty to take an active part in the affairs of the company to the extent that they should be aware of what is going on in the company: *Statewide Tobacco Services Ltd* v *Morley*.[31]

The s 588H(3) defence has two main elements. The first requires directors to prove they had reasonable grounds to believe that a competent and reliable person was responsible for providing them with adequate information about whether the company was solvent and that person was fulfilling the responsibility.[32] The second element ensures that directors cannot avoid liability merely by delegating responsibility. It requires the delegate to supply them with information about the company's solvency. Directors must establish that the competent and reliable person was in fact providing them with information about the company's solvency and on the basis of this information the directors expected the company was solvent when the debt was incurred.[33]

The directors argued that they had both relied on Raymond Miller,[34] who they said was responsible for the day to day running of Raydar's business and for providing them with all necessary information about its affairs. Further, as far as they were aware he was fulfilling those responsibilities and on the basis of the information he provided they expected that Raydar would remain solvent when it incurred the debt to Metropolitan.

Einfeld J held that Patricia Miller was not entitled to rely on the s 588H(3) defence. She was employed by the company as a full-time casual clerk as well as being a director. The evidence indicated that while she lacked detailed knowledge of Raydar's financial position she was aware that it was "in trouble". She believed it was trading profitably and was solvent, however, there was no evidence of her making inquiries of her husband, Raymond Miller, on whom she relied, for information as to the state of the company's finances. Her lack of inquiries was fatal to her reliance on s 588H(3). Einfeld J stated:

> She may have believed that her husband would inform her if the company was in trouble but as a director she had a duty to take an interest in and demand information on the financial state of the company, especially as she undoubtedly knew that it was at best "in trouble". As a working director, she had a duty to observe and draw reasonable and obvious conclusions from facts coming to her attention.[35]

Einfeld J held that Patricia Miller's opinion that the company was solvent was not based on information provided by her husband but on her own observations as part of her

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30. (1997) 23 ACSR 699 at 712.
31. (1990) 2 ACSR 405 at 431 per Ormiston J.
32. Corporations Law s 588H(3)(a).
33. Corporations Law s 588H(3)(b).
34. Raymond Miller's competence and reliability was not an issue considered by the court.
35. (1997) 23 ACSR 699 at 712.

duties. Accordingly, she failed to satisfy the court that she had reasonable grounds for believing that her husband was fulfilling the responsibility of providing her with adequate information as required by s 588H(3).

Einfeld J thought that the reasons for rejecting the s 588H(3) defence in relation to Leonard Ewins were even stronger. As well as being a director he was employed as a full-time electrician and was involved in the ordering of goods and the preparation of quotes. His assertions that he believed Raydar to be solvent were not based on any information provided by Raymond Miller. Einfeld J commented:

> As a director, he had an obligation to inquire as to the financial health of Raydar, yet so far as the evidence goes, he failed to make any demands for information at a time when his suspicions about the company's financial viability and survival should and would have been aroused.[36]

4. *Personal liability of directors*

There are several different ways that compensation can be recovered from directors who contravene s 588G.[37] Compensation orders can be made in the context of an ASIC application for civil penalty orders[38] and as part of proceedings for the criminal offence.[39] Compensation orders in these situations can be made whether or not the court imposes a civil penalty order or a criminal penalty.[40] Liquidators are also permitted to seek compensation from a director who contravenes s 588G.[41] They are permitted to mount such proceedings whether or not ASIC has commenced an application for a civil penalty order or criminal proceedings.[42]

Metropolitan Fire Systems Pty Ltd v *Miller* is noteworthy because it was brought by a creditor and not by the company's liquidator even though the scheme of the insolvent trading provisions aims to ensure that ASIC and liquidators have the ability to initiate s 588G proceedings against directors ahead of individual creditors.[43]

The amount of compensation recoverable from directors in ASIC or liquidator initiated proceedings is the amount of loss or damage suffered by all unsecured creditors in relation

36. Ibid at 713.
37. Contravention of s 588G may also result in the imposition of a civil penalty order pursuant to Pt 9.4B of the Corporations Law. Further, where the director contravenes s 588G dishonestly, contravention is regarded as a criminal offence: s 588G(3).
38. Corporations Law s 588J gives the court the power to order compensation on an application for a civil penalty order.
39. Corporations Law s 588K sets out a regime for compensation orders similar to s 588J where a director is convicted of a criminal offence under s 588G(3).
40. Corporations Law ss 588J(1) and 588K(1).
41. Corporations Law s 588M(2).
42. Corporations Law ss 588M(1)(e) and (f).
43. Corporations Law ss 588R–588U set out the regime for creditor initiated actions against directors. These provisions ensure that the liquidator has sufficient time to consider whether to mount his or her own compensation claims. They require unsecured creditors to wait at least 6 months after the beginning of winding up and then apply for the liquidator's consent to the individual creditor's action.

to their debts because of the company's insolvency. The amount is payable to the company[44] and is available to all its creditors.[45] In proceedings initiated by an unsecured creditor, however, the compensation is only payable to that creditor and the amount recoverable is the amount of loss or damage suffered by that creditor in relation to the debt because of the company's insolvency.

According to Einfeld J, the loss or damage suffered by Metropolitan in relation to the debt incurred because of Raydar's insolvency was the amount of the debt less the likely dividends it would otherwise have received in Raydar's winding up. Since it was unlikely that Metropolitan would be able to recover anything in the winding up the directors were liable under s 588M to pay it the amount of the debt.

While it was not considered in *Metropolitan Fire Systems*, the amount of compensation recoverable from directors could also conceivably include consequential losses suffered by creditors as well as the amount of the debt less the likely dividends. This possibility is open because s 553 admits to proof in a winding up all debts and claims (present and future, certain or contingent, ascertained or sounding only in damages).

***Quick* v *Stoland Pty Ltd*[46]**

In this case a creditor initiated an insolvent trading case against a director of a debtor company under former s 592 in relation to debts incurred both before and after 23 June 1993 (the date when s 588G came into operation). The creditor subsequently realised that it needed the company's liquidators' consent under s 588R in relation to the post–23 June 1993 debts. This consent was obtained and an amended statement of claim was filed.

The creditor succeeded at first instance,[47] and was awarded compensation under both ss 592 and 588M. The director appealed the first instance decision. One of his arguments in relation to the debts incurred after 23 June 1993 concerned the s 588R(1) requirement of obtaining the liquidator's consent to the proceedings. This section provides:

> A creditor of a company that is being wound up may, with the written consent of the company's liquidator, begin proceedings under s 588M in relation to the incurring by the company of a debt that is owed to the creditor.

The director asserted that the creditor had not obtained the company's liquidator consent prior to the commencement of the insolvent trading claim as required by s 588R and therefore the claim was invalid. The director argued that the "proceedings" referred to in s 588R(1) were curial proceedings and a curial proceeding under s 588M only begins when an initiating process (whether a writ, application or motion) is filed in a court of competent jurisdiction. In this case the initiating process was filed on 3 May 1994 and the liquidator had not given his consent to that process.

44. Corporations Law ss 588J(1), 588K(1) and 588M(2).
45. However, under s 588Y(1) secured creditors are not entitled to share in the compensation until all the company's unsecured debts have been paid in full.
46. (1998) 29 ACSR 130.
47. *Stoland Pty Ltd* v *Thurn* [1997] 1587 FCA (18 Dec 1997).

The Federal Court rejected this argument. Finkelstein J (with Branson and Emmett JJ concurring), held that the word "proceeding" in s 588R(1) included any process by which a claim under s 588M is made. The claim may be made in an originating process. It also included a claim made by way of amendment to an existing proceeding.

ASC v *Forem-Freeway Enterprises Pty Ltd*[48]

In this case the ASC applied to the Federal Court for civil penalty orders against Morton, the sole director and shareholder of Forem-Freeway Enterprises Pty Ltd (Forem) for breaches of former ss 232(2) and (4) (see now ss 180(1) and 181(1)) and s 588G. The ASC also applied for a compensation order under s 588J for the contravention of s 588G. While Madgwick J held that Morton contravened each of ss 232(2), (4) and 588G, the main focus of his decision concerned the various contraventions of the statutory duties in ss 232(2) and (4) and the appropriate civil penalty order in the circumstances. In this chapter I will deal only with that aspect of His Honour's judgment that deals with the contravention of s 588G.

The ASC alleged that Morton breached s 588G by failing to prevent his company from incurring debts to three creditors when a reasonable person in Morton's position would have suspected that the company was insolvent. The debts represented money borrowed from the ANZ Bank, equipment leasing from Advance Leasing Ltd and an amount due to a trade creditor, Alpha Computers Pty Ltd.

The only insolvent trading issue considered by the court concerned whether Forem was insolvent at the time the debts were incurred and whether Morton reasonably suspected insolvency. The company was held to be insolvent because there was no evidence to rebut the s 588E(4) presumption of insolvency. Under that provision, unless there is evidence to the contrary, a company is presumed to be insolvent when it has contravened s 286 by failing to keep adequate financial records.

Madgwick J concluded that the failure to comply with s 286 was "of a very high order". He accepted the evidence of Forem's liquidator that such books that he obtained inadequately recorded the company's financial transactions, financial position and performance. In particular, the company did not keep a general ledger reporting the balances of assets, liabilities and shareholders' funds. Nor did it have a cash book showing records of receipts and payments. Further, numerous cheque butts failed to disclose information such as the name of the payee or the purpose of the payment for which a particular cheque was paid.

Impact of Voluntary Administration on Directors' Section 588G Liability

While there are a relatively large number of reported cases dealing with its predecessors[49] there are only a handful of reported s 588G cases in the seven years since it became

48. (1999) 17 ACLC 511.
49. For example, there were 45 ss 556 and 592 cases reported in the CCH *Australian Company Law Cases* between 1992 and 1996.

operative. The main reason for the lack of s 588G cases is the decline in the number of companies wound up in insolvency[50] and the increasing use of voluntary administrations followed by deeds of company arrangement as preferred forms of insolvency administration. Indeed, if this trend continues insolvent trading cases are likely to be relatively rare.

While there are a number of factors that encourage directors to initiate voluntary administrations, creditors have the ultimate say in deciding what happens to the company after the administration period expires. In a significant number of cases creditors will have sound reasons for voting in favour of a deed of company arrangement even though the directors may have had a potential s 588G liability if the company were wound up instead.

The voluntary administration scheme contained in Part 5.3A of the Corporations Law was the result of amendments made by the *Corporate Law Reform Act* 1992, which also inserted the current insolvent trading provisions into the Corporations Law. The scheme implemented one of the main recommendations of the Australian Law Reform Commission contained in the Harmer Report[51] for a constructive and creative approach to corporate insolvency. Section 435A indicates that the object of the voluntary administration scheme is to maximise the chance of a company or its business continuing in existence and if this is not possible, to result in a better return for the company's creditors and members than would result from an immediate winding up.

Popularity of voluntary administrations

The embracement of voluntary administration by directors and insolvency practitioners as a preferred form of insolvency administration is revealed in the table[52] on the following page.

These statistics indicate that there have been 5914 voluntary administrations from 23 June 1993 (when the provisions of Part 5.3A of the Corporations Law became operative) to the end of June 1997 compared to 8837 compulsory liquidations in the same period. However, of more significance is the decline in the number of liquidations. These are down 28 per cent over the six-year interval. The most notable decline is the number of court-appointed winding ups — down 55 per cent. Creditors voluntary winding ups have increased markedly. This is a direct result of the voluntary administration process because most companies which enter into liquidation after a voluntary administration enter into a creditors voluntary winding up.[53]

50. Under s 588M liquidation is an essential prerequisite for successful compensation claims against directors under the insolvent trading provisions.
51. Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45, AGPS 1988 ("Harmer Report").
52. Appointments of External Administrators since 1 July 1991, by financial year. "A Study of Voluntary Administrations in NSW" ASC Research Paper 98/01, Appendix II.
53. Ibid, Appendix II, para 4.3.

Types of external administration	Types of administrators	91–92	92–93	93–94	94–95	95–96	96–97	Total
Administration	Administrator	n/a	11	827	1374	1765	1937	**5914**
	Administrator of DCA	n/a	0	331	576	689	677	**2273**
	Official Manager – Court Appointed	1	0	n/a	n/a	n/a	n/a	**1**
	Dep Official Manager	0	0	n/a	n/a	n/a	n/a	**0**
	Official Manager	8	9	n/a	n/a	n/a	n/a	**17**
	Scheme Manager	34	39	48	34	23	7	**185**
Total		**43**	**59**	**1206**	**1984**	**2477**	**2621**	**8390**
Liquidation	Creditors Voluntary Winding Up	914	884	933	1113	1553	1747	**7144**
	Compulsory Winding Up	4508	4145	2900	2018	1884	2035	**17490**
	Members Voluntary Winding Up	3729	3375	2869	2838	3284	2963	**19058**
	Provisional Liquidation	490	431	233	170	228	207	**1759**
Total		**9641**	**8835**	**6935**	**6139**	**6949**	**6952**	**45451**
Management of charged assets	Controller	n/a	8	199	151	120	114	**592**
	Receiver	172	125	119	101	102	95	**714**
	Receiver Manager	1017	916	711	588	537	545	**4314**
	Managing Controller	n/a	1	26	11	8	10	**56**
Total		**1189**	**1049**	**1055**	**851**	**767**	**764**	**5675**
Grand Total		**10873**	**9943**	**9196**	**8974**	**10193**	**10337**	**59516**

A company is under voluntary administration for a relatively short time.[54] Under s 439C creditors may resolve that the company executes a deed of company arrangement or that it should be wound up.[55] While a company is subject to a deed of company arrangement no compensation recovery action can be brought against its directors for contravention of s 588G.[56] The statistics indicate that a significant number of companies in financial difficulties are not placed in liquidation and move from voluntary administration to a deed of company arrangement. As the table indicates, there have been 2273 deeds of company arrangements from 23 June 1993 to the end of June 1997. Thus about half of all the voluntary administrations are followed by deeds of company arrangement.

Legislative incentives for directors to initiate voluntary administration

Directors are entitled to make the decision to place their company in voluntary administration if they believe the company is insolvent or is likely to become insolvent at some future time.[57] However, while this decision can also be made by the company's liquidator[58] as

54. Corporations Law s 439A.
55. While s 439C also enables creditors to terminate voluntary administration and hand control back to the company's directors, this is relatively rare.
56. Under s 588M liquidation is an essential prerequisite for directors' liability.
57. Corporations Law s 436A.
58. Corporations Law s 436B.

well as a secured creditor entitled to enforce a charge on the whole or substantially the whole of the company's property,[59] a survey on voluntary administration carried out by the Australian Society of Certified Practising Accountants' Centre of Excellence for Insolvency and Reconstruction in 1996 ("the Voluntary Administration Survey") led to some surprising results. In particular, the survey indicated that most voluntary administrations are initiated by directors, with secured creditors appointing their own administrator in 2 per cent of voluntary administrations and liquidator initiated voluntary administrations in 12 percent of cases.

The Harmer Report[60] recognised that the voluntary administration scheme would only achieve its object if directors were encouraged "to take early and orderly steps to deal with an existing or impending state of insolvency". Various provisions of the Corporations Law and other legislation provide an incentive for directors to place their company in voluntary administration.

1. Sections 588H(5) and (6)

The insolvent trading provisions themselves encourage directors of companies in financial difficulties to appoint an administrator sooner, rather than later. A director will not contravene s 588G if, pursuant to s 588H(5), the director can establish that he or she took all reasonable steps to prevent the company from incurring debts when there were reasonable grounds to suspect that it was insolvent. In determining whether the s 588H(5) defence has been proved, s 588H(6) directs the court to have regard, inter alia, to any action the director took with a view to appointing an administrator, when that action was taken and the results of the action.[61]

Because a director's personal liability for contravening s 588G only arises if the company is in liquidation, the action taken by a director with a view to appointing an administrator for the purposes of ss 588H(5) and (6) will be significant in only two situations. It will be a relevant defence for a director who has, prior to liquidation, unsuccessfully attempted to convince the board to place the company in voluntary administration.[62] It will also be relevant where the board has resolved to place the company in voluntary administration but the creditors, pursuant to s 439C, decide that the company should be wound up.

