Directors duties in the zone of insolvency

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What we will discuss today

- What is insolvency?
- Should directors duties change when the company is insolvent/ in the zone of insolvency?
- The legislative provision: s 588G
- Safe harbour to s 588G: s 588GA

When is a company insolvent?

- S 95A – cash flow test

95A Solvency and insolvency

(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.

Note: A company is taken to be insolvent if the company proposes a restructuring plan to creditors (see subsection 455A(2)).

Insolvency

- Sandell v Porter (2006) 58 ACSR 631.:

Insolvency is expressed in s 95 as an inability to pay debts as they fall due out of the debtor's own money. But the debtor's own moneys are not limited to his cash resources immediately available. They extend to moneys which he can procure by realization by sale or by mortgage or pledge of his assets within a relatively short time — relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor. The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirely and generally speaking ought not to be drawn simply from evidence of a temporary lack of liquidity. It is the debtor's inability, utilizing such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency.

Directors' duties in the zone of insolvency
What's at stake here?

Protecting creditors

Discouraging director misconduct

Encouraging entrepreneurship and innovation

Directors' duties

COMMON LAW	STATUTE
Duty to act with reasonable care and diligence	S. 180 (1): Duty to exercise of due care and diligence S. 180(2): Business judgement rule S. 198D: Power to delegate S. 189: Reliance on information or advice provided by others S. 588G: Duty to prevent insolvent trading
Loyalty and good faith: Duty to retain discretion Duty to avoid conflicts of interests Duty to act in good faith in the interests of the company	S. 181: Duty to act in good faith in the best interests of the company, for proper purpose. Ss. 191-196 : Duty to disclose conflicts of interest Chapter 2E: Related party transactions Ss. 182, 183: Duty not to improperly use their position/ any

Duty to take into account the rights of creditors

- As a general rule, directors' duties are owed to the company.
- However, in certain circumstances, directors must take into consideration, the interests of creditors. The duty is to protect creditors once the company is insolvent. (***Westpac Banking Corp v The Bell Group Ltd (No. 3) [2012] WASCA 157***.)
- If the company is actually insolvent, then conduct that takes away assets from the general pool available to creditors can be said to prejudice creditors.

Insolvent trading

- This duty prevents directors from continuing to trade (and incurring debts) when their company is insolvent and likely to be unable to pay the debts that it incurs. (S. 588G)
- The focus here is to compensate unsecured creditors.
- Liquidators are required to refer breaches of S. 588G to ASIC in their reports under S. 533.

S. 588G: Conditions for liability

- For a director to contravene S. 588G, all the following conditions should apply:

(1) They are directors when the company incurs a debt

(2) The company was insolvent at the time when the debt was incurred or became insolvent as a result of incurring of the debt.

(3) There were reasonable grounds for suspecting that the company was insolvent or would become insolvent as a result of the debt being incurred.

(4) A reasonable person in a like position in a company in the company's circumstances would be aware of the company's insolvency.

- (3) <u>Reasonable grounds to suspect insolvency</u>
- The factual circumstances that are to be taken into account in assessing whether there were reasonable grounds to suspect insolvency are all those reasonably capable of being known to any of the directors. ***Standard Chartered Bank of Australia Ltd v Antico (1995) 38 NSWLR 290***.
- This would call for an examination of what reasonable enquiries would be made, or processes of obtaining information about the company's affairs would be implemented, by a reasonable director in the circumstances of that company, and what those enquires and processes would have revealed.
- Certain 'insolvency indicators' like overdue taxes, letters of demand and judgements obtained against the company should also alert the directors about the company's insolvency. (***ASIC v Plymin [2003] VSC 123***).

Defences (S. 588H)

- Any one of the following four defences will allow the director to defend an action successfully.

(1) When the debt was incurred, the director had reasonable grounds to expect that the company was solvent and would remain solvent even if the debt was incurred. (S.588H(2)).
The expectation must be that the debts will be paid when due, not that funds will become available at some indefinite time in the future. ***Hall v Poolman [2007] NSWSC 1330***.

(2) When the debt was incurred, the director had reasonable grounds to believe and did believe, that a subordinate person was competent, reliable and responsible for providing adequate information about the company's solvency and the director expected, on the basis of this information, that the company was solvent and would remain solvent.
S. 588 H (3).

Defences

(3) When the debt was incurred, the director, because of illness or some other good reason, did not at that time take part in the management of the company. S. 588H(4).
Lack of knowledge or skills is not 'some other good reason' to fail to take part in management: DCT v Clark [2003] NSWCA 91.

