

588G Protection of creditors: Liability of directors for insolvent trading

Concept ESSAY

Justification: moral hazard. Discourages directors from trading out of difficulties at the disadvantage of new creditors. Also provides a disincentive on directors to allow the cos financial position to deteriorate

Criticism: directors who may try to turn a business around may be concerned about insolvent trading liability

Step 1: Does the duty apply? S 588G(1)

This section applies if:

- (a) a person is a **director** of a coy (s 9 definition -> can be appointed, shadow, or de facto) at the time when the coy incurs a debt; and

(1A) For the purposes of this section, if a coy takes action set out in column 2 of the following table, it incurs a debt at the time set out in column 3.

	Action of <u>coy</u>	When debt is incurred
1	paying a dividend	when the dividend is paid or, if the <u>coy</u> has a <u>const'n</u> that <u>provides</u> for the declaration of dividends, when the dividend is declared
2	making a reduction of share capital to which Division 1 of Part 2J.1 applies (other than a reduction that consists only of the <u>cancellation</u> of a share or shares for no consideration)	when the reduction takes effect
3	buying back shares (even if the consideration is not a sum certain in <u>money</u>)	when the <u>buy-back agreement</u> is entered into
4	redeeming <u>redeemable preference shares</u> that are redeemable at its option	when the <u>coy</u> exercises the option
5	issuing <u>redeemable preference shares</u> that are redeemable otherwise than at its option	when the shares are <u>issued</u>
6	financially assisting a <u>person</u> to <u>acquire</u> shares (or <u>units</u> of shares) in itself or a <u>holding coy</u>	when the <u>agreement</u> to <u>provide</u> the assistance is entered into or, if there is no <u>agreement</u> , when the assistance is <u>provided</u>
7	entering into an <u>uncommercial transaction</u> (within the meaning of <u>section 588FB</u>) other than one that a <u>court orders</u> , or a <u>prescribed agency</u> directs, the <u>coy</u> to <u>enter into</u>	when the <u>transaction</u> is entered into

- A debt is incurred when a coy enters a contract by which it subjects itself (VOLUNTARILY) to an unavoidable obligation to pay a CERTAIN sum of money (not just a claim for compo that reqs some sort of calc'n by ct) at a future time, even if that obligation is conditional; look at the SUBSTANTIAL ACT of the coy that incurs the debt (*Hawkins v Bank of China* (1992))

- *Southern Cross Interiors* -> debts incurred despite the fact that creditors might have delayed or might not have actively enforced repayment

(b) the coy is **insolvent** at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and

- Insolvent (s 95A)

(1) 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

(2) A person who is not solvent is insolvent.

Powell v Fryer (2001): consider the commercial reality of the cos financial position (not just cash; consider other assets as well). It is legitimate to consider any indulgences extended by creditors. However, need a firm arrangement with all creditors for an extension, i.e. it's about whether or not coy can service liabilities WHEN THEY FALL DUE. [Also look for ability to collect A/Rs]

S 588E presumptions (can be rebutted)

(3) If:

(a) the coy is being wound up; and

(b) it is proved, or because of subsection (4) or (8) it must be presumed, that the coy was insolvent at a (ANY) particular time during the 12 months ending on the relation-back day (s 9: either by filing the app to wind-up or is deemed to have begun);

it must be presumed that the coy was insolvent throughout the period beginning at that time and ending on that day.

(4) presumption of insolvency if coy

(a) has failed to keep financial records in relation to a period as required by subsection 286(1); or

s286 (1) A company, registered scheme or disclosing entity must keep written financial records that:

(a) correctly record and explain its transactions and financial position and performance; and

(b) would enable true and fair financial statements to be prepared and audited.

(b) has failed to retain financial records in relation to a period for the 7 years required by subsection 286(2);

s 286 (2) The financial records must be retained for 7 years after the transactions covered by the records are completed.

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

- *ASIC v Plymin* (2003): objective test - 'reasonable' in this context imports the standard of reasonableness appropriate to a director of reasonable competence and diligence, seeking properly to perform his duties as imposed by law (when viewed as a whole), and capable of reaching a reasonably informed opinion as to a coy's financial capacity
 - Suspect is more than mere speculation and reqs a positive feeling of actual apprehension

- Bunch of factors listed, none determinative:
 - Continuing losses
 - Liquidity ratios below 1
 - Overdue Commonwealth and State taxes
 - Poor relationship with present Bank, including inability to borrow further funds
 - No access to alternative finance
 - Inability to raise further equity capital
 - Suppliers placing [coy] on COD, or otherwise demanding special payments before resuming supply
 - Creditors unpaid outside trading terms
 - Issuing of post-dated cheques
 - Dishonoured cheques
 - Special arrangements with selected creditors
 - Solicitors' letters, summons[es], judgments or warrants issued against the coy
 - Payments to creditors of rounded sums which are not reconcilable to specific invoices
 - Inability to produce timely and accurate financial information to display the coy's trading performance and financial position, and make reliable forecasts.
- *Metropolitan Fire Systems v Miller* (1997): directors should have suspected that the co was insolvent b/c of the lack of incoming payments and the continued accumulation of business debts that were not paid

(d) that time is at or after the commencement of this Act (June 23 1993).