2. Guarantor directors

Placing an insolvent company in voluntary administration may be an attractive option for directors who have personally guaranteed company debts. While the company is under

59. Corporations Law s 436C.
60. Supra n 51 at para 54.
61. Corporations Law s 1317S sets out similar considerations to be considered by a court when it determines whether or not a person should be relieved from the civil penalty consequences of contravening s 588G.
62. However, as a result of the NSW Court of Appeal decision in *Byron* v *Southern Star Group Pty Ltd* (1997) 15 ACLC 191, it may not be sufficient action to invoke the defence.

voluntary administration, s 440J prevents creditors from enforcing the guarantee against the director. Section 440J also prevents creditors from enforcing guarantees of company debts provided by a director's spouse or other relative. This restriction on enforcement of guarantees is not necessarily bad for creditors. The fact that a guarantee becomes enforceable upon termination of voluntary administration may encourage guarantor directors to contribute to the assets under a deed of company arrangement.

3. Impact of Australian Tax Office s 222AOE notices

It is quite common to find that directors, especially of small companies, are unaware of the extent of the company's financial difficulties.[63] Even if directors are aware of financial problems they often have unrealistic expectations that they can trade their way out of difficulties. An early reminder of their potential s 588G liabilities may prompt them to take action to avoid liquidation.

Changes to the Income Tax Assessment Act made by the Insolvency (Tax Priorities) Legislation Amendment Act 1993[64] have the effect of alerting directors at a relatively early stage of their company's precarious financial state and prompt them to take remedial measures. The object of these provisions is to ensure that a company meets relevant tax obligations, such as employer group tax obligations, or goes promptly into voluntary administration or liquidation.[65]

Under these provisions, directors who ignore a notice served on them under s 222AOE of the Income Tax Assessment Act by the Australian Tax Office may become personally liable by way of penalty for their company's unremitted PAYE tax obligations.[66] Under s 222AOB, directors may avoid personal liability if they, inter alia, put the company into liquidation or appoint an administrator.[67]

The Voluntary Administration Survey referred to above indicates that 15 percent of voluntary administrations followed the Australian Taxation Office issuing directors with a s 222AOE personal liability notice. Clearly, receipt of a s 222AOE notice has a significant impact on directors of insolvent companies and focuses their attention on the plight of their company and encourages them to take action to avoid potential personal liability.

4. Avoiding potential consequences of liquidation

Directors may decide to initiate voluntary administration as a means of frustrating outstanding creditors' winding up applications and avoiding some of the potential

63. See, for example, *Morley* v *Statewide Tobacco Services Pty Ltd* (1992) 10 ACLC 1233 and *Group Four Industries Pty Ltd* v *Brosnan* (1992) 10 ACLC 1437.
64. Particularly Pt VI Div 9 of the Income Tax Assessment Act which came into effect about the same time as s 588G and the voluntary administration provisions.
65. Income Tax Assessment Act s 222ANA.
66. See S Barkoczy and M Barkoczy, "Directors' Liability and the New Regime for Collecting Unremitted Tax Instalments" (1996) 6 *Revenue Law Journal* 117.
67. Under s 222AOB directors may also avoid personal liability if they either cause the company to pay the amount claimed or enter into an agreement with the Commissioner of Taxation for payment.

consequences of liquidation. For example, liquidation can be a precursor to ASIC prosecution for Corporations Law offences apart from contravention of s 588G. Further, if directors have been involved in other companies that were placed in liquidation, another winding up may result in ASIC serving s 206F management disqualification notices on them.

A 1998 study of voluntary administrations by the ASC's NSW Regional Office[68] revealed that avoiding these potential consequences of liquidation was the aim in 15 of the 55 administrations investigated. Frustrating outstanding winding up applications was the aim in seven of the 55 administrations.

Factors influencing creditors' decision

Notwithstanding that directors are provided with legislative incentives to initiate voluntary administration, the ultimate decision regarding the fate of the company rests with its creditors.[69] The voluntary administration scheme gives creditors the opportunity to make a cost benefit analysis and decide whether the company's liquidation or a deed of company arrangement produces a better outcome for them. This analysis will include an assessment of the likelihood of a liquidator increasing the amount of the company's assets available for distribution to creditors by successful s 588G proceedings against directors. The likelihood of successful unfair preference claims against particular creditors will also be relevant.

Creditors base their decision on the fate of the company on information provided to them by the administrator. When convening the second creditors' meeting, s 439A(4)(a) requires the administrator to provide them with his or her report about the company's business, property, affairs and financial circumstances. In addition, under s 439A(4)(b) creditors must be sent a statement setting out the administrator's opinion as to whether it is in their interests for the company to execute a deed of company arrangement, or whether administration should end or the company should be wound up.

Amongst other things, the Corporations Regulations prescribe that an administrator's report must specify whether there are any transactions that appear to be voidable transactions, such as unfair preferences, that would be recoverable in a liquidation.[70] While it is not prescribed, administrators' reports usually indicate whether or not directors may be potentially liable for breaching s 588G.[71] If a complaint is made that an administrator's report inadequately canvassed the possibility of pursuing directors or holding companies in either ss 588G or 588V actions, the court must assess, on the basis of the material

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68. ASC Research Paper 98/01 'A Study of Voluntary Administrations in New South Wales' para 7.103.
69. Under s 439C the creditors, at the second creditors' meeting, may resolve that the company execute a deed of company arrangement, that the company should be wound up, or that administration should end.
70. Corporations Regulations reg 5.3A.02.
71. In its January 1997 Discussion Paper, *Voluntary Administration*, the Legal Committee of the Companies and Securities Advisory Committee did not support a mandatory legislative checklist of matters to be covered in an administrator's report (such as directors' s 588G liabilities) but proposed that the Corporations Law should follow the general disclosure requirements and require the report to include "any other matter material to the creditors' decision".

before it, whether there is a real prospect that the action would produce a better result for creditors than under the proposed deed of company arrangement.[72] A failure by the administrator to quantify the amounts that may be recoverable on a liquidation does not of itself constitute a material omission.[73]

According to *Deputy Commissioner of Taxation* v *Comcorp Australia Ltd*,[74] because of the tight time constraints imposed for preparation of the report, the information in it need not be as extensive as is required for an explanatory statement for a scheme of arrangement under Part 5.1A of the Corporations Law. However, it should contain sufficient information as can reasonably be expected to be material to creditors in all the circumstances. If an administrator's report canvasses whether or not directors have potential s 588G liabilities if the company were to be wound up, creditors should be informed of the "commerciality" of such proceedings including the litigation risks, whether or not funds would be available to pursue the claims and whether directors have the means to meet successful compensation claims.

Despite the fact that directors avoid potential personal liability for failing to prevent insolvent trading if creditors decide in favour of a deed and not to wind up the company, there is evidence that such a decision does produce a better outcome. A significant finding of the Voluntary Administration Survey referred to above was that the average dividend of companies entering into deeds of company arrangement was 30 cents in the dollar.[75] By contrast, the insolvency practitioners surveyed estimated that had those companies been placed in liquidation, the average dividend would have been seven cents in the dollar.

The voluntary administration scheme produces a better outcome for creditors than formal liquidation for a number of reasons.[76] In some cases, directors may be prepared to contribute to funds available for distribution to creditors in a deed of company arrangement from their own personal resources in order to avoid potentially higher claims against themselves. This is likely to be the case if, prior to the commencement of voluntary administration, directors have failed to prevent insolvent trading, have received unfair preferences or have breached their fiduciary duties by not taking creditors' interests into account. In addition, directors will frequently be willing to contribute to a deed of company arrangement to regain control over the company's business or purchase some or all of its assets perhaps for a higher price than would be paid by outsiders.[77] Evidence from the Voluntary Administration Survey suggests that resumption of control by directors is quite a common outcome in deeds of company arrangement. The survey reveals that directors

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72. *Molit (No 55) Pty Ltd* v *Lam Soon Australia Pty Ltd* (1997) 24 ACSR 47.
73. *Hagenvale Pty Ltd* v *Depla Pty Ltd* (1995) 17 ACSR 139 at 150.
74. (1996) 14 ACLC 1616.
75. Routledge, "An Exploratory Empirical Analysis of Part 5.3A of the Corporations Law" (1998) 16 *Company and Securities Law Journal* 4, finds similar high returns for unsecured creditors in an empirical investigation.
76. See Crutchfield, *Annotated Corporate Voluntary Administration Law* (1994) at 30–34 where a number of factors in favour of creditors supporting voluntary administration are outlined.
77. On regaining control directors will be in a better position to utilise the company's carry forward tax losses than third party purchasers of the company's shares.

commenced similar businesses shortly after the completion of the administration in 16 per cent of all cases.

Factors Influencing a Liquidator's Decision to Commence Section 588G Cases

As discussed earlier in this chapter, there has been a significant increase in the number of voluntary administrations and a corresponding decline in liquidations. Further, about half of the companies that enter into voluntary administration then move to deeds of company arrangement. According to a study carried out by Coopers & Lybrand in 1995 about half of the deeds of company arrangement entered into by 31 May 1995 were reconstructions where some or all of the business continued and creditors received payment out of future profits and/or injections of capital. The rest of the deeds of company arrangements involved an informal liquidation where business assets were sold and a dividend paid to creditors.

These figures lead to the conclusion that most companies that are formally wound up will not only be insolvent but hopelessly so. They will have insufficient funds available for their liquidators to commence insolvent trading proceedings against directors even if there is good evidence of contravention of s 588G. If the company has already gone though the voluntary administration process[78] its carcass will have been picked over and licked clean by its creditors, leaving nothing for a liquidator.

Funding for liquidators' s 588G cases may come from sources other than the company's assets. For example, some creditors may be convinced to contribute to a fighting fund to enable the liquidator to initiate compensation recovery proceedings against directors. Where creditors provide such assistance, s 564 enables the liquidator to apply to the court for an order that contributing creditors receive a dividend from the company's assets that they would otherwise not be entitled to in a winding up. As was the case in *Metropolitan Fire Systems* a creditor who is willing to take the risk of litigation on itself may not wish to contribute to a liquidator's fund and can, with the liquidator's consent, take action against the directors.

As a result of the Federal Court's decision in *Re Movitor Pty Ltd*,[79] liquidators now have an alternate source of funding. They are allowed to assign causes of action to third parties without the arrangement constituting champerty or maintenance. In *Movitor*, a liquidator entered into a "debt retrieval agreement" with an insurance company under which the insurer agreed to cover half the costs of an insolvent trading action, including half the defendant's costs if the action failed. If the action were successful the insurer would receive a "premium" of 12 per cent of the sum recovered. According to the *Australian Financial Review* the market for such agreements has grown dramatically since its

78. The statistics produced by the Voluntary Administration Survey reveal that only 12 percent of companies go from an executed deed of company arrangement to formal liquidation.

79. (1996) 14 ACLC 587. See also *Re Toisch Construction Pty Ltd* (1997) 23 ACSR 303.

legality was confirmed by the Federal Court.[80] It goes without saying that before a liquidator can obtain funds in such circumstances the insurer will satisfy itself that evidence of a contravention by directors is particularly strong. In addition, they will need to satisfy themselves that the directors against whom they contemplate legal action have the means to pay the compensation awarded against them.

Starting s 588G cases has also been hampered by the fact that, until relatively recently, all cases had to be heard by either the Federal Court or the Supreme Courts of the States or Territories. Inferior courts had no jurisdiction even though the amount claimed from directors was relatively small.[81] This was a disincentive for liquidators to start a case for relatively small claims because of the likely higher legal costs involved. This problem was resolved from October 1995 onwards when the Corporations Legislation Amendment Act 1994,[82] which ensures that inferior courts have jurisdiction with respect to civil claims arising under the Corporations Law, became operative. The Corporations Legislation Amendment Act did not help the plaintiff in *Metropolitan Fire Systems*. Even though the hearing took place after the commencement of the legislation, its proceedings had been initiated beforehand, so that even though the claim involved a relatively small amount, $50,000, it could not be transferred to a lower court.

Role of ASIC in Section 588G Cases

Insolvent trading is one of ASIC's major stated concerns. For example, on its Internet homepage, under the heading "reporting misconduct", ASIC says that it is targeting illegal practices, such as insolvent trading, and invites the public to report such practices.

ASIC has the legislative means to police insolvent trading through the civil penalty provisions of the Corporations Law. Section 588G is a civil penalty provision and consequently the provisions of Part 9.4B set out the civil consequences of a contravention of the section.[83] Sections 1317G and 1317J allow the court, on application by ASIC, to impose a pecuniary penalty order of up to $200,000 on the person who breached s 588G. Section 206C allows the court, on application by ASIC, to disqualify a person who has breached s 588G from managing corporations for a period that the court considers appropriate.

Where a director breaches s 588G and their failure to prevent the company incurring the debt was dishonest, the person commits an offence under s 588G(3).

The civil penalty provisions also enable ASIC or the company to apply for compensation orders against directors who contravene s 588G.[84] Compensation orders can be made in the context of an application for civil penalty orders[85] and as part of proceedings for the

80. *The Australian Financial Review,* 10 October 1997 p 26.

81. See *Re Satellite Productions Pty Ltd* (1993) 11 ACLC 22 and *Churcher* v *Edwardstown Carpets* (1993) 11 ACLC 393.

82. *The Corporations Legislation Amendment Act* 1994 also amended the cross-vesting provisions to facilitate the transfer of civil proceedings from an inferior court of one State or Territory to the inferior court of another.

83. Criminal consequences are dealt with in s 588G(3).

84. Sections 1317H and 1317J(2).

85. Corporations Law s 588J gives the court the power to order compensation on an application for a civil penalty order.

criminal offence.[86] Compensation orders can be made whether or not the court imposes a civil penalty order or a criminal penalty.[87]

It is significant that, unlike claims pursuant to s 588M, under ss 588J and 588K liquidation of the company is not an essential prerequisite to compensation claims. Under ss 588J(1) and 588K(1) any compensation recovered from directors is payable to the company.

Conclusion

The decision in *Metropolitan Fire Systems* demonstrates that provided a company is in liquidation, s 588G is just as effective as its predecessors in providing a means of recovering compensation from directors who fail to prevent insolvent trading. However, this does not mean that we are likely to see as many insolvent trading cases coming before the courts as was the case prior to the introduction of s 588G. As a result of the Corporations Law's voluntary administration scheme, a significant proportion of insolvent companies nowadays do not go through formal liquidation, an essential prerequisite for liquidator and creditor initiated compensation recovery proceedings. Notwithstanding this, creditors of companies that go through the voluntary administration process as a whole are not disadvantaged. Voluntary administration often produces a better outcome for them than liquidation.

The lack of s 588G actions will not necessarily result in a disrespect for the law and an increase in the incidence of malpractice by directors. The threat of s 588G compensation actions will always hang over the heads of directors who are unable to convince their company's creditors to accept a deed of company arrangement. In addition, in serious incidents of incurring debts while insolvent, ASIC has the legislative means to recover compensation from directors even if the company never goes into formal liquidation.

Perhaps the main cause for community concern is insolvent trading where neither the company nor its directors have sufficient funds available to make it commercially practical to begin s 588G actions. In these circumstances ASIC should take the initiative by applying for disqualification orders under s 206C.

86. Corporations Law s 588K sets out a regime for compensation orders similar to s 588J where a director is convicted of a criminal offence under s 588G(3).
87. Corporations Law ss 588J(1) and 588K(1).

PART IV

INTERNATIONAL PERSPECTIVES ON INSOLVENT TRADING

Chapter 7

Directors' Liability for Trading While Insolvent: A Critical Review of the New Zealand Regime

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Introduction

In 1993, New Zealand enacted new companies legislation which represented a decisive break with the country's pattern of adopting, with minor modifications, successive English Acts. The Companies Act 1993 drew heavily on North American models, in particular the Canada Business Corporations Act, but with a number of innovations including novel provisions imposing liability on directors for insolvent trading, and unreasonably risking insolvency.

In the first part of this chapter, I identify the policy concerns that underlie New Zealand's insolvent trading provisions. Before looking at some putative solutions, it is important to understand the problem that is being addressed. My basic thesis is that the current New Zealand answers are inappropriate largely because the issue has been insufficiently clearly defined.

I then go on to outline the New Zealand law on directors' liability for insolvent trading prior to 1993. In the third part of the chapter I review the evolution of the provisions of the 1993 Act which may impose liability on directors for continuing to trade while insolvent, or risking future insolvency (which for convenience I will refer to as the "insolvent trading provisions"). This leads to part four, in which I consider the relationship between the insolvent trading provisions and other facets of the 1993 Act.

I conclude with a critical evaluation of the current insolvent trading provisions and a suggestion for reform. I propose reform because (to anticipate my conclusions) the current provisions are difficult to apply in practice, and deter risk-taking in a manner which is fundamentally inconsistent with the basic objectives of company law. This is one area where the 1993 reforms are in fact worse than that which went before, though even that was far from ideal.