(4) The director took all reasonable steps to stop the company from incurring the debt. S. 588H(5).
It is for the director to prove that the debt was incurred without his or her express or implied authority.

S. 588H(6) provides that in making a determination whether such reasonable steps were taken, matters considered include: (a) any action the person took with a view to appointing an administrator; (b) when that action was taken; and (c) the results of the action

Relief

- Steele, et. al. article:
- Where a director has acted “honestly” or ought to be fairly excused from the contravention, the director may be provided relief from civil liability. Sections 1317S and 1318.
- “However, it should be noted that the courts have only granted relief from liability in a small number of cases in which reasonable restructuring efforts were made in an attempt to save the business.”

Is there a problem with s 588G?

- Is fraud a pre-condition of liability? (contrast with Singapore: Steele, et. al. article)
- What is the penalty for criminal liability? The penalty is up to 5 years imprisonment, 2,000 penalty units (AUD 420,000), or both, and the court may also order compensation. Section 588G(3) Schedule 3.
- Why do we need a safe harbour?

True enough, Australian directors, especially in large companies, have been so spooked by the possibility of personal liability that they have tended to put the company into the insolvency resolution process (known as voluntary administration in Australia) at the slightest possibility of insolvency.[257] An empirical study found that only 103 cases of insolvent trading had been filed between 1961 and 2004.[258] Thus, the Australian model had indeed resulted in "timid directors" rather than those willing to try to restructure the company when it is on the brink of bankruptcy.

Acknowledging that this approach of entering the company into premature voluntary administration could be value destructive, the Australian legislature introduced a safe harbor provision. In the explanatory memorandum to the Bill introducing this safe harbor provision, it was stated as follows:

> The appointment of an administrator to a company is almost always value destructive, making it harder for the company to restructure and increasing the likelihood of its eventual liquidation. Even where a company may actually be solvent or could be turned around, the appointment of an administrator has the potential to result in the company being liquidated because of the loss of confidence amongst its suppliers, credit providers and employees and the general public.[259]

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3387001

Law on the books versus law in action

- Empirical study: https://law.unimelb.edu.au/__data/assets/pdf_file/0011/1723529/11-InsolventTrading-AnEmpiricalStudy2.pdf

Safe harbour

(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.

Note 1: The person bears an evidential burden in relation to the matter in this subsection (see subsection (3)).

Note 2: For subsection (1) to be available, certain matters must be being done or be done (see subsections (4) and (5)).

Safe harbour

(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.

Is the safe harbour working?

- The TMA/KordaMentha Turnaround survey in 2019 found that almost half of respondents believed that the safe harbour has had no impact on the restructuring environment, which was almost double the number of respondents in the 2018 survey, so with a year's further experience with the procedure more TMA members believed that the safe harbour would have no impact.
- A review of external administrations by McGrathNicol in 2019 also found limited evidence of safe harbour engagements in the firm's matters, and where it was found it was far more likely in ASX listed companies, with less than 5% of matters involving SMEs including directors seeking safe harbour advice.
- https://australianinsolvencylaw.com/2020/11/20/early-guidance-on-safe-harbour-zombie-companies-need-not-apply/

Safe harbour

- Case: Re Balmz Pty Ltd (in liq) [2020] VSC 652 (7 October 2020) [See page 40]
- http://www.austlii.edu.au/cgi-bin/sign.cgi/au/cases/vic/VSC/2020/652

Consequences of liability

- S. 588M imposes liability for breach under S. 588G.
- The director may be ordered to pay an amount of the loss or damage suffered by a creditor in respect of the debt incurred by the company in breach of S. 588G which the creditor has not been able to recover by reason of the company's insolvency.
- The creditor's debt must have been unsecured and the creditor must have suffered loss.
- For proceedings to be brought under S. 588M, the company must be in the process of "being wound up". It is too late for such an action after the liquidator has applied for a company to be deregistered.

- The liquidator usually brings the action under S. 588M.
- An individual creditor is not entitled to sue a director unless the consent of the liquidator is obtained. (S. 588R)
- Where the liquidator has commenced proceedings claiming a voidable transaction in relation to the relevant debt of the creditor, the creditor cannot bring an action.
- A creditor also cannot bring an action where ASIC has brought a civil penalty action against the director (S 588U). Where ASIC takes action against a director under 588G, the court may order compensation in favour of an unsecured creditor. The liquidator may intervene in an application for a civil penalty order and seek compensation for creditors. S. 588J(2).