Step 2: Is the duty breached? S 588G(2)

By failing to prevent the company from incurring the debt, the person contravenes this section if:

Water wheel cases: must take all reasonable steps w/in their power; positive ob

(a) [**subjective**] the person is aware at that time that there are such grounds for so suspecting; OR

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

- Non-executive director *ASIC v Plymin* (2003); *ASIC v Elliott* (2004): E, an NED, argued that he was unable to prevent the insolvent trading b/c he was an NED, and therefore owed lesser duties to the co.
 - Argument was rejected on the basis that the obligation under s 588G requires individual directors to take reasonable action necessary to prevent insolvent trading
 - Significance is that s 588G imposes a positive obligation on all directors to stop the cos insolvent trading, including NED. Where directors cannot prevent insolvent trading, they have an obligation to resign immediately

['reasonable' grounds: refer to factors in step 1 588G(1)(c)]

Safe harbour 588GA

Taking course of action reasonably likely to lead to a better outcome for the company

Better outcome = better than immediate appointment of an administrator, or liquidator, of the company.

(1) Subsection 588G(2) does not apply in relation to a person and a debt, and subsections 588GAB(1) and (2) and 588GAC(1) and (2) do not apply in relation to a person and a disposition, if:

(a) at a particular time after the person starts to suspect the company may become or be insolvent, the person starts developing one or more courses of action that are reasonably likely to lead to a better outcome for the company; and

(b) the debt is incurred, or the disposition is made, directly or indirectly in connection with any such course of action during the period starting at that time, and ending at the earliest of any of the following times:

- (i) if the person fails to take any such course of action within a reasonable period after that time--the end of that reasonable period ;
- (ii) when the person ceases to take any such course of action;
- (iii) when any such course of action ceases to be reasonably likely to lead to a better outcome for the company;
- (iv) the appointment of an administrator, or liquidator, of the company.

(2) For the purposes of (but without limiting) subsection (1), in working out whether a course of action is reasonably likely to lead to a better outcome for the company, **regard may be had to whether the person:**

- (a) is properly informing himself or herself of the company's financial position; or
- (b) is taking appropriate steps to prevent any misconduct by officers or employees of the company that could adversely affect the company's ability to pay all its debts; or
- (c) is taking appropriate steps to ensure that the company is keeping appropriate financial records consistent with the size and nature of the company; or
- (d) is obtaining advice from an appropriately qualified entity who was given sufficient information to give appropriate advice; or
- (e) is developing or implementing a plan for restructuring the company to improve its financial position.

(3) A person who wishes to rely on subsection (1) in a proceeding for, or relating to, a contravention of subsection 588G(2), 588GAB(1) or (2) or 588GAC(1) or (2) bears an **evidential burden** in relation to that matter.

Matters that must be being done or be done

(4) Subsection (1) **does not apply** in relation to a person and either a debt or a disposition if:

(a) when the debt is incurred, or the disposition is made, the company is failing to do one or more of the following matters:

- (i) pay the entitlements of its employees by the time they fall due;
- (ii) give returns, notices, statements, applications or other documents as required by taxation laws (within the meaning of the Income Tax Assessment Act 1997); and

(b) that failure:

- (i) amounts to less than substantial compliance with the matter concerned; or
- (ii) is one of 2 or more failures by the company to do any or all of those matters during the 12 month period ending when the debt is incurred;

unless an order applying to the person and that failure is in force under subsection (6).

Note: Employee entitlements are defined in subsection 596AA(2) and include superannuation contributions payable by the company.

(6) The **Court** may order that subsection (4) or (5) does not apply to a person and one or more failures if:

(a) the Court is satisfied that the failures were due to exceptional circumstances or that it is otherwise in the interests of justice to make the order; and

(b) an application for the order is made by the person.

Step 3: Do any defences apply? S 588H

(2) It is a defence if it is proved that, at the key time, the person had **reasonable grounds** to expect, and did expect, that the company was solvent at that time and would remain solvent despite all its debts incurred, and dispositions of its property made, at that time.