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The Policy Issues

One of the principal rationales for modern company law is limited liability. That is, company law enables investors and entrepreneurs to trade on the basis of a default limited recourse term, under which creditors' claims will be satisfied out of the assets of the company. Creditors cannot, in general, look to the assets of the owners or managers of the business. I have examined the rationale for this default limited recourse term in more detail elsewhere, and will not repeat that discussion.[1] In brief, limited liability reduces transaction costs and investor monitoring costs. This in turn facilitates the taking of business risks. Lord Buckmaster put it well earlier this century in *Rainham Chemical Works Ltd* v *Belvedere Fish Guano Co Ltd* [1921] 2 AC 465 at 475:

> But in truth the Companies Acts expressly contemplate that people may substitute the limited liability of a company for the unlimited liability of the individual, with the object that by this means enterprise and adventure may be encouraged.

At around the same time as Lord Buckmaster made that observation, the Greene Committee in England recommended introducing into English company law a fraudulent trading provision.[2] The provision was enacted in the English Act of 1928 (and included in the 1929 consolidation) and copied in the New Zealand Companies Act 1933. It reflected a concern that the beneficial institution of limited liability was being abused by some unscrupulous individuals to defraud unwitting creditors. That provision was the root of today's insolvent trading provisions. So what, precisely, was the concern that was being addressed? What were the abuses that were to be prevented?

The practice which attracted the Greene Committee's attention was the taking of debentures by shareholder directors to secure past advances to an insolvent company, allowing the company to purchase further goods on credit from third parties, then appointing a receiver. The result was that the directors obtained the benefit of the goods under the debenture, and the unsecured suppliers were left unpaid. Practices of this kind raise two quite distinct issues. First, the directors are procuring a preference for themselves in respect of their existing debts, by granting the debenture. This issue is dealt with separately in most modern company and insolvency laws, and can be put to one side for present purposes. Second, however, there is the concern that unwitting creditors are extending credit to a company that has no real prospect of repaying them: this is quite a different issue from that of preferences. It is concern about the position of creditors dealing with doomed companies that has driven the extension of insolvent trading provisions, as we shall see below.

Normally we do not worry about creditors of limited liability companies who are not paid in full — that is a risk they take, knowing that the company has limited liability. As a number of commentators have pointed out, there is no externality in the case of voluntary

1. D Goddard, "Corporate Personality — Limited Recourse and its Limits" in Grantham and Rickett (eds) *Corporate Personality in the 20th Century* (1998).
2. United Kingdom, *Report of the Company Law Amendment Committee*, HMSO, London (1926) Cmd 2657.

transactions — price and other terms reflect the risk of default, internalising it to the firm.[3] High risk debtors (whether incorporated or not) pay more for credit. And prices (and sometimes other terms) reflect the risk that the debtor will take on additional risk after credit has been extended.[4] Creditors can manage risk through a range of contractual and other techniques, including diversification and insurance (the cost of which becomes a cost of credit).

This is why the famous decision in *Salomon* v *A Salomon & Co Ltd*[5] is clearly right. The company's creditors knew they were dealing with a limited company. They had the ability to refuse to give credit, or to fix the terms on which they were willing to do so. They could price to all customers for the risk of a proportion of bad debts — and undoubtedly many of them did. People who take a risk and who are paid to take it should not complain when the risk materialises. It is irrelevant to argue that they were not aware of the precise extent of the risk. Their lack of knowledge itself reflects a judgment that detailed investigation of the creditworthiness of every trade debtor, or protection from loss in other ways (e.g. obtaining security or a guarantee), is more costly than simply taking the risk of a certain level of bad debts, and that it is cheaper to manage the risk through diversification over many debtors and over time. In many businesses, this is a rational judgment to make.

Supporters of insolvent trading liability regimes argue that, though it may be true in general that voluntary creditors take the risk of insufficiency of the debtor company's assets, the position is different once a company is insolvent, or on the brink of insolvency. They point out that there comes a point in time where trading on involves:

- taking business risks with creditors' funds, rather than shareholders' funds; and/or
- duping new creditors into extending credit.

These two concerns are in fact very different in nature, and in their implications for possible remedial liability regimes. Suppose, for example, that a company which is insolvent trades on for several months, repaying some creditors and incurring new debts of $1 million, resulting in a net increase in its indebtedness of $600,000. Liability under the first head must, logically, be limited to the losses of $600,000. But if deception of new

3. See, for example, F Easterbrook & D Fischel, *The Economic Structure of Corporate Law* (1991) at 50–2, and for a summary of the argument see Goddard supra n 1 at 26–8. The risk is internalised on average, across the range of firms with which the creditor deals. Thus some companies will not bear the full costs of the risks which they pose, while others will pay the same price while posing a lesser risk. It is not rational for creditors to price separately for each and every firm with which they deal — distinctions will be drawn only if it is economic to do so. So some firms do externalise some risk — but it is externalised not to creditors, but rather to the other firms with which they are grouped for pricing purposes by those creditors. This is a common phenomenon in any insurance market — and limited liability can be thought of as a form of insurance — see Goddard supra n 1 at 29–30. An argument that this averaging was unacceptable because of the inevitable muting of incentives faced by particular firms would amount to an argument that all forms of third party insurance should be prohibited — a position few would advance.
4. In some cases, debtors contract not to undertake new or additional risks without creditor approval — consider the normal terms of debentures and trust deeds constituting debt securities for issue in public markets, which typically restrict change of primary business activities or disposal or acquisition of assets beyond specified thresholds, or the incurring of certain types of competing obligations.
5. [1897] AC 22 (HL).

creditors post-insolvency is the concern, all new creditors should have separate claims, and the directors would be liable for the full $1 million. This distinction is even more acute where the company trades on and is in fact profitable, as the first head would not found any liability, while the second would still result in claims by new creditors who took the place of those fortunate enough to be paid out.

This example illustrates the importance of clarity in identifying the rationale for insolvent trading provisions, and in their legislative expression. I will therefore look at each of the two possible rationales for such provisions in a little more detail, before turning to the New Zealand law.

Risks taken by companies after obtaining credit

It is sometimes suggested that where a company engages in risky activity after credit is provided, this poses an additional concern since the price will not reflect the true risk of providing credit to the company in question. As long as the company continues to return to the market for credit, the need to avoid prejudicing the availability of such credit or increasing its cost creates an incentive not to engage in irrationally risky activities. But there is an "end game" problem. If the company is about to go out of business, and does not contemplate seeking further funding, the incentive to refrain from unduly risky activity is removed — especially where shareholder funds are negligible.

This end game problem raises questions concerning the incentives facing directors of a company on the brink of insolvency. But the concern is not protection of creditors, as some commentators argue. If directors systematically face perverse incentives of this kind, this is a form of moral hazard for which creditors will price (once again, on average). The cost of credit will reflect the risk that some firms, on the brink of insolvency, will take high risk gambles rather than closing down and realising remaining assets for the benefit of creditors. (In precisely the same way the cost of car insurance reflects the cost to insurance companies of the moral hazard which such insurance poses.) Particular firms may externalise this risk to some extent — but companies in general will not, and creditors in general will be no worse off.

Deterring excessive risk-taking by directors of (near) insolvent companies

This brings us to the first possible justification for rules imposing liability on directors for trading while insolvent. There are good reasons to believe that the cost to creditors of contracting with companies to avoid excessive risk-taking on the brink of insolvency, and monitoring those contracts, is such that all but the largest creditors (e.g. trustees for holders of debt securities) will not do so. Where there are many small creditors, who extend credit for short periods, it would not be in the interests of any one creditor to take such steps. The cost of co-ordinating such action on behalf of a group of small creditors will also probably be disproportionate to the advantages obtained. So firms will continue to act in this (inefficient) way — and will pay for the privilege of doing so in the cost of credit.

A law imposing liability on directors for insolvent trading to discourage such conduct, would (if effective) improve creditors' recoveries — which would in turn be reflected in the average cost of credit. Note that it is not creditors who benefit (at least, where creditors operate in competitive markets where cost reductions are competed away), but the companies to which credit is provided. The principal (long run) beneficiaries of insolvent trading rules are the companies whose cost of credit is reduced, rather than those who deal with them.

There is also, however, a cost to such rules. Directors who bear greater personal risk will charge more for their services, or require the company to meet the cost of insuring their exposure, to the extent permitted. And if the liability rules are overly severe or are unclear, directors may refrain from taking risks which would have been beneficial both for the company, and society at large.

Drafting a provision that is intended to deter excessive risk-taking while a company is insolvent, or near insolvent, raises complex issues. One possible approach is to require all trading — i.e. all risk-taking — to stop once a particular threshold is reached, and to impose liability for all losses suffered after that point. But this is both under-inclusive, in the sense that it does not address excessive risk-taking at an earlier stage, and over-inclusive, in that it imposes personal liability for taking justified business risks after the cut-off point, should those risks not come off. Another approach would be to condition liability on whether or not particular business decisions were "excessively risky", with the test applying in a wider range of financial circumstances — but such a test would be much more difficult to apply, and would create greater uncertainty and associated costs.

Even if a provision is appropriately worded, the exposure of directors may be increased beyond desirable levels by the application of the test by risk-averse judges with little familiarity with commercial decision making, reviewing board decisions with the benefit of hindsight, guidance from expert witnesses, and argument by advocates whose job it is to identify every possible downside of the relevant decision. The review will occupy far more time than is likely to have been available to make the initial decision. And it is not easy to recreate the flavour of the commercial decision-making process in a courtroom, some years after the event. All these factors tend to encourage excessive intervention, and a fear of liability on the part of directors and their insurers which increases the cost of doing business and discourages the taking of novel or very significant risks, even where the pay-off for success may be very great. To these indirect costs must of course be added the direct enforcement costs in respect of any such rules. Commercial litigation is never cheap.

Whether rules of this kind are desirable depends on weighing the gains from enhanced incentives against the costs of creating those incentives. This balancing exercise will depend very much on the particular rule proposed, and on the legal and institutional context, and cannot be determined in the abstract. Suffice to say that it is by no means self-evident that the gains from such rules will always — or even often — outweigh the costs. Any rule which is put forward on the grounds that it will discourage excessive risk-taking by directors of insolvent or near-insolvent companies needs to be assessed carefully, drawing on this framework.

If there is to be liability in this area, there is much to be said for a well defined statutory regime which balances risks and incentives, and provides safe harbours for directors, rather than leaving development of the law to broad-brush obligations fashioned by the courts.[6] The UK regime appears to take this general approach — though even under that regime, which is considerably narrower than New Zealand's, the absence of provision for contracting out is difficult to reconcile with the rationale for such rules.[7]

Deceiving voluntary creditors about solvency

I now turn to consider the second concern that is invoked to justify insolvent trading provisions, the general thrust of which is that a point is reached where new creditors are being "ripped off" because:

- there is little or no chance of their being repaid;
- if they knew the company's true financial position, they would not be willing to extend credit to it.

These factors alone are not enough to make directors liable under the insolvent trading laws of New Zealand or of any other country with which I am familiar. They do underpin many insolvent trading liability regimes. However, the implications of such a regime being founded on a concern about creditor deception are not followed through coherently in New Zealand's legislation, as we shall see below.

The link between controller liability and deception of creditors was in fact identified over 100 years ago, in Lord Macnaghten's speech in *Salomon*, where his Lordship observed that in that case there "was no fraud or misrepresentation, and there was nobody deceived". Mr Salomon was held to be not liable for the company's debts. Conversely, however, if a controller or other agent of a company deliberately or carelessly deceives a creditor as to the person with whom the creditor is dealing, or as to the creditworthiness of the company, and the information is material to the creditor's willingness to give credit, the person making the false or deceptive statement should in principle be liable for the loss caused by their fraud or negligence.

Express misstatements about creditworthiness are not too difficult to identify, and the suggestion that they should attract liability is not in the least controversial. The more difficult question is whether, simply by asking for credit, a person representing a company makes any implied representation as to its creditworthiness.

The issue is one of actionable non-disclosure — and the law has always struggled to define the circumstances in which a duty to disclose may arise in the pre-contractual context. The law relating to guarantors is, in my view, a useful guide here — in the absence of

6. As in, for example, *Kinsela* v *Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722; *Nicholson* v *Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Winkworth* v *Edward Baron Development Co Ltd* [1987] 1 All ER 114.

7. For the UK regime generally, see D Prentice, "Corporate Personality, Limited Liability and the Protection of Creditors", and the insightful commentary on this paper by T Telfer, in Grantham and Rickett (eds) supra n 1. For other criticisms of the UK regime, see B Cheffins, *Company Law: Theory, Structure and Operation* (1997) at 537–48.

any inquiry by the other party, or half-truths on the part of an agent for the company, the question should be whether the agent for the company knows (and so should disclose) that the company's ability to meet its obligations is outside the range of circumstances that would normally be encountered in a transaction such as that contemplated.[8]

It seems to me that an agent seeking credit is representing that there are no aspects of the company's financial position out of the ordinary for transactions such as that which is contemplated, which he or she is aware of *and has not disclosed*, which make it impossible for the company to perform, or highly probable that it will not do so. Context will matter: a company seeking credit from a high-risk lender (or trade creditor) need not disclose that its financial position makes recourse to normal bank credit impossible.[9]

Obviously directors are not tacitly representing that the creditor will definitely be paid — that is simply inconsistent with the institution of limited liability, and could not reasonably be assumed by any creditor. Guarantees must be express. But agents of a company who solicit credit for the company are, in my view, making implied representations concerning their knowledge of the company's financial position. Actual knowledge by the agent of insolvency or impossibility of performance is, on this approach, sufficient to trigger a disclosure obligation, and hence liability for non-disclosure.

A much more difficult question is whether liability should be imposed based on recklessness (turning a blind eye to facts indicating insolvency) or negligence (failing to make inquiries and obtain information that a reasonably prudent director would have obtained). This can be put another way: are directors tacitly representing not only that they do not know that the company is doomed, but also that they have made reasonable inquiries into the company's financial position as a foundation for their belief in its continuing viability?[10]

One needs to be careful in drawing inferences from silence. For myself, I would be slow to infer from a company's continued trading that the directors had made any particular inquiries into the company's financial position. Certainly, a "due inquiry" commitment does not meet the standard test for implying terms into a contract — it neither goes without saying, nor is necessary to give business efficacy to all such transactions.[11] This is in my view the most helpful test for the existence of an implied obligation or commitment, in

8. Compare *Laws of New Zealand*, "Guarantees and Indemnities" paras 34–35; *Halsbury's Laws of England*, "Guarantee and Indemnity" vol 20 paras 124–6.

9. As in the case of guarantees, where it is well established that a lender seeking a guarantee need not disclose expressly that the principal obligor's credit is unsatisfactory: that is implicit in the fact that a guarantee is being sought. There will be difficult boundary issues here, as in the context of guarantee cases, and the frequency with which such issues arise may justify spelling out the test in some detail in legislation.

10. There is an interesting tension here between the level of vigilance required of directors under most companies laws, and commercial reality (especially in small businesses). Few creditors with any experience of commerce would believe that directors (in particular, non-executive directors) have anything more than a rough idea of the company's financial position at any given time. Rough records of transactions are kept during the year, and compiled by "the accountant" periodically (often, annually). A general sense of how things are going (are creditors more or less up to date? how is the cash position? is stock turning over, or ageing? is business slow — and if so, will it pick up? and so forth) is as much as can be expected.

11. *BP Refinery (Westernport) Pty Ltd* v *Shire of Hastings* (1977) 16 ALR 363 (PC); *Rod Milner Motors Ltd* v *Enterprise Cars Ltd* [1999] 2 NZLR 568 (CA).

circumstances where parties deal face to face. So I would not favour founding liability for non-disclosure on anything short of actual knowledge of inevitable, or highly probable, financial collapse.

Directors who know that a company cannot meet its obligations as they fall due, and who nonetheless continue to carry on the business of the company by, for example, authorising employees to obtain goods or services on credit, similarly seem to me to be practising a deception on those creditors.

However, an express warning that the tacit assumption of solvency cannot be made should be sufficient to remove any liability. If the creditor is willing to proceed despite knowing that the risk of non-payment is high — presumably pricing to reflect that risk — then that creditor has no complaint if and when the risk materialises. There are creditors who are willing to lend at high margins to assist in corporate rescues — if they know the facts, they should receive the protection they contract for, but no more.

Summary: the proper scope of director liability

In summary:

- Creditors should have a claim against company controllers where the controllers enter into a transaction (or authorise entry into a transaction) at a time when they have actual knowledge that the company will not be able to perform, or it is highly probable that it will not do so, and this is not disclosed to the other party. This claim would be vested in each creditor separately, and would depend on the nature and circumstances of each transaction. A successful claimant would recover the full amount of any deficit in its claim against the company.
- There may also be a case for controller liability to deter "excessive" risk-taking where companies are insolvent or on the brink of insolvency, i.e. to deter inefficient conduct by controllers which it is typically too costly for creditors to monitor, despite the absence of any "wrong" to creditors in the sense of uncompensated risk. Such a claim would, logically, be vested in the company and would be for the amount of any loss resulting from trading on past a certain point, or from certain overly risky decisions made while insolvent or near-insolvent.

Having identified the nature and scope of the problem, and the type of response that might be appropriate, we can now proceed to consider the legislative techniques that have been employed to address it.

The Insolvent Trading Provisions of the Companies Act 1955

"Fraudulent trading" provisions

The general criminal law in relation to fraud has always applied to company directors, who are personally liable for frauds perpetrated by them through the company. For many years, this was as far as liability for insolvent trading went under English and New Zealand law.

However, as noted above, the Greene Committee's report in England in 1926 identified types of dishonest action by controllers which might not be caught by the general law, and recommended introducing specific criminal and civil liability on the part of a director of an insolvent company for fraudulent practices. This led to the enactment of s 75 of the Companies Act 1928 (UK) (subsequently s 275 of the 1929 UK consolidated Act), which became s 268 of the New Zealand 1933 Act, then (with some minor amendments) s 320 of the New Zealand 1955 Act. The provision (as enacted in 1955) read as follows:

> **320. Responsibility for fraudulent trading of persons concerned —**
>
> (1) If in the course of the winding-up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the Court, on the application of the Official Assignee, or the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct. On the hearing of an application under this subsection the Official Assignee or the liquidator, as the case may be, may himself give evidence or call witnesses.
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> (2) Where the Court makes any such declaration it may give such further directions as it thinks proper for the purpose of giving effect to that declaration, and, in particular, may make provision for making the liability of any such person under the declaration a charge on any debt or obligation due from the company to him, or on any mortgage or charge or any interest in any mortgage or charge on any assets of the company held by or vested in him, or any company or person on his behalf, or any person claiming as assignee from or through the person liable or any company or person acting on his behalf, and may from time to time make such further order as may be necessary for the purpose of enforcing any charge imposed under this subsection. For the purpose of this subsection the expression "assignee" includes any person to whom or in whose favour, by the directions of the person liable, the debt, obligation, mortgage, or charge was created, issued, or transferred or the interest created, but does not include an assignee for valuable consideration (not including consideration by way of marriage) given in good faith and without notice of any of the matters on the ground of which the declaration is made.
>
> (3) Where any business of a company is carried on with such intent or for such purpose as is mentioned in subsection one of this section, every person who was knowingly a party to the carrying on of the business in manner aforesaid shall be liable on conviction on indictment to imprisonment for a term not exceeding two years or to a fine not exceeding five hundred pounds or to both.
>
> (4) The provisions of this section shall have effect notwithstanding that the person concerned may be criminally liable in respect of the matters on the ground of which the declaration is to be made, and every declaration under subsection one of this section shall be deemed to be a final judgment within the meaning of paragraph (f) of section twenty-six of the Bankruptcy Act 1908.

The courts, influenced by the fact that the provision was concerned with fraud, and that it imposed criminal liability as well as civil liability, insisted on a very high standard of proof of actual dishonesty. One case referred to "an actual purpose consciously pursued of swindling creditors out of their money".[12] By the 1970s a number of commentators considered that this was too demanding a standard for civil liability, and that the difficulty of establishing a claim was discouraging liquidators and creditors from pursuing directors who had continued to trade long after they should have realised that the company was doomed. In other words, it was felt that liability should attach not only to directors who knowingly deceived creditors, but also to those who recklessly or carelessly traded on when the company was insolvent.

The question was whether directors should be treated as making an implied representation not only that there was nothing unusual in the transaction proposed to a creditor in terms of the company's ability to pay its debts, so far as they were aware (actual fraud), but also that they were not turning a blind eye to indications to the contrary (recklessness) or even that they had made reasonable inquiries on which their belief in the company's ability to perform was based (a negligence standard). Bearing in mind the extension of negligence liability at common law in the late 1960s and 1970s, it is perhaps not surprising that there was considerable support for a similar extension of statutory liability in relation to directors.

The 1980 extensions of director liability — recklessness and negligence

In 1980 the New Zealand Act was amended by deleting the criminal liability provision in subsection (3) (and re-enacting it in amended form as s 461D), adding a reference to "reckless" trading to the provision's title, and extending subsection (1) along the lines of the contemporary Australian legislation.[13] The modified s 320(1) reads as follows:

> (1) If in the course of the winding-up of a company it appears that —
>
> (a) Any person was, while an officer of the company, knowingly a party to the contracting of a debt by the company and did not, at the time the debt was contracted, honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts, (including future and contingent debts); or
>
> (b) Any person was, while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless manner; or
>
> (c) Any person was knowingly a party to the carrying on of any business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose,

12. *Re Patrick & Lyon Ltd* [1933] Ch 786, followed in New Zealand in a series of cases including *Re Brighton Coal Mines Ltd* (in liq) [1944] NZLR 275; *Re Maney & Sons Deluxe Service Station Ltd*; *Cowan* v *Maney* [1968] NZLR 624 (HC), [1969] NZLR 116 (CA); *Re Day-Nite Carriers Ltd* (in liq) [1975] 1 NZLR 172; *Re Southmall Hardware Ltd* (in liq) (1984) 2 NZCLC 99,102. This line of cases rejected the wider test propounded in *Re William C Leitch Bros Ltd* [1932] 2 Ch 71, where it was held that fraud could be inferred where the company continues to trade at a time when, to the knowledge of directors, there is no reasonable prospect of payment of the debts then being incurred.

13. These amendments implemented, with some minor modifications, the recommendations of the Macarthur Committee Report: *Special Committee to Review the Companies Act* 1973 AJHR Vol IV H7. See in particular paras 324–9.

the Court, on the application of the Official Assignee or the liquidator or any creditor or contributory of the company, may, if it thinks it proper to do so, declare that the person shall be personally responsible, without any limitation of liability, for all or any part of the debts and other liabilities of the company as the Court may direct. On the hearing of an application under this subsection the Official Assignee or the liquidator, as the case may be, may himself give evidence or call witnesses.

If directors are to be held liable for negligently failing to appreciate that a company is insolvent and should stop trading, then it is but a short step to conclude that they should not be able to avoid liability by failing to keep accounting records from which that information could be deduced. Hence in 1980 New Zealand also enacted a new s 319, which provided:

319. Liability where proper accounting records not kept —

(1) Subject to subsection (2) of this section, if —

(a) A company that is being wound up and that is unable to pay all its debts has failed to comply with section 151 of this Act (which relates to the keeping of accounting records); and

(b) The Court considers that —

(i) The failure to so comply has contributed to the company's inability to pay all its debts or has resulted in substantial uncertainty as to the assets and liabilities of the company or has substantially impeded the orderly winding-up thereof; or

(ii) For any other reason it is proper to make a declaration under this section —

the Court, on the application of the Official Assignee or the liquidator or any creditor or contributory of the company may, if it thinks it proper to do so, declare that any one or more of the officers and former officers of the company shall be personally responsible, without any limitation of liability, for all or any part of the debts and other liabilities of the company as the Court may direct.

(2) The Court shall not make a declaration under subsection (1) of this section in respect of a person if the Court considers that —

(a) He took all reasonable steps to secure compliance by the company with section 151 of this Act; or

(b) He had reasonable grounds to believe and did believe that a competent and reliable person was charged with the duty of seeing that that section was complied with and was in a position to discharge that duty.

A number of cases were brought under these provisions.[14] In several, directors were found liable, and ordered to pay the company the amount of certain debts incurred after the provision was held to have been triggered. Individual creditors did not receive the proceeds of these claims: they were available to unsecured creditors generally.

14. The leading New Zealand cases were *Thompson* v *Innes* (1985) 2 NZCLC 99,463; *Re Petherick Exclusive Fashions Ltd* (in liq) (1986) 3 NZCLC 99,946; *Maloc Construction Ltd* v *Chadwick* (1986) 3 NZCLC 99,794; *Re Bennett, Keane & White Ltd* (1988) 4 NZCLC 64,317; *Vinyl Processors (New Zealand) Ltd* v *Cant* [1991] 2 NZLR 416. A recent addition to the list — perhaps the last under the old Act — is *Re Wait Investments Ltd* (in liq) [1997] 3 NZLR 96.

Though the new title of s 320 referred to "reckless" trading, the language of s 320(1)(a) was more apt to describe a lower negligence-based standard. The courts certainly took this approach, and also significantly watered down the reference in s 320(1)(b) to reckless trading. In *Thompson* v *Innes*[15] the High Court put the test under s 320(1)(b) thus:

> Was there something in the financial position of the company which would have drawn the attention of an ordinary prudent director to the real possibility, not so slight as to be a negligible risk, that his continuing to carry on the business of the company would cause the kind of serious loss to creditors of the company which s 320(1)(b) was intended to prevent?

Defects in sections 319 and 320

If ss 319 and 320 were intended to address the two policy concerns identified in the first part of this chapter, they were defective in several respects.

First, liability for debts incurred while the company was insolvent was in effect strict liability so far as any director who was knowingly a party to the incurring of the debts was concerned, subject to a defence of honest belief on reasonable grounds that the company would be able to pay the debt. This reverses (and arguably extends) the normal negligence test, effectively requiring directors to prove that they acted in good faith and took reasonable care. As discussed above, there is a strong argument that this goes too far, and may deter desirable risk-taking by directors.

Secondly, the first limb of s 320(1) appears to be intended to address the concern that creditors may be misled by an implicit representation of creditworthiness. But if this is the focus of the provision:

- liability should not arise where disclosure of the company's position was made to the creditor concerned, and there was no deception. No such exception is provided for; and
- the loss is the individual creditor's, not the company's (indeed the company is better off, since it has received value but has not paid for it) — so relief should have been given to the affected creditor, not to the company as a whole.

Thirdly, the second limb of s 320(1) was presumably intended to focus on continued trading, rather than obtaining new credit, as otherwise it would add nothing to the first limb. Liability in these circumstances can only be justified on the basis of an argument that directors are likely to take excessive risks on the brink of insolvency, and that such conduct should be prohibited. As noted above, this is not self-evidently correct. But assuming that such a provision was desirable in principle, the language of the 1980 amendments lent itself to a judicial approach which focused on the existence of a high risk of default rather than on the trade-off between risk of loss and prospect of gain.[16] This is undesirable, as it biases risk-taking away from higher risk ventures, even where they have a positive net present value, defeating one of the fundamental rationales for limited liability.

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15. (1985) 2 NZCLC 99,463; cited with approval in several of the cases referred to in supra n 14.
16. See, for example, *Thompson* v *Innes* (1985) 2 NZCLC 99,463; *Re Bennett, Keane & White Ltd* (1988) 4 NZCLC 64,317; *Re Wait Investments Ltd* (in liq) [1997] 3 NZLR 96, where there is no discussion at all of the size of the likely gain from the transaction, let alone a balancing of risk and potential gain.

The Law Commission's Proposals for Reform and the 1993 Act

In 1989 the New Zealand Law Commission published its report *Company Law: Reform and Restatement.*[17] The Report recommended a substantially recast company law, which looked more to North American models than to England. Among other reforms, the Report sought to codify the duties of directors, and to reform the law relating to liquidation along the lines suggested by the Australian Law Reform Commission.[18]

The Commission suggested reforming s 320 of the 1955 Act:[19]

- to recast the provision as a positive duty owed by directors to the company, moving it from the part of the Act concerned with liquidation to the part concerned with the obligations of directors; and
- to reduce its tendency to deter risk-taking by directors. The Commission recognised that companies may undertake very risky or speculative ventures, and that often this is socially desirable. It felt that s 320 (as interpreted by the courts) could impose liability in such circumstances, and that this should be changed so that liability would be incurred only if the directors had *unreasonably* risked insolvency. The concept of risk-taking was integral to this approach.

The Commission's draft Bill contained the following provision:

> **105. Solvency**
>
> (1) A director of a company must not agree to the company entering into a contract or arrangement or acting in any other manner unless he or she believes at that time on reasonable grounds that the act concerned does not involve an unreasonable risk of causing the company to fail to satisfy the solvency test.
>
> (2) A director of a company must not agree to the company incurring an obligation unless he or she believes at that time on reasonable grounds that the company will be able to perform the obligation when required to do so.

These duties would be owed to the company, not to creditors. A creditor could bring anticipatory proceedings to prevent a future breach — but only the company (normally, acting through a liquidator) would be able to bring proceedings against the directors to recover compensation for a breach.[20] The Commission did not propose any provision along the lines of s 319. Failure to keep accounting records would be an offence, but would not entail civil liability.

The topic of directors' duties proved one of the most controversial during the prolonged select committee hearings that followed introduction of a new Companies Bill based on the Law Commission's draft. The Bill was originally introduced into Parliament

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17. New Zealand Law Commission, Report No 9, June 1989.
18. Australian Law Reform Commission, Report No 45, *General Insolvency Inquiry* (1988). The NZ Law Commission's adoption of the general approach in the Australian Report, and of many specific proposals, is noted at NZLC Report No 9 para 309, and see Chapter 4 generally.
19. NZLC Report No 9, paras 515–16.
20. NZLC Report No 9, paras 517–18. The Commission recommended a statutory derivative action regime which could be invoked by directors and shareholders, but not by creditors.

in 1989. It included a clause based on the Law Commission's cl 105(2), but replaced cl 105(1) with a provision more closely modelled on s 320(1)(b), prohibiting directors from agreeing to the business of a company being carried on recklessly, or causing or allowing the company's business to be carried on recklessly.[21] The Bill's provisions then underwent significant modification before the select committee, including:

- changes to the "reckless trading" provision to omit reference to recklessness, and instead to mirror the High Court's watered down test in *Thompson* v *Innes*; and
- reinsertion of a provision imposing civil liability for failure to keep proper accounting records, along the lines of s 319 of the 1955 Act.

The Bill as finally enacted in 1993 contained the following provisions addressing this subject:

> **135. Reckless trading**
>
> A director of a company must not —
>
> (a) agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company's creditors; or
>
> (b) cause or allow the business of the company to be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.
>
> **136. Duty in relation to obligations**
>
> A director of a company must not agree to the company incurring an obligation unless that director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so.

These duties are owed to the company, and not to shareholders or, seemingly, direct to creditors.[22] It is unlikely that an individual creditor could bring a claim against a director based on these provisions. Nor can creditors obtain leave to bring a derivative action on behalf of a company under the statutory regime governing such actions.[23] However, one possible avenue for direct claims is established by s 301 of the 1993 Act, which provides:

> **301. Power of Court to require persons to repay money or return property —**
>
> (1) If, in the course of the liquidation of a company, it appears to the Court that a person who has taken part in the formation or promotion of the company, or a past or present director, manager, liquidator, or receiver of the company, has misapplied, or retained, or become liable or accountable for, money or property of the company, or been guilty of negligence, default, or breach of duty or trust in relation to the company, the Court may, on the application of the liquidator or a creditor or shareholder,
>
> (a) Inquire into the conduct of the promoter, director, manager, liquidator, or receiver; and
>
> (b) Order that person —

21. A provision which would probably have been an improvement on the Law Commission draft, were it not for the serious dilution of the concept of recklessness in the case law: see H Rennie and P Watts, "Directors' Duties and Shareholders' Rights" *NZ Law Society Seminar* (1996) at 32–3.
22. Section 169 of the 1993 Act, which is concerned with personal actions by shareholders against directors, expressly provides that the duties set out in ss 135 and 136 are owed to the company and not to shareholders.
23. 1993 Act, ss 165–8.

(i) To repay or restore the money or property or any part of it with interest at a rate the Court thinks just; or

(ii) To contribute such sum to the assets of the company by way of compensation as the Court thinks just; or

(c) Where the application is made by a creditor, order that person to pay or transfer the money or property or any part of it with interest at a rate the Court thinks just to the creditor.

(2) This section has effect even though the conduct may constitute an offence.

It has been held that a creditor can apply under s 301 in respect of a breach of s 135, but that s 301(1)(c) does not apply to claims in respect of breaches of duty to the company (as opposed to claims in respect of misapplications etc. of property). Thus a creditor who applies under s 301 in respect of a breach of s 105 must do so for the benefit of all creditors.[24]

A limited safe harbour is provided for directors whose belief in the company's solvency is founded on information provided by others:[25]

138. Use of information and advice —

(1) Subject to subsection (2) of this section, a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:

(a) An employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned;

(b) A professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence;

(c) Any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.

(2) Subsection (1) of this section applies to a director only if the director —

(a) Acts in good faith; and

(b) Makes proper inquiry where the need for inquiry is indicated by the circumstances; and

(c) Has no knowledge that such reliance is unwarranted.

Contrary to the Law Commission's approach, the 1993 Act also imposes civil liability for failing to keep adequate accounting records. Section 300, which is closely modelled on the former s 319, provides as follows:

300. Liability if proper accounting records not kept

(1) Subject to subsection (2) of this section, if —

(a) A company that is in liquidation and is unable to pay all its debts has failed to comply with —

(i) Section 194 of this Act (which relates to the keeping of accounting records); or

24. *Mitchell* v *Hesketh* (1998) 8 NZCLC 261,559.

25. For a brief note of some concerns in relation to s 138, see D Goddard, "Company Law Reform — Lessons from the New Zealand Experience" (1998) 16 *Company and Securities Law Journal* 236 at 246–7.

(ii) Section 10 of the Financial Reporting Act 1993 (which relates to the preparation of financial statements); and

(b) The Court considers that —

(i) The failure to comply has contributed to the company's inability to pay all its debts, or has resulted in substantial uncertainty as to the assets and liabilities of the company, or has substantially impeded the orderly liquidation; or

(ii) For any other reason it is proper to make a declaration under this section,

the Court, on the application of the liquidator, may, if it thinks it proper to do so, declare that any one or more of the directors and former directors of the company is, or are, personally responsible, without limitation of liability, for all or any part of the debts and other liabilities of the company as the Court may direct.

(2) The Court must not make a declaration under subsection (1) of this section in relation to a person if the Court considers that the person —

(a) Took all reasonable steps to secure compliance by the company with the applicable provision referred to in paragraph (a) of that subsection; or

(b) Had reasonable grounds to believe and did believe that a competent and reliable person was charged with the duty of seeing that that provision was complied with and was in a position to discharge that duty.

(3) The Court may give any direction it thinks fit for the purpose of giving effect to the declaration.

(4) The Court may make a declaration under this section even though the person concerned is liable to be convicted of an offence.

Corresponding provisions were inserted in the Companies Act 1955 for the duration of the three-year transition period during which companies could continue to operate under the 1955 Act.[26]

Few cases have as yet been decided under the new insolvent trading provisions. I am aware of only one substantial award against directors, under the new ss 189 and 275 of the 1955 Act, which correspond to ss 135 and 301 of the 1993 Act.[27] In that case the High Court held that there had been a clear breach of s 189, following which the company incurred obligations totalling some $890,000 and increased its net indebtedness by some $600,000. The court considered that s 275, like the former s 320, conferred a general discretion to be exercised taking into account all the circumstances of the case, and "often requiring a broad, global approach".[28] The court considered that the two directors against whom proceedings had been brought (one other had been omitted as a defendant for "humane reasons") should be cumulatively responsible for most but not all of the increase in net indebtedness, and required each to pay the company $250,000.

This is in many respects an odd outcome. Despite a strong finding that the directors had breached the s 135 duty owed to the company, an award was made in favour of the company for less than the loss caused by the breach, and was made against the directors severally rather than jointly. It is difficult to see how such a result could have been reached

26. See Companies Act 1955, ss 189, 190, 192, 274.

27. *Nippon Express (New Zealand) Ltd* v *Woodward & Nutt* (1998) 8 NZCLC 261,765.

28. Ibid.

if the company had simply claimed for breach of s 189 (the 1955 Act equivalent of s 135), and it is far from obvious that the use of s 275 (the 1955 Act equivalent of s 301) to bring the matter before the court should lead to a different outcome. In this respect the position under the 1993 provisions is fundamentally different from the position under the former law, where all liability for insolvent trading was discretionary. This significant change in the statutory framework does not appear to have been considered by the court. One can perhaps take from the decision a reluctance to impose on the directors the full burden of liability contemplated by s 135 — which for the reasons considered below is understandable, though difficult to reconcile with the current legislation.

This decision was recently followed, and an award made against a director following an undefended hearing, in *Ocean Boulevard Properties Ltd* v *Everest*.[29] In that case, a company with no assets and no firm business plan entered into an agreement to lease premises but then refused to enter into a formal lease or to perform the agreement, and was shortly afterwards put into liquidation. The court found that there had been a breach of s 136 of the 1993 Act, as on the evidence the directors had no basis for believing that the company would be able to pay the rent. This has disturbing implications for high-risk start-up companies — though the decision may have been influenced by the absence of any evidence from the director explaining the intended business activities of the company. The court also approved the discretionary approach to relief under s 301 taken in *Nippon Express*: however as in *Nippon Express* itself, there was no consideration of the significant changes from the 1955 Act in the statutory regime for insolvent trading liability.

Problems with the Insolvent Trading Provisions of the 1993 Act

Sections 135 and 136 go far beyond the scope of any proper liability for failure to disclose risk, even if liability for negligent non-disclosure is (contrary to my view) appropriate.

Section 135 imposes liability whenever a director is involved in carrying on business in a manner which creates a substantial risk of serious loss to creditors. But this is a feature of many high risk businesses. Creditors can decline credit, or price accordingly. Every creditor of a new restaurant venture, for example, knows that there is every risk of failure. So no special disclosure would seem to be required. Even more unsatisfactorily, the provision does not exclude liability where a creditor is in fact aware of the risk, and agrees to run it. Yet in such cases, where is the rationale for director liability?

This objection applies even more strongly to s 136. Both director and creditor may know that there is a very real risk that the company will not be able to perform a contract. But the risk may be acceptable to the creditor, who knows that the company alone will be answerable for its failure to perform, and may not have sufficient assets to pay damages. Why does the law intervene to impose liability on the director?

The basic problem is that neither s 135 nor s 136 is a coherent response to the two policy concerns identified in the first part of this chapter. To address the first concern —

29. (2000) 8 NZCLC 262,289.

deception of creditors — requires an inquiry into each transaction, and what a reasonable creditor would have understood about the company's financial position. Neither provision even adverts to this factor. To address the second concern — excessive risk-taking by directors — requires some balancing of risk and return. Yet the subject of potential return from risks taken does not feature in either provision.

Not only are the provisions poorly conceived — they are also most unfortunately worded, using vague and unhelpful terminology that provides few signposts to the border between acceptable commercial conduct, and unacceptable conduct that will result in imposition of liability. How is a court to decide what is a "serious" risk or a "substantial" loss? How is a director making a decision supposed to know whether the risk he or she is considering will be seen as transgressing these very fuzzy boundaries? What model of appropriate commercial decision-making is to be applied, if "big" risks are frowned on? Undoubtedly expert evidence will be called — but how precisely should the questions to be addressed by those experts be framed?

Two other problematic features of the new provisions deserve mention:

- Section 135 applies not only to directors who are active parties to the carrying on of the business in a manner which creates a substantial risk of serious loss, but also to those who simply stand by and allow the business to be carried on in this way. By creating a positive duty to know whether the company faces a "serious risk of substantial loss" and to intervene to prevent this, s 135 creates strong incentives for non-executive directors to encourage a risk-minimising approach on the part of management. This is by no means in the best interests of shareholders.
- Both provisions apply at all times, not just when the company is insolvent or nearly so. Directors of a perfectly solvent company who authorise entry into a novel and speculative venture, or who assume contingent obligations which are remote but very large, may find that they have breached these duties.

Finally, in this catalogue of concerns, it is necessary to note the relative lack of commercial experience of much of the New Zealand judiciary. A generalist judiciary needs more guidance rather than less from the legislature when it comes to drawing difficult distinctions in a complex field. Instead, the judiciary has been asked to act on the basis of confused generalities.

These very serious flaws are likely to breed excessive liability, and a high degree of uncertainty in the commercial and insurance communities. This will in turn discourage appropriate risk-taking, and increase the cost to companies of obtaining the services of high quality directors, through higher fees and director insurance premiums. Directors are encouraged to protect themselves with opinions from lawyers and financial advisers — at the expense of shareholders (or, in some cases, creditors). Corporate rescues will become particularly problematic, not only for directors themselves but also for financiers and "corporate doctors" who may be treated as shadow directors. (While empirical support for these fears is not easy to come by, anecdotal evidence of refusals of directorships and additional expenditure on "papertrails" is abundant in the commercial community.)

It is possible to take a more sanguine view of the likely effect of these provisions, as has one New Zealand judge, writing extra-judicially.[30] This approach is based on reading into ss 135 and 136 some significant qualifications and glosses which are notably absent from the statutory language, such as a balancing of risk and return to determine whether or not a decision creates a serious risk of substantial loss. However, His Honour acknowledges that it would have been preferable for the statute to set these out expressly — and for my part, I am less confident that these ameliorations can be achieved without legislative intervention.

Turning to s 300, which imposes liability for failure to keep proper accounting records, what the law says here is, in effect, that directors must stop trading not only if they know the company is insolvent, but also if they would have known this had proper accounting records been kept and proper financial statements been prepared. This provision troubles me, for two reasons:

- it goes beyond the normal subjective trigger of disclosure obligations, effectively imposing an obligation to know whether or not certain facts exist; and
- disclosure is not a defence: even if a creditor knows the company's affairs are a muddle, the directors may be liable for the debt. Should an accountant hired to sort out the company's defective records be able to obtain the benefit of this provision?

The court's discretion under s 300 (a palliative lacking with respect to ss 135 and 36) may enable consent to dealing with the company by a creditor with notice of the correct facts to be raised as a defence. However, it would be preferable for the provision to provide expressly that a creditor may contract out of the protection which s 300 provides. A review of ss 135 and 136 should also embrace section 300, with a view to providing a single coherent response to the concerns identified in this chapter.

A Possible Solution?

The starting point for fashioning a replacement for ss 135, 136 and 300 must be the limited policy rationale for any provision imposing liability on directors who trade while insolvent. Directors should be liable if:

- they have misled a creditor as to the risk involved in dealing with the company, either expressly or by failing to disclose circumstances so far out of the ordinary that they call for remark; and
- their action meets the culpability threshold (dishonesty, negligence etc.) appropriate in the circumstances.

I begin by considering express statements as to the company's financial position made by a director or other agent. If such a statement is false, the maker will be liable:

- at common law, if it is made fraudulently or negligently. Negligence could be established by absence of reasonable grounds for the statements, including (probably) failure to

30. Hon Justice Tompkins, "Directing the Directors: The Duties of Directors Under the Companies Act 1993" (1994) 2 *Waikato Law Review* 13.

prepare and take into account the accounting records and financial statements required for every company;
- under s 9 of the Fair Trading Act 1986, without proof of fault of any kind.[31]

The existence of these comprehensive grounds of liability for express statements means that there is no need to include further liability provisions in the Companies Act. (An argument can be made for limiting liability in negligence, and under the Fair Trading Act. And the inability to contract out of liability under that Act is anomalous, at least so far as commercial transactions are concerned, given the law's acceptance that liability for negligent misstatement can be excluded by contract. But these are wider issues that require separate consideration.)

What, then, should the position be in relation to non-disclosure? Both at common law and under the Fair Trading Act, the better view is that in the absence of any misleading half-truth or prior representation, liability for failure to warn of adverse factors in connection with a transaction can arise only where there is a duty to speak — and the law imposes such a duty only where:

- the circumstances are so unusual that they call for remark; and
- these matters are actually known to the person who fails to disclose them.[32]

Moreover, the person who deals with the company must in fact be misled, and must act to his or her detriment as a result.

It is difficult to see any reason for liability for deception in relation to a company's solvency being stricter, or more extensive, than liability for other forms of deception under the general law. Rather than leaving it to the courts to develop the law in this area, it may well be desirable to set out in the Companies Act the precise scope of this head of liability. But it should be carefully conditioned on the factors described above. The duty would be owed to the person who is misled, not to the company. The measure of loss would be the amount lost by that creditor as a result of the dealing that would not have occurred but for the misrepresentation.

That leaves only the alternative policy argument identified above — that it is more efficient for the default rule to be that directors are liable for excessive risks taken while insolvent or near-insolvent, as the costs of such a rule to the company in terms of higher directors' fees and more risk-averse directors are less than the additional cost of credit incurred in the absence of such rules. The trigger for liability could be trading on past a

31. Section 9, which is based on s 52 of the Australian Trade Practices Act 1974 (Cth), provides that "No person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive." Section 43 of the Fair Trading Act 1986 confers on the court the power to grant a wide range of relief where a breach of s 9 results in loss or damage, including an award of compensation for that loss or damage.

32. See, for example, *Dell* v *Beasley* [1959] NZLR 89 at 95 (common law); *Mills* v *United Building Society* [1988] 2 NZLR 392 at 406 (HC), upheld on appeal at 411–13 (Fair Trading Act). The need for actual knowledge under the Fair Trading Act or the statutory misrepresentation regime in the Contractual Remedies Act 1979 is queried by some commentators such as Burrows, Finn and Todd, *The Law of Contract in New Zealand* (1997) at 313, 329. But in circumstances where there has been no misleading half-truth or prior representation, it seems to me that the most that the other party can reasonably infer from silence is that there is nothing exceptional known to the speaker which makes the transaction almost inevitably doomed.

certain point, or taking "excessive risks", or some combination of the two. The desirability of such a rule is not self-evident: it is an empirical issue that cannot be answered in the abstract, and which requires more careful scrutiny than legislators in New Zealand have accorded it. Framing such a rule in a way that deters undesirable conduct, but does not deter socially desirable risk-taking or give rise to considerable uncertainty and cost, would be far from simple. If such a rule is adopted, the measure of liability to the company (not to creditors) should be the net losses suffered as a result of trading on, or as a result of taking the proscribed "excessive" risks, rather than the face value of particular debts incurred.

In summary, the existing ss 135, 136 and 300 are as misguided as they are novel. They should be repealed. They should probably be replaced with a provision imposing liability to creditors for culpable non-disclosure, and possibly (depending on further analysis) with an additional provision imposing liability to the company for net losses incurred as a result of trading on after the directors knew (or should have known) that the company was insolvent, or as a result of taking certain excessive risks in specified financial circumstances. It is not easy to identify a principled basis for any more extensive imposition of liability in this area.

Chapter 8

Civil Liability of Directors for Company Debts Under English Law

Jenny Payne* and Dan Prentice**

Introduction

This chapter examines the ways in which a director can be made liable for the debts and other civil obligations of a company under English law. The first part deals with the common law aspects of the matter and the second with the statutory developments which, as will be seen, are superceding the common law techniques for holding directors liable for the debts of their company.

Common law

There are three techniques whereby the common law can impose liability to creditors on directors. The first requires the courts to lift the veil of incorporation,[1] the second imposes a duty on the directors qua director to take account of the interests of the creditors, and the third requires the court to establish an independent duty owed by the directors to the creditors.

Lifting the veil

Where the directors are also shareholders the creditor may try to attach liability to the directors of the company by attempting to lift the veil of incorporation. At common law there

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1. There has been a great deal of discussion as to the correct word to use in order to describe the process of bypassing the doctrine set out in *Salomon* v *A Salomon & Co Ltd* [1897] AC 22; see, for example, S Ottolenghi, "From Peeping Behind the Corporate Veil to Ignoring it Completely" (1990) 53 *Modern Law Review* 338. Staughton LJ in *Atlas Maritime Co SA* v *Avalon Maritime Ltd (No 1)* [1991] 4 All ER 769, 779 said "[t]o *pierce* the corporate veil is an expression that I would reserve for treating the rights or liabilities or activities of a company as the rights or liabilities or activities of the shareholders. To *lift* the corporate veil or *look behind it*, on the other hand, should mean to have regard to the shareholding in a company for some legal purpose." [original emphasis] To be clear, the cases which will be discussed in this chapter require the activities of the company to be ascribed to one or more of the shareholder/directors of that company. Although the phrase "lifting the veil" will be used, this process would be termed "piercing the veil" in Staughton LJ's assessment.

are only two arguments which creditors could attempt to use to achieve this: either that the corporate form has merely been set up as a sham or fraud to "avoid recognition by the eye of equity"[2] or that the justice of the case requires that the veil should be lifted.[3] These arguments were interpreted very restrictively by the Court of Appeal in *Adams* v *Cape Industries plc*[4] and recent decisions of the English courts have continued this trend.[5]

The most recent assessment of the circumstances in which the veil will be lifted is found in *Ord* v *Belhaven Pubs Ltd*.[6] This case dealt with the attempt to attach liability to other companies within a group rather than to the director/shareholders, but it is important for the tone it sets for future lifting the veil cases. In that case the plaintiffs brought a claim against Belhaven, but before the issue could be decided Belhaven's assets were transferred at net book value to another company within its group as part of an internal reorganisation, prompted by a genuine desire to react to changes in the property market. The plaintiffs argued that the veil should be lifted because this transfer involved the corporate form being used as a sham to avoid Belhaven having to pay them any money. However, the Court of Appeal disagreed.

The Court of Appeal quoted with approval the view set out in *Adams* v *Cape*[7] that the corporate veil will only be pierced where the company is a "mere façade concealing the true facts", effectively dismissing the "single economic entity" argument[8] and the idea that the veil could be lifted on the grounds of justice.[9] As far as the possibility of lifting the veil on the grounds of a "mere façade" is concerned, the court in *Ord* v *Belhaven* reiterated the narrow definition set out in *Adams* v *Cape*: that a façade only exists where a company is being used to evade a pre-existing liability.[10] In *Ord*, the court asserted that although the plaintiffs were left with a claim against an empty purse, as a result of the reshuffling of assets between the companies, all of the transfers were done legally and without fraud. There was no suggestion of asset stripping and therefore no lifting of the veil was possible.

2. *Jones* v *Lipman* [1962] 1 WLR 832 at 836, per Russell J.
3. An argument accepted by the Court of Appeal in *Re a Company* [1985] BCLC 333 at 337–8.
4. [1990] Ch 433.
5. In fact the Court of Appeal in *Ord* v *Belhaven Pubs Ltd* [1998] 2 BCLC 447, stated that to say that there is no presumption in favour of lifting the corporate veil "may be regarded as an understatement" (at 453, per Hobhouse LJ).
6. [1998] 2 BCLC 447.
7. [1990] Ch 433 at 544.
8. That is, the argument that a group of companies, if a single economic entity, can also be regarded as a single legal entity: *Woolfson* v *Strathclyde Regional Council* [1978] SLT 159; *DHN Ltd* v *Tower Hamlets LBC* [1976] 3 All ER 462. This idea was effectively squashed by the Court of Appeal in *Adams v Cape Industries plc* [1990] Ch 433.
9. While the Court of Appeal in *Adams* v *Cape* [1990] Ch 433 were clear that justice was not a sufficient ground, the decision in *Creasey* v *Breachwood Motors Ltd* [1998] 2 BCLC 480 suggested that this might still be a possibility. The court in *Ord* v *Belhaven* went out of its way to state that the decision in *Creasey* "cannot be sustained"(at 458, per Hobhouse LJ). It is clear, then, that no separate head of "justice" presently exists.
10. In fact, on one interpretation, the façade argument is even narrower than that and can only be used where a company is *set up* to evade a pre-existing liability (see, for example, *Creasey* v *Breachwood Motors Ltd* [1993] BCLC 480), although it is submitted that this goes too far: J Payne, "Lifting the Corporate Veil: A Reassessment of the Fraud Exception" (1997) *Cambridge Law Journal* 284.

Where does all of this leave creditors hoping to bring claims against directors? The recent case of *Yukong Lines of Korea* v *Rendsburg Investments Corp (No 2)* provides an insight.[11] The basis of this case was a straightforward claim by Yukong against Rendsburg for damages for a wrongful repudiation of a charterparty agreement between them. This straightforward claim started to get messy when a Mareva order obtained by Yukong turned up evidence that the shareholders of Rendsburg were a Mr Yamvrias, directly and through his wife, and another company, Ladidi, which was also beneficially owned by Mr Yamvrias. It was also discovered that on the day of the repudiation of the charterparty agreement almost the entirety of Rendsburg's assets had been transferred to Ladidi, on the instructions of Mr Yamvrias. Yukong quickly joined Mr Yamvrias in the action, arguing that he was liable for the damages for breach of charterparty, in strict contravention of the *Salomon* principle,[12] because his improper conduct was such as to allow the court to look behind Rendsburg's corporate veil.

Yukong argued that Mr Yamvrias could be regarded as a party to the charterparty on the basis that the companies set up by Mr Yamvrias were a mask designed to allow him to evade his contractual liabilities. It was not suggested that Mr Yamvrias had any fraudulent or improper purpose when entering the charterparty on behalf of Rendsburg. Yukong's claim was founded on the subsequent conduct of Mr Yamvrias, in causing Rendsburg to pay money to Ladidi with a view to preventing that money being available to meet Yukong's claim. Toulson J had no difficulty dealing with this submission, and dismissed Yukong's claims against Mr Yamvrias.

A comparison with existing case law was sufficient to establish that no sham existed here. The definition of a "fraud" or "sham" entails the use of the corporate form in order to evade some pre-existing personal liability. In *Jones* v *Lipman*,[13] for example, a vendor of land had attempted to avoid being compelled to convey the land to the purchaser by forming a company and conveying the land to the company. The judge awarded specific performance against the company and the vendor. In that case, a shareholder used a company to avoid a pre-existing contractual obligation attaching to him, and the sham company was the means by which the breach of contract was perpetuated. In *Yukong*, by comparison, the contractual liability did not attach to the shareholder but to another legal entity (Rendsburg) and the transfer of funds was not the breach of contract itself, but just went to the issue of Rendsburg's ability to pay.[14] This was really a maintenance of capital issue and no lifting of the veil was possible. With the definition of "fraud" restricted to this extent, and no possibility of arguing that justice requires the veil to be lifted, creditors such as Yukong are left in a poor position as far as the common law methods of lifting the veil are concerned.

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11. [1998] 4 All ER 82.
12. That is the principle that the company is "at law a different legal person altogether from the subscribers to the memorandum": *Salomon* v *A Salomon & Co Ltd* [1897] AC 22 at 51, per Lord Macnaghten.
13. [1962] 1 WLR 832.
14. Toulson J gave the plaintiff a crumb of potential comfort, stating that in his view Mr Yamvrias would have no answer to proceedings by the liquidator of Rendsburg for breach of fiduciary duty, if the funds which Mr Yamvrias had moved from Rendsburg's account had effectively been put beyond the company's reach.

Yukong therefore went on to argue that Mr Yamvrias should be liable because he was Rendsburg's undisclosed principal. This did not involve a lifting of the corporate veil, where primary liability attaches to the company. Instead, if Mr Yamvrais could be shown to be the undisclosed principal, primary liability on the contract would attach to him immediately.[15] On this point, Toulson J reasserted the clear principle laid down by the Court of Appeal in *Adams* v *Cape*,[16] that an agency agreement will only exist where there is an actual consensual relationship between the principal and agent to that effect. The correct test is whether there has been any intention to create the relationship of agency. The mere fact that the parties have adopted a particular structure through which to conduct business will not, of itself, be sufficient, whether that structure is parent and subsidiary, as in *Cape,* or a one man company, as in *Salomon*. There was no evidence to support the existence of such a principal–agent relationship in *Yukong*.

The decisions in *Ord* v *Belhaven* and *Yukong* are indicative of the persistence of the English courts in upholding the separate legal personality of the company set out in *Salomon* almost in its entirety. These decisions make it clear that the possibility of imposing liability on shareholder/directors via the common law is small.

A duty to creditors

It is now well recognised that, in some circumstances at least,[17] the courts can impose a duty on directors to consider the interests of the company's creditors.[18] The duty owed by the directors is a duty owed to the creditors as a whole, not to individual creditors.[19] Once a company goes into liquidation, the shareholders cease to have any interest in the assets of the company[20] and the interests of the company are equated with the interests of the creditors so that the directors must act so as to maximise creditor welfare: "[i]n a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company . . . where a company is insolvent the interests of the creditors intrude . . .".[21] In insolvency the shareholders "come last"[22] and, as the company's assets are insufficient to meet the claims of the creditors, the shareholders drop out of the picture.[23]

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15. This method of attaching liability to a director really belongs under the third head of liability therefore, establishing an independent duty, but it will be dealt with here for the sake of convenience.
16. [1990] Ch 433.
17. Where the company is insolvent or nearly so: *Re Horsley & Weight Ltd* [1982] 3 All ER 1045.
18. Although they will be discussed as though they were an homogenous group, this is not, of course, the case. Some may be secured, some unsecured, some will have the opportunity to assess the risk taken and adjust the interest payments accordingly whilst others, notably those with tortious claims, will not.
19. *Yukong Lines of Korea* v *Rendsburg Investments Corp (No 2)* [1998] 4 All ER 82 .
20. *Ayerst (Inspector of Taxes)* v *C & K (Construction) Ltd* [1976] AC 167.
21. *Kinsela* v *Russell Kinsela Pty Ltd* (1986) 4 ACLC 215 at 221, per Street CJ.
22. *Soden* v *British and Commonwealth Holdings plc* [1996] 2 BCLC 207 at 213.
23. This also means that there can be no possibility of the shareholders acting to ratify the wrongs that have been done by the directors, since the directors' duties are now owed to the creditors: *Re Horsley & Weight* [1982] 3 All ER 1045; *Nicholson* v *Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Kinsela* v *Russell Kinsela Pty Ltd* (1986) 4 ACLC 215.

However, it is worth noting that the creditors may not be particularly well protected by this duty. First, it only arises when the company is in, or near, insolvency.[24] Secondly, the essential features of this duty remain a duty owed by the board to the company[25] to act in the company's interests, whilst acknowledging that in order to achieve this the directors will have to have regard to the interests of the creditors. As a result, enforcement of the duty is primarily on behalf of the company and only indirectly on behalf of the creditors. Also, the amount of recovery is measured according to the loss to the company. Consequently, loss caused by, for example, making preferential payments[26] may amount to a breach of duty to the creditors, but the loss recovered will simply be the loss to the company, with no additional obligation for the directors to make contributions to those creditors.

Thirdly, the utility of this duty has been called into question at least as far as the unsecured creditors are concerned, and they, after all, may be most in need of protection. It has been suggested that even if the above points are satisfied and loss to the company is recovered, that recovery may simply advantage the secured creditors by feeding a charge, such as a floating charge over all or substantially all of the company's assets.[27] Against this it has been argued that recovery from the directors should instead increase the assets available to unsecured creditors[28] since the duty is owed to creditors as a whole (including, therefore, unsecured creditors) and it would therefore not be appropriate to allow recovery of the loss to benefit secured creditors to the exclusion of unsecured creditors.

Given the uncertainty surrounding this duty, it would be a brave creditor who trusted his or her claim entirely to this method of recovery.

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24. *Re Horsley & Weight Ltd* [1982] 3 All ER 1045*; Nicholson* v *Permakraft (NZ) Ltd* [1985] 1 NZLR 242, despite some early cases which held that the duty could apply when the company was solvent: *Ring* v *Sutton* (1980) 5 ACLR 546.
25. Cf Lord Templeman in *Winkworth* v *Edward Baron Co* [1987] 1 All ER 114 at 118, who stated that the board, being the company's conscience, owed a duty to "the company and the creditors of the company" to keep its property "inviolate and available for the repayment of its debts". Although there is some doubt as to whether his Lordship did, by this phrase, intend directors to owe a duty directly to the creditors as well as to the company, subsequent decisions have taken the view that, in fact, the duty is owed to the company, but that in determining the company's interests regard should be had to the creditors: *West Mercia Safetywear Ltd* v *Dodd* [1988] BCLC 250; *Re Produce Marketing Consortium* [1989] 5 BCC 569. This latter view has been widely supported by commentators (see, for example, R Grantham, "The Judicial Extension of Directors' Duties to Creditors" [1991] *Journal of Business Law* 1; D Prentice, "Creditor's Interests and Director's Duties" (1990) 10 *Oxford Journal of Legal Studies* 265) who argue, in particular, that it eliminates the possibility of double recovery and that it preserves the pari passu principle established in *Re Gray's Inn Construction Ltd* [1980] 1 WLR 711.
26. *West Mercia Safetywear Ltd* v *Dodd* [1988] BCLC 250.
27. This is held to be the case in relation to assets recovered by the liquidator in misfeasance proceedings such as s 212 Insolvency Act 1986: *Re Asiatic Electric Co Pty Ltd* (1970) 92 WN (NSW) 361.
28. Support for this view can be found in *Re Yagerphone Ltd* [1935] Ch 392, in the context of improper preference proceedings.

An independent duty

By comparison with the duty to creditors above, which arises out of the director's position qua director, there is also the possibility of the courts imposing a duty on the directors which arises out of the facts of the transaction itself. Commonly this will be either a tortious or a contractual duty.[29] A good example of a situation in which the courts might impose an independent duty on the directors arose in *Williams* v *Natural Life Health Foods Ltd*.[30] This case arose out of a franchise agreement under which the plaintiffs set up a health food shop. The franchisor was the defendant company, formed by Mr Mistlin. The plaintiffs relied on income projections provided by the defendant company when deciding whether to enter into the franchise. These projections proved inaccurate and after just 18 months the plaintiffs' business closed with substantial losses. The defendant company was wound up shortly afterwards and the plaintiffs brought an action against Mr Mistlin, alleging that he had assumed a personal duty of care to them.

The basic principle is clear:

> The authorities . . . clearly show that a director of a company is not automatically to be identified with his company for the purpose of the law of tort, however small the company may be and however powerful his control over its affairs. Commercial enterprise and adventure is not to be discouraged by subjecting a director to such onerous potential liabilities. In every case where it is sought to make him liable for his company's torts, it is necessary to examine with care what part he played personally in regard to the act or acts complained of.[31]

In a number of cases the personal liability of a director for a tort carried out by him in the course of his directorship has been discussed. In *Fairline Shipping Corp* v *Adamson*,[32] a managing director, who was effectively operating as a one-person company by the time of the relevant activities, was held personally liable for the negligent storage of perishable goods by his company, which was the contracting party in relation to the storage of meat. This decision hinged on a letter written by the managing director to the plaintiffs on his own notepaper rather than that of the company, an act which the court in that case held displayed an assumption of a duty of care by that director. In *Trevor Ivory* v *Anderson*,[33] a New Zealand case, the director of a one-person company gave advice to a third party, through that company, regarding the spraying of insecticide around fruit trees. The advice was negligent and the fruit trees eventually died. The court held that Mr Ivory did not have any personal liability to the third party in relation to this negligent act:

> While the respondents looked to his personal expertise, Mr Ivory made it clear that he traded through a company, which was to be the legal contracting party entitled to charge. The structure was negotiated and known. There was nothing like the personal superimposition so central to the *Fairline* case. There was no representation, express or implicit of personal involvement, as distinct from routine involvement for and through his company. There was no

29. Where the court finds the existence of a collateral contract: *Esso Petroleum Co Ltd* v *Mardon* [1976] AC 167.
30. [1997] 1 BCLC 131 (CA) and [1998] 2 All ER 577 (HL).
31. *C Evans & Sons Ltd* v *Spritebrand Ltd* [1985] BCLC 105 at 110, per Slade LJ.
32. [1975] QB 180.
33. [1992] 2 NZLR 517.

> singular feature, which would justify belief that Mr Ivory was accepting a personal commitment, as opposed to the known compere obligation. If anything, the intrinsic high risk nature of spray advice and his deliberate adoption of an intervening company structure would have pointed to the contrary likelihood.[34]

In *Williams*, the majority of the Court of Appeal did impose liability upon Mr Mistlin. Although the director of a company will not normally be liable for torts where the tort was committed by him in his capacity as director, the court held that Mr Mistlin had in fact acted in a capacity outside that of a mere director and had thereby assumed a personal responsibility to the plaintiffs. This seems to be due largely to the fact that the skill and knowledge in the company resided in Mr Mistlin: "the relevant knowledge and experience was entirely his qua Mr Mistlin, and not his qua director."[35]

It was a surprising decision given the fact that the advice given by Mr Mistlin was given to the plaintiffs only indirectly, through the medium of an independent consultant. This was held to be irrelevant because "although Mr Mistlin's involvement was indirect, its extent was considerable",[36] although the extent of the involvement of a director in a company had previously been held not to be sufficient of itself.[37] The decision of the Court of Appeal in *Williams* sat oddly with the decision in *Trevor Ivory*. It is difficult to see why Mr Mistlin's involvement was not regarded as "routine involvement for and through his company".[38] Surely advice in relation to the setting up of a business of any kind is an activity of an "intrinsic high risk nature" and the fact that Mr Mistlin had adopted an intervening company structure through which to give that advice would seem to put Mr Mistlin in the same situation as Mr Ivory. Further, Mr Mistlin's behaviour can be contrasted sharply with that of the director in *Fairline* who dealt directly with the plaintiffs, writing them a letter which made it clear that "he regarded himself, and not [the company] as concerned with the storage of these goods".[39]

The Court of Appeal's decision in *Williams* was obviously rather worrying for company directors, particularly those running one-person companies as it suggested that the courts would be willing to break down the barriers between the director and the company where the courts see fit. This was an unattractive prospect as it "would go near to imposing personal liability in every case".[40] It was not, therefore, surprising that the House of Lords overturned the Court of Appeal's decision. Their Lordships did not disagree with the basic principle that ". . . in relation to an obligation to give careful and skilful advice, the owner of a one-man company may assume personal responsibility. *Fairline* is an analogy. But it seems that something special is required to justify putting a case in that class."[41]

34. Ibid at 532, per McGechan J.
35. [1997] 1 BCLC 131 at 153, per Hirst LJ.
36. Ibid.
37. See, for example, *C Evans & Sons Ltd* v *Spritebrand Ltd* [1985] BCLC 105.
38. [1992] 2 NZLR 517 at 532, per McGechan J.
39. [1975] QB 180 at 191, per Kerr J.
40. *White Horse Distillers Ltd* v *Gregson Associates Ltd* [1984] RPC 61 at 92, per Nourse J in relation to the proposal in that case that personal liability should be imposed on a director simply because that director expressly or impliedly procures the commission of the tortious conduct.
41. *Trevor Ivory* v *Anderson* [1992] 2 NZLR 517 at 524, per Cooke P.

However, they did disagree that that "something special" was present in *Williams*. They held that the "considerable" indirect involvement and the fact that much of the knowledge of the company resided in Mr Mistlin was not sufficient to justify a departure from the norm, and therefore no personal liability should be imposed on him.

Lord Steyn, giving the leading judgment, emphasised the need to establish an assumption of responsibility by Mr Mistlin for the statements made.[42] An objective approach to the existence of an assumption of risk was adopted: "[t]he touchstone of liability is not the state of mind of the defendant. An objective test means that the primary focus must be on things said or done by the defendant or on his behalf in dealings with the plaintiff."[43] Reasonable reliance on the part of the plaintiffs is also a necessary part of the claim, in order to establish a causative link between the defendant's statement and the plaintiff's loss. The test, according to Lord Steyn, is whether the plaintiff could reasonably rely on an assumption of personal responsibility by the individual who made the statement or performed the services on behalf of the company.[44]

In any principal–agency scenario the agent may incur personal liability in tort as well as imposing vicarious or attributed liability upon his principal. In order to establish personal liability, a special relationship is required between the plaintiff and the tortfeasor.[45] It is not sufficient that there should be a special relationship with the principal. There must, therefore, have been an assumption of responsibility by the agent, Mr Mistlin, towards the plaintiffs. The House of Lords held that the facts in *Williams* did not establish such a relationship. Whilst Mr Mistlin had owned and controlled the company which had held itself out as having the necessary expertise to advise the plaintiffs, this was not sufficient to found personal liability. The fact that the company's brochure made it clear that the company's expertise was derived from Mr Mistlin's experience was likewise insufficient to found personal liability, as was the mere fact that Mr Mistlin's involvement in the company was "considerable". Again, this was to be expected in one-person companies.

Whilst there will, undoubtedly, be occasions, as in *Fairline*, when "something special" will justify an assumption of personal responsibility by a director for statements made, or services provided, by the company, those occasions will, following the House of Lords' decision, be rare. The fact of incorporation itself will be taken as a strong indication of the fact that a separation of identity is intended between the directors and the company, and that the acts of the directors on behalf of the company are not intended to result in personal liability for the directors. Their Lordships have made it clear that to deviate from this norm will require very clear objective evidence that the director was acting on his or her own behalf rather than that of the company. Such circumstances are not likely to occur very often and consequently the ability of creditors to impose personal liability on the directors by establishing an independent tortious, or indeed contractual, duty is likely to be of

42. In doing so his Lordship relied very heavily on the judgment of Lord Goff in *Henderson* v *Merrett Syndicates Ltd* [1995] 2 AC 145.
43. [1998] 2 All ER 577 at 582.
44. Ibid at 583.
45. *Hedley Byrne & Co Ltd* v *Heller & Partners Ltd* [1964] AC 465.

limited use. It is worth remembering that if the creditors do manage to establish such a duty, that duty arises from the facts of the transaction and not from the director's position qua director. As a result, any recovery goes directly to the creditor plaintiff and does not swell the assets of the company available for the company's general creditors.[46]

Summary

It will quickly be appreciated that the three common law routes to the imposition of liability by creditors on directors are not likely to provide much joy. The recent trend in the case law[47] has been to render these common law liabilities more restrictive and accordingly more difficult for creditors to obtain. As a result it is not surprising that creditors are increasingly relying on statutory methods of recovery.

Legislative response

The legislative response of directors continuing to trade when the company is insolvent, or on the verge of insolvency, has been to impose liability on directors for fraudulent or wrongful trading. It is proposed to examine these in turn, concentrating on the latter in greater detail.[48]

Fraudulent trading

The United Kingdom[49] has, for well over the last half century, provided that directors responsible for reckless or fraudulent trading can be ordered without limit of liability to contribute to the asset pool should the company go into insolvent liquidation. Broadly these provisions apply where directors or others who participated in the management of a company, did so in a reckless manner or so as to defraud the members or creditors. The court could make such order as it saw fit that the director contribute to the assets of the company. The shortcomings (in the sense of proving liability) of the "reckless" or "dishonesty" requirement, particularly the latter, have been well documented,[50] particularly the

46. This is no way constitutes a departure from the pari passu rule of distribution since "the assets" were never the assets of the company but damages (whether contractual or tortious) payable to the plaintiff and therefore there is no justification for channelling them through the company.

47. See *Ord* v *Belhaven Pubs Ltd* [1998] 2 BCLC 447; *Yukong* v *Rendsburg Investments Corp (No 2)* [1998] 4 All ER 82; *Williams* v *Natural Life Health Food Ltd* [1998] 2 All ER 577 (HL).

48. We do not intend addressing the issue of whether in certain circumstances "passive" shareholders who have benefited from the conduct of the directors should be held liable.

49. Companies Act 1985 s 458; Insolvency Act 1986 s 213.

50. The "reckless" requirement could be taken to import, and has been so interpreted, an objective requirement, namely, would the circumstances of the company's business have indicated to the ordinary prudent director that the carrying on of the business would cause loss to the company's creditors?: *Re Petherick Exclusive Fashions Ltd* (1986) 2 BCR 177 at 191.

requirement of showing dishonesty. As was stated by the Cork Committee in 1982,[51] when commenting on s 332 of the Companies Act 1948:[52]

> Section 332 not only creates a civil and personal liability it also creates a criminal offence. The constituent elements of the two are identical. As a result the courts have consistently refused to entertain a claim to civil liability in the absence of dishonesty and, moreover, have insisted upon a strict standard of proof. It is the general experience of those concerned with the administration of the affairs of insolvent companies that the difficulty of establishing dishonesty has deterred the issue of proceedings in many cases where a strong case has existed for recovering compensation from the directors or others involved.

In determining the quantum of recovery, the courts have held that the amount, which the director is ordered to pay, could contain a punitive element.[53] It is also clear that recovery cannot be ordered in favour of individual creditors; the action is brought by the liquidator on behalf of the creditors as a general body.[54] It probably follows from this that such cause of action would not be assignable and this has a bearing on the funding of liquidation proceedings.

Wrongful trading

Although the fraudulent trading provisions proved inadequate,[55] they did highlight the range of issues that arises in imposing liability on directors for incurring "credit" in circumstances where a company had no reasonable prospect of paying its debts when they fell due. These issues are:[56] (i) what are the trigger conditions for liability? (ii) who is liable? (iii) what (if any) defences are available? (iv) anticipatory relief (v) who can seek relief and for whom is relief granted? and (vi) what is the quantum of recovery? It is proposed to use primarily s 214 of the 1986 Act for the purpose of illustrating these issues but the solutions in other jurisdictions will also be referred to.

What are the trigger conditions for liability?

Section 214 applies where (i) a company goes into insolvent liquidation, and (ii) at some time before the commencement of the winding up the directors concluded or ought to have concluded that there was "no reasonable prospect"[57] that the company could avoid going into insolvent liquidation. In determining whether or not the company's insolvent liquidation

51. Cmnd 8558 at para 1776.
52. This combined what is now s 458 of the 1985 Act and s 213 of the 1986 Act.
53. *Re A Company No 001418 of 1988* [1990] BCC 526.
54. *London & Sugar Overseas (Sugar) Co Ltd* v *Punjab National Bank* [1997] 1 BCLC 705.
55. There is, however, still life in these provisions: see *Re a Company (No 001418 of 1988)* [1991] BCLC 17; *Re L Todd (Swanscombe) Ltd* [1990] BCLC 454.
56. Most of these issues are addressed in: Law Reform Commission of Australia, *General Insolvency Inquiry*, Report No 45, Ch 7 (referred to hereafter as "the Harmer Report") which contains the best official discussion of these matters.
57. Section 214(2)(a) of the 1986 Act.

should have been foreseen by the directors, the directors will be treated as having the knowledge and skill of a "reasonably diligent person" having:[58]

> (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 the director in relation to the company, and
>
> (b) the general knowledge, skill and experience that that director has.

It seems reasonably clear that in this standard, subsection (a) sets the floor (the objective standard), and subsection (b) sets the ceiling (the subjective standard). As was stated by the court in *Re Brian D Pierson (Contractors) Ltd*:[59]

> In my judgment this paragraph [i.e. s 214(4)(a)] is indicating that only where a director performs a special function, such as "finance director" or "marketing director" then the special skills expected of a person in that capacity are to be expected of him. The paragraph cannot be used to reduce the basic standard required on the grounds that the director in question exercised no particular function in the company's management.

For the purposes of s 214, the test of insolvency is balance sheet insolvency, namely, that the company's assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding up.[60] This, of course, entails that a company may have been commercially solvent and that it is able to pay its debts as they fall due, but nevertheless, the directors can still be held liable for wrongful trading. It also seems reasonably clear that debts and liabilities include present and future debts or liabilities whether contingent or liquidated.[61] It would also cover liability in tort.[62] A number of points can be made with respect to the conditions that trigger liability.

(i) *"No reasonable prospect"*. The section applies where the director should have concluded that there was "no reasonable prospect" that the company could avoid insolvent liquidation. The standard to be applied in determining when liability should be imposed on directors for the consequences of a company's insolvency raises one of the most difficult problems in designing such legislation. It would be possible to make directors automatically liable (with or without defences) to contribute to the assets of a company should it go into insolvent liquidation. In other words, liability would be strict. No proposals along these lines have been made. Leaving aside questions of fairness as between creditors,[63] such an approach would in all probability lead to the precipitate closure of otherwise viable businesses and, what may be the same thing, directors failing to take risky decisions that would otherwise be in the interests of the company's creditors and shareholders. It must also be remembered that premature closure of otherwise viable businesses imposes an unnecessary social cost. In

58. Section 214(4) of the 1986 Act. This provision has now been treated as reflecting the common law standard of the duty of care of directors: *Re D'Jan of London Ltd* [1994] 1 BCLC 561.
59. [1999] BCC 26 at 55.
60. Section 214(6) of the 1986 Act.
61. Insolvency Rules 1986 (SI 1925) (referred to hereafter as "the Rules"), Rule 13.12(3).
62. The Rules, Rule 13.12(2).
63. That is, that continued trading may cause loss to "new" creditors but "old" creditors may be paid off.

addition, not to continue a business, which ultimately may prove profitable, would prejudice creditors who are creditors at the time the business is discontinued to the extent that the business's assets are insufficient to cover its liabilities. What is required of directors where they appreciate that the company cannot avoid insolvent liquidation will be examined in greater detail when the issue of defences is dealt with.

(ii) *Language of probability*. Because the liability of directors is not strict, inevitably some language of probability will have to be used to determine when directors will be liable. Section 214 uses the terminology of "no reasonable prospect". This is to be contrasted with the Australian legislation where the standard is more demanding in the sense that the possibility of director's liability is much wider. Section 588G(1)(b) of the Corporations Law imposes liability where there are reasonable grounds for "suspecting" that the company is insolvent or will become insolvent by incurring a debt. Whether this will make a great deal of difference is impossible to predict, but in all probability it will be easier to show contravention of this provision.

(iii) *Trading at creditors' expense.* The third point is that because directors do not necessarily have to bring a company's business to an end when it is in financial difficulties, it means that companies will trade at the expense of creditors. As was stated by the Cork Committee: "A company will not be under an obligation to show as a certainty that its debts will be paid . . .".[64] It is inevitable that in some situations directors will make a reasonable decision to continue trading but the company nevertheless goes into insolvent liquidation. Overall, this may produce socially desirable results if the number of companies in difficulty that trade out of their difficulties outnumber those companies that fail to trade out of their difficulties.[65] However, it is arguably unfair to the creditors of the failed companies if they are not adequately compensated for the risk they have run.

(iv) *Different classes of creditors.* It may be that it is inevitable that a company will go into insolvent liquidation but that continued trading for a period of time will enhance the pool of assets available for creditors. During this period of continued trading its creditors will change identity; some creditors will be paid off and new debt incurred. It is submitted that in this situation the directors would and should be liable for wrongful trading if they form, or ought to have formed, the opinion that the company could not avoid insolvent liquidation. As a matter of principle, it is wrong to allow directors to cherry pick between the company's creditors.

64. Cmnd 8558 at para 1800.

65. This is somewhat simplistic. What is needed is some measurement of value comparing the failed companies with the successful ones.

Who is liable?

Section 214 imposes liability on directors and for this purpose director includes a shadow director.[66] It is also clear that de facto directors are caught.[67] A shadow director is defined as a person in accordance with whose instructions the board is accustomed to act. In applying this definition, the matter has to be viewed through the eyes of the board of directors of the dominated company. Thus even where the alleged shadow director issues detailed instructions, if those instructions are ignored by the board, the definition of shadow director will not be satisfied. Millett J has held that the terms "de facto", "de jure" and "shadow director" are mutually exclusive.[68] While this will normally be the case, it is difficult to see that it should always be so. For example, it would be possible to have a de jure director who so dominated the board of directors (a Maxwell figure) that he would also be treated as a shadow. However, whether anything of significance flows from the dual status is to be doubted. There are two special situations where the issue of extended liability has created problems: the first relates to bank lending, and the second relates to corporate groups.

1. Bank lending

When a company is in financial difficulties, an obvious source of finance is bank borrowing normally secured. There is no risk to the bank that it will be held liable for putting funds into the company in the form of debt rather than equity. Nor will the loan be treated as equity.[69]

Propping up an insolvent business, no matter how irresponsible the support is, does not affect the creditor status of a lender.[70] Normally banks do not appoint representatives to the board of their debtor companies. A secured creditor has the right to police his security and the fact that he does so does not, and should not, entail that he becomes a shadow director. Where a company is in trouble its bank may, inter alia, require it to:[71] (i) appoint investigating accountants; (ii) provide extra security; (iii) reduce its borrowing, particularly where the company has exceeded its borrowing limits; and/or (iv) call for management accounts and business plans as to how the company is to trade out of its difficulties. None of these should make the bank a shadow director. Even where the bank makes the adoption of a particular business plan a condition for extending additional credit, the status of shadow director will not arise provided the directors retain a discretion to

66. 1986 Act s 214(7). See also Corporations Law, s 588G(1)(a) and s 9 (definition of director).
67. *Re Hydrodan (Corby) Ltd* [1994] 2 BCLC 180. An alternate director would only be caught provided he or she participated qua director in the company's affairs: see *Playcorp Pty Ltd* v *Shaw* (1993) 10 ACSR 212.
68. *Re Hydrodan (Corby) Ltd* [1994] 2 BCLC 180 at 183.
69. These two consequences could follow in certain Continental jurisdictions. See, for example, H Rajak, P Horrocks and J Bannister (eds), *European Corporate Insolvency* (1995) at 242. See also D R Fischel, "The Economics of Lender Liability" (1989) 99 *Yale Law Journal* 131.
70. Self-interest would, of course, curb, if not eliminate, such behaviour.
71. P Fidler, "Banks as Shadow Directors" [1992] 7 *Journal of International Banking Law* 97 at 99.

accept or reject.[72] Economically the company may have little option but to accept the bank's proposal, but this does not make it a shadow director since the directors retain a discretion to refuse and to put the company into creditors' voluntary liquidation or administration.

2. Parent — subsidiary relationship — corporate groups

It is a truism that the corporate group is a feature of developed economies. One of the reasons for this in the UK is the ease of access to the corporate form — few impediments are placed in the way of obtaining corporate status.[73] Although the separate legal entity principle is the starting point, there is something commercially unreal in finding that a wholly owned subsidiary is not subject to the stringent control of its parent. It is clear that in terms of strict company law principles, there are no legal objections to a subsidiary supporting the activities of its parent, or other members of the group in circumstances where the collapse of the group would prejudice the subsidiary's interests. If the directors of a subsidiary decide that the transaction is in the interests of the subsidiary, it is submitted that the parent would not be a shadow director.[74] In this situation, the directors would have brought independent judgment to bear on the matter and the fact that what they decided coincided with the parent's desires would not make the latter a shadow director.

In *Re Hydrodan (Corby) Ltd*, Millett J had to consider the application of the shadow director concept in the context of a parent/subsidiary relationship. In that case, H was a wholly owned subsidiary twice removed from E plc. H had two corporate directors. It went into liquidation and the liquidator sought to make two of the directors of E plc liable under s 214 claiming that they were shadow directors. Millett J held that if E plc had given directions to the board of H and the directors were accustomed to act on such instructions, this would have rendered the company a shadow director.[75] More interestingly, he held that in this situation the directors of E plc would not be shadow directors since they would be acting as the appropriate organ of the company and in so acting only rendered the company liable.[76]

In dealing with the issue of corporate groups, the Insolvency Act 1986 does not have a tailor-made provision. It simply applies the general provisions of s 214 which will require a liquidator to show sustained and pervasive interference with the management of the subsidiary by the parent which has the effect of rendering the latter a shadow director. More importantly, it means that a parent company can abandon its subsidiary since such abandonment will not by itself result in liability.

72. Millett J, "Shadow Directorship — A Real or Imagined Threat to the Banks" (1991) *Insolvency Practitioner* 24.

73. Companies Act 1985 s 1(3)(A) recognising the "one person" company. See generally, T Hadden, "Regulating Corporate Groups: An International Perspective" in J McCahery, S Picciotto and C Scott (eds), *Corporate Control and Accountability: Changing Structures and the Dynamics of Regulation* (1993) Ch 18.

74. *Equiticorp Finance Ltd* v *Bank of New Zealand* (1993) 11 ACSR 642.

75. [1994] 2 BCLC 180 at 184.

76. Ibid: "But if they did give such directions . . . acting as a board they did so as agents . . . (or more appropriately as the appropriate organ of the company . . .)". This follows from the application of the rules of attribution.

Take, for example, the facts in *Re Augustus Barnett & Son Ltd*.[77] In that case, a subsidiary had during the period when it was under the control of R, its parent, consistently shown a substantial deficiency in current assets. The auditors refused to sign its accounts on a going-concern basis unless there was a letter of support from R. R issued such letters of comfort which were recorded in the subsidiary's accounts, and they provided the normal assurance that R was willing to provide the subsidiary with such financial support as was necessary to enable it to continue to trade at its current level of activity. On other occasions when suppliers became jittery, R indicated that it would continue to support its subsidiary. The subsidiary went into insolvent liquidation and the question arose as to whether R could be made liable under the then fraudulent trading provision.[78] The court held that: (i) R had not participated in the management of its subsidiary, and (ii) the directors of the subsidiary had not been fraudulent; they had in all good faith assumed that R would live up to its letter of comfort.[79] There was no serious argument in the case that R might have misled its subsidiary's creditors and therefore this would constitute a basis for piercing the corporate veil.[80] Although there appears to be no English case law dealing with this point, this would be a perfectly appropriate basis for piercing the corporate veil on the grounds that the parent's conduct indicated an assumption of liability.

The *Augustus Barnett* decision arguably would be decided no differently under s 214. R would not, on the finding of facts in the case, be a shadow director. The directors of the subsidiary might, although this is far from clear, be liable under s 214, in that their failure to obtain a binding legal commitment from the parent entailed that they had failed to take all reasonable steps to ensure that the creditors would be paid. In other words, the creditors have to be protected by a legally enforceable mechanism. In many ways, this is an unsatisfactory state of affairs since the parent by its conduct created the impression that it would stand behind the debts of its subsidiary.

Defences available for wrongful trading

Section 214 provides defences for wrongful trading. A director will escape liability if he can show that he took "every step" with a view to minimising loss to creditors after he concluded, or should have concluded, that the company could not have avoided insolvent liquidation.[81] Although the section speaks in terms of "every step", the standard against which the director's conduct has to be measured is that of the "reasonable" director[82] and

77. [1986] BCLC 170 (noted in D D Prentice (1987) 103 *Law Quarterly Review* 11). The facts are somewhat similar to those in *Deputy Commissioner for Corporate Affairs* v *Coratti* (1980) 5 ACLR 119. See generally K J Bennetts, "Expectations of Financial Support — Grounds for Avoidance of Directors' Liability Under Section 592, Corporations Law" (1991) 9 *Company and Securities Law Journal* 268.
78. Companies Act 1948 s 332.
79. Although this ultimately turns on its wording, a letter of comfort will not normally give rise to any liability: *Kleinwort Benson Ltd* v *Malaysia Mining Corp Berhard* [1988] 1 WLR 799.
80. F H Easterbrook and D R Fischel, *The Economic Structure of Corporate Law* (1991) at 58.
81. Section 214(4) of the 1986 Act. This is the only defence. It has been held that s 727 of the 1985 Act does not apply to s 214: *Re Produce Marketing Consortium Ltd* [1989] BCLC 513.
82. Section 214(4) of the 1986 Act.

accordingly the director will have to take every step that a reasonable director would have taken.

It is necessary to return to the circumstances in which liability can arise. Liability arises where the director concluded or ought to have concluded that there was no reasonable prospect that the company could avoid going into insolvent liquidation. The trigger event relates to consequences of continued trading and it does not require the insolvency to be brought about by a particular type of trading activity, for example, the incurring of debts.[83] Debts and liabilities cover nearly every form of imaginable claim against the company and it is to deter the incurring of these types of losses (and not just debts) that s 214 is directed.[84]

The directors must have concluded or should have concluded that the company had no reasonable prospect of avoiding insolvent liquidation.[85] Normally the issue of what constitutes a reasonable prospect will only arise where it is alleged that the directors should have concluded that there was no such prospect. If they had so concluded then, leaving aside the question of proof which is made that bit easier by the fact that the liquidator has access to the company's books,[86] there can be no doubt that the directors will be liable to contribute.

Greater difficulties arise in determining what the directors ought to have concluded. A number of points can be made on this.

First, as we have seen the test will in part be objective. Broadly the director will be deemed to have the knowledge and skill of a reasonable director.[87] Thus reasonable grounds will have to exist on which the directors can base their conclusions. As regards this, the normal rules of company law will apply and directors will be able to rely on the work product of subordinates unless they are put on notice that such reliance is misplaced.

Secondly, in determining what information the directors ought to have known, directors will be assumed to have known the information that would have been revealed had the company complied with its statutory obligations to maintain proper books of account and to prepare annual accounts.[88]

Thirdly, it is assumed that the directors carried out their duties. Section 214(5) provides that in determining whether a director has displayed a reasonable standard of competence in carrying out his functions for which he has responsibility, such functions will include "any functions, which he does not carry out but which have been entrusted to him".

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83. For example, where the collateral of a debtor of the company is declining in value, the directors could be held liable for wrongful trading.
84. For a claim that falls outside s 214, see *Re Kentish Homes Ltd* [1993] BCLC 1375.
85. The burden of proof is probably on the director.
86. Also, the liquidator has very powerful investigative tools at his or her disposal: ss 235 and 236 of the 1986 Act. There is no privilege against self-incrimination in answering the questions of the liquidator: *Bishopgate Investment Management Ltd* v *Maxwell (No 2)* [1993] BCLC 1282. This may need to be altered in the light of the *Saunders Case* (European Court of Human Rights, 17 December, 1996): see *Saunders* v *United Kingdom* [1998] 1 BCLC 362.
87. Section 214(4)(a) of the 1986 Act. *Re Brian D Pearson (Contractors) Ltd* [1999] BCC 26 (office of director has certain minimum responsibilities).
88. *Re Produce Marketing Consortium (No 2) Ltd* [1989] BCLC 520 at 550.

Fourthly, the courts have recognised that the quantum of information and expertise possessed by directors will vary with the commercial sophistication and size of the company. As Knox J stated in *Re Produce Marketing Consortium (No 2) Ltd*,[89] the "general knowledge, skill and experience...will be much less extensive in a small company in a modest line of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures."

What constitutes a reasonable prospect is inherently elusive. In applying this test the court has to balance creditor protection against a policy which could cause the precipitate termination of a company's business. What is clear from s 214 is that the legislature has accepted that in appropriate circumstances a company in financial distress can nevertheless attempt to trade out of its difficulties without the directors being necessarily liable should it fail to do so. The reasonable prospect requirement, and the defence provided to directors, are conceptually distinct but nevertheless they are linked since actions taken by directors to avoid loss to creditors could be equally applicable to both aspects of s 214.

Whether or not the defence is satisfied will very much depend on the facts of a given case. It is probably not a requirement that the steps taken by the directors must legally ensure that the creditors are protected, for example, by a bank guarantee, or the injection of fresh equity into the company. Vague assurances or expectations of support will not suffice.[90] It is unclear on what side of the line *Re Augustus Barnet & Sons Ltd*[91] would fall. It is submitted that the reliance on the parent's letter of comfort in that case should not constitute a defence. It is simply much too easy for a parent to renege from such a commitment, and the directors of the subsidiary will possess little leverage to compel the parent to live up to its commitments. The observations of Tamlerlin J (dealing with a different matter) are apposite for describing whether or not the defence has been established:[92]

> The question is one of fact. Attention should be directed to whether a reasonable director or manager operating in a practical business environment would expect that at some point the company would be unable to meet a liability. The question involves consideration of the timing of revenue flow and debts incurred, and contingencies including the ability to raise funds. The conclusion ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity.

Anticipatory relief

Obviously directors of a company in financial difficulties will be faced with a difficult decision, and it was to ameliorate this that the Cork Committee proposed that a procedure should be set up to seek anticipatory relief. Under this procedure the court would be vested with jurisdiction to declare that, no matter how events eventually turned out, the future trading sanctioned by the court could not give rise to a claim for wrongful trading.[93]

89. Ibid.
90. See, for example, *Williams* v *NCSC* (1990) 2 ACSR 131.
91. [1986] BCLC 170.
92. *Hawcroft General Trading Co Ltd* v *Edgar* (1996) 20 ACSR 541 at 548.
93. Cmnd 8558 at paras 1798–1803. The application would be in Chambers and therefore there would be no publicity.

This, of course, raises difficult questions of court competence to make such judgments. There was also a concern that there would be a conservative judicial reluctance to make such an order which would result in the precipitate closure of businesses. The Cork Committee, while recognising these difficulties, considered that the courts had the requisite competence. What is interesting is the type of orders that the Committee recommended that the court should be empowered to make. Two such orders proposed were: (i) permission to continue trading for a specified period, or (ii) trading so as to complete existing or prospective contracts would not be wrongful.[94]

The first of these proposed orders deals with what is one of the most intractable problems in applying s 214, namely, what timing horizons should directors apply.[95] Given the uncertainty associated with this decision, a power in the courts to authorise trading for a specified period would probably be beneficial. The second example deals with a situation where continued trading would be wrongful in that it is clear at the time the order is made that at the end of the day the company would inevitably end up in insolvent liquidation. While continued trading in this situation may increase overall societal welfare (the continued trading will increase the asset pool available for distribution) it will do so at the expense of inter-creditor fairness, as certain creditors will be advantaged at the expense of others. It is questionable whether this is a principle that insolvency law should adopt.[96]

Who can seek relief and for whom is relief effected?

These questions raise a fundamental issue which is not always openly addressed by insolvency law. As we have already seen, there are principles of insolvency law that result in the swelling of a company's assets in liquidation. The question arises as to the nature of such recoveries. If the relevant statutory provision merely establishes mechanics then it is plausible to argue that the recovered assets, being assets vested in the company, remain subject to any security which the company has created over its assets. This, for example, is the position with respect to s 212 of the Insolvency Act 1986.[97] Where the section is perceived as creating a substantive right, it is more plausible to argue that the assets are recovered for the benefit of the unsecured creditors[98] and thus not subject to any such security. Also, to the extent that the assets recovered are treated as having always inhered in the company as the company's property, the right to such assets is assignable by the liquidator as a means of financing the liquidation.

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94. Ibid at 1798.
95. See, for example, *Re Sherborne Associates Ltd* [1995] BCC 40.
96. Also, in many situations the liquidator can complete the contract.
97. *Re Anglo-Australian Printing and Publishing Union* [1895] 2 Ch 891. This establishes a procedure for assessing damages against an officer of the company for breach of duty or misfeasance and it is clear that it establishes no new cause of action but is merely procedural.
98. This appears to be the position with moneys recovered as having constituted a preference: *Re Yagerphone Ltd* [1935] Ch 392. Such recoveries may constitute assets for certain aspects of insolvency: *Katz* v *McNally* [1997] BCC 784.

Section 214 vests the power to seek an order under the section in the liquidator. It is also clear that what the liquidator is seeking to recover are "assets" which were never vested in the company; what the liquidator is seeking to obtain is a contribution from the directors for the purpose of satisfying the claims of the company's creditors. Because of these two features, the courts have concluded:

(i) Any recovery swells the assets available for the unsecured creditors. In *Re Oasis Merchandising Services Ltd*,[99] the court held that potential recoveries under s 214 were not the company's property which the liquidator could sell to a third party in order to obtain funding to bring such proceedings. As the right to seek a contribution under s 214 only arose on liquidation, the contribution benefited the unsecured creditors.

(ii) It follows from the above that s 214 recoveries do not form part of the company's assets that could be charged by the company. The company can only charge assets with respect to which it is the beneficial owner. As the right of action under s 214 is not one vested in the company it could not charge it, or the proceeds arising from it.[100]

(iii) Because s 214 payments form part of the general assets available for unsecured creditors, payment from such assets cannot be made to individual creditors.[101] This means that creditors who are creditors before the date when the directors first became liable will share with creditors who acquire this status when wrongful trading took place. While this has implications for the financing of liquidations, it creates no unfairness since the wrongful trading will have affected the ability of the company to satisfy the claims of all of its creditors.

Quantum of recovery

Where wrongful trading is shown to have taken place, the court has to determine the measure of recovery. In *Re Produce Marketing Consortium (No 2) Ltd*,[102] the court held that the purpose of s 214 was to compensate the creditors for their losses suffered as a result of the wrongful trading and therefore the amount that the court should order the directors to contribute should reflect this compensatory purpose. The amount that the directors should be ordered to contribute is the amount by which "the company's assets can be discerned to have been depleted by the director's conduct"[103] in continuing to trade after the date on which they should have appreciated that the company could not avoid going into insolvent liquidation. It is, in other words, a simple causation test. The fact that there was no fraud was not a reason for fixing the amount at a nominal or minimal value

99. [1997] BCC 282.
100. For example, assets recovered as being void dispositions made after the commencement of insolvency are chargeable: Insolvency Act 1986, s 127; *Mond* v *Hammond Suddards* [1996] 2 BCLC 470.
101. *Re Purpoint Ltd* [1991] BCLC 491 at 499.
102. [1989] BCLC 520 at 552–3; *Re Brian D Pearson (Contractors) Ltd* [1999] BCC 26.
103. [1989] BCLC 520 at 553.

although this fact could not be completely ignored. The liability of the directors was joint and several but the court could order one director to contribute to his fellow directors.[104]

There is much to be said for joint and several liability at least being the starting point as this will enhance the deterrent effect of the section. Under such a liability regime, directors will have an incentive to monitor the conduct of their fellow directors so as to avoid liability for their conduct. The maximum that the directors could be ordered to contribute under s 214 is obviously the net deficit in the company's assets. In other words, net loss to the creditors sets the maximum liability on the part of the directors. It follows from this that any sums recovered by the liquidator as, for example, preferences or transactions at an undervalue will go to reduce the maximum sum which the directors could be obliged to contribute under any s 214 order.

Conclusion

Section 214 is the right start. It focuses liability on those who are in a position to determine whether a company is simply trading at the expense of its creditors. Also, the approach of imposing collective liability on directors is appropriate. However, its application to groups is unsatisfactory. Perhaps the major problem is insufficiency of enforcement. But this is a general problem as regards liquidation proceedings because often the liquidator will not have sufficient funds. Although the common law methods of imposing liability do have the clear advantage of being able to make the person behind the company liable for the obligations, these common law methods are already declining in significance and the courts look set to continue this trend in the future.

104. This is useful where the directors are not equally culpable.