DECISIONS IN THE TWILIGHT ZONE OF INSOLVENCY - SHOULD DIRECTORS BE AFFORDED A NEW SAFE HARBOUR?

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Abstract

The current insolvent trading prohibitions are framed in such a way that there are no reasonable safe harbours for directors who responsibly attempt to trade a company out of financial difficulty. When faced with decisions concerning the financial viability of a company, it is in a director's best interests to stop trading and transfer the company to either an administrator or liquidator. This paper proposes that to counter this conservative approach, a more flexible statutory defence should be adopted. This proposed defence would afford directors a new safe harbour, which can relax the threat of personal liability, prevent premature transfer to