- *Hall v Poolman* (2007): directors **must** take a proactive stance in maintaining their expectation of solvency (certain/probable) Need to be proactive and ask questions on a regular basis
- Expect > suspect; more than mere hope/possibility; implies a measure of confidence

(3) Without limiting the generality of subsection (2), it is a defence if it is proved that, at the key time, 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 despite all its debts incurred, and dispositions of its property made, at that time.

Williams v Scholz (2007) -> **distrust** of person relied on is fatal to defence

Stake Man: **must prove** that person was engaged for the purpose of supplying information regarding the company's state of solvency and not merely advice of a general nature.

(4) If the person was a director of the company at the key time, 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.

- Valid reasons:
 - Alt director doesn't act b/c primary director is present
 - Material pers interest & didn't participate in the decision
 - Goes overseas & asks another director to be appointed in lieu
- Invalid reasons:
 - Total reliance on spouse, who was also director, for mgmt. due to their love, faith, & confidence; *Clark* (2003); *Morley* (1990): C was wife, M was mother, but that wasn't an excuse to avoid liability
 - Not participate in the management of the company or monitoring the financial performance of the company

Reasonable steps taken to prevent debt or disposition

(5) It is a defence if it is proved that the person took all reasonable steps to prevent the company from incurring the debt or making the disposition of its property.

(6) 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.

Consequences of Breach

Section 588G is a **civil penalty** provision, meaning that it will lead to civil sanctions. The liquidator can also sue the directors for compensation under s 588M CA. Relief from civil liability may be sought by a director under ss 1317S and 1318 CA. If the breach is dishonest, it is an offence that leads to criminal sanctions (s 588G(3) CA).

Holding Coy's Liability

Section 588V CA provides that holding companies will be liable for insolvent trading by their subsidiary. This section is broadly **similar to s 588G**. For liability to attach to the holding company:

1. It must be the holding company at the time the subsidiary incurs a debt
2. The subsidiary is insolvent at the time that it incurs a debt, or becomes insolvent by incurring that debt, and there are reasonable grounds for suspecting that the company is, or will become, insolvent
3. It, or one or more of its directors, were aware of these grounds OR having regard to the nature and extent of the holding company's control over the subsidiary's affairs, it is reasonable to expect that the holding company, or one or more of its directors, would have been aware of these grounds

The **defences** available to the holding company under s 588X CA are broadly similar to those available to directors under s 588H CA; they also have a safe harbour under s 588WA CA that is similar to that provided under ss 588GA and 588GAAA CA to directors.

4 Framework of Directors' Duties

Corporate Governance ESSAY

Concept

Owen J

"Corporate governance... describes the **framework** of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations"

Diff perspectives:

Financial economics: ensuring that suppliers of finance to corporations can assure themselves that they're getting a return on their investment, i.e. good CG reduces risks, so the cost is compensated by lower shareholder expectations, creditor terms etc.

Accounting theory: ensuring the quality of the financial information that is provided by the company

Social science: focus on the role of corporations in society, especially the exercise of corporate power and its impact on society

Other: a system of direction, control and accountability and those who think of it as being about relationships

Role of law:

It provides an underlying **framework** within which corporate governance practises operate.

It **creates incentives and shapes corporate behaviour**; laws relating to corporate governance can both have an ex post and ex ante impact.

- Ex post: the legal rules and standards relating to corporate governance can be enforceable by regulators and the courts.
- Ex ante: the law could also potentially lead the way in shaping business behaviour, so can set the standard to be met rather than playing catch up to plug the gaps that have been exposed by corporate failures. But most of the time, the law is playing catch up.

Features of legal regulation:

Require the disclosure of information; **provides** rights of participation and control that arise out of owning shares, and it protects private rights that attached membership.

Other characteristics

There are also **soft rules** that also form part of the governance landscape, such as the listing rules of the stock exchanges and the guidelines that are provided by corporate regulators.

Need CG to **avoid** stealing and shirking; and to reduce agency costs

Costs of CG: costs associated w/ actual mechanism and opportunity costs

Directors have a **duty of care**: if duty of care is tightened, less likely to take risks due to legislation

Mechanisms

Independent chairperson

Separation of roles of chair and CEO

Independent directors

Disclosure rules

Audit independence and accountability

Executive remuneration roles

Market forces including the market for corporate control – takeovers

Enforcement of directors' and officers' duties

Shareholder voting – approval and veto rights

Creation

Legislation: corporate law economic reform program 9 (clerp 9)

Codes: OECD, ASX

Business organisation codes; market forces, gov't enforcement, shareholder voting

However, CG doesn't prevent business failure, fraud, doesn't increase profitability, or guarantee anything else

Right to Sue

General law: cases give a right to sue. Corps Act does not codify/replace general law, so it still applies

Case law has its own causes of action. Cases also used to clarify statutory breaches

General law includes directors' duties, such as negligence, duty of loyalty, breach of contract

Corps Act: criminal breaches (large and small); civil penalty breaches (eg directors' duties), civil rights of action (eg breach of contract, winding up, oppression etc.)

Overview of Directors' Duties

Structure

There are **two sources** of directors' duties:

- General law – common law and equity
- Statute – ie, the *Corporations Act* (CA). The statutory directors' duties are contained in ss 180-184 CA. Also keep in mind that we looked at s 588G in Topic 2

The statutory directors' duties under ss 180-184 CA apply in addition to any general law duties (s 185 CA). This means that directors can be sued for breaching both their general law and statutory directors' duties.

General law duty	Statutory duty under the CA
<u>Duty of care, skill, and diligence (common law)</u>	s 180
<u>Duty of loyalty and good faith</u>	
<ul style="list-style-type: none">• Duty to avoid conflicts/no profit (equity, fiduciary)	ss 182, 183 ss 191-196, Ch 2E – these provisions are about managing conflict
<ul style="list-style-type: none">• Duty to use powers for a proper purpose (equity, unclear whether fiduciary)	s 181(1)(b)
<ul style="list-style-type: none">• Duty to act in good faith in the best interests of the company (equity, unclear whether fiduciary)	s 181(1)(a)

<u>Duty to retain discretions (equity)</u>	N/A – but potential arguments may be brought up in the context of, eg ss 180 and 181
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To Whom are the duties owed?

Directors duties are owed to the **company as a whole**, and this is based off the old English case of *Percival and Wright*.

This also means that the duty is not owed to individual shareholders, employees or creditors, although there are some limited circumstances when the actions of the directors may give rise to an independent and separate fiduciary duty being owed to a particular shareholder.

In general, the duties are owed the company as a whole, which means that **the proper plaintiff** to sue for a breach of the duties is the company and not any individual shareholder. It also means that the compensation is paid to the company and not any individual shareholder.

But note that the power to initiate proceedings is typically a management decision, with some exceptions – unlikely that directors will institute proceedings against one of their own or a senior management person.

Who owes the duties?

<u>Statutory duty</u>	Who owes the duty?
s 180	Director, other officer
s 181	Director, other officer
s 182	Director, secretary, other officer, or employee
s 183	Director, other office, employee
<u>General law duty</u>	Director, senior executive officer

Directors

Section 9 CA provides the definition of a director. It states that a "*director of a company or other body means:*

(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."

* This **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 question of whether someone is a director is a matter of **substance**, not form. Even a person who was not validly appointed as a director may in fact still be regarded as a director under the CA if:

- They act in the position of a director – commonly referred to as a “de facto director”
- The validly appointed directors are accustomed to acting in accordance with their instructions or wishes – also known as a “shadow director”

De Facto

Either **appointed** to be a director regardless of the name given to the position, OR **not appointed** as a director BUT they act in the position of a director

Examples include:

- a person who was appointed by the company, but the instrument of appointment was defective.
- a director who was removed or resigns but continues to effectively act as a director after the fact
- a person who was appointed as an external consultant but effectively act as a director.

This is determined **objectively** on a case by case basis because there's a wide range of corporate and commercial life. It is a question of degree, and it requires consideration of the duties that are performed by that person in the context of that particular company. *Austin*: whether a person acts as a director “will often be a question of degree, and requires a consideration of the duties performed by that person in the context of the operations and circumstances of the particular company concerned.” Relevant factors:

- coy size: in a large & diversified coy, great discretion to deal w/ sig matters may be given to employees
- coy's internal practices/structure in that certain work given to an indiv may be of such a type that it's more appropriate to classify that work as being undertaken by the indiv in that capacity as an expert employee/consultant rather than as a director
- how the pers was reasonably perceived by outsiders who deal w/ the coy
- What are the sorts of duties/responsibilities that a director in that type of coy typically undertake?
- Does anyone else in the coy think he's a director?
- Does the coy hold the pers out as a director?
- If a consultant to a co is itself a co and what it does, through the actions of its own directors/officers, is act in the position of a director, then consistently with the policy of s 201B which requires a director to be a natural person, it is a question of fact as to which director/officer in the consultant co is a de facto director
- A person may still be a de facto director even if the co concerned has a properly constituted and functioning board
- Whether a co has held out a person as a director is a relevant consideration
- Participation in the decision making process as part of the company's governance structure is also a factor in finding whether de facto director exists (*Holland*) BUT just because someone might attend board meetings regularly, that alone is not sufficient to make them a director. They need to actually be participating in the decision making process for them to be viewed as a de facto director

Shadow Directors (Buzzle)

[*Harris*: is it the will of the pers and not the board who calls the tune to which the board dances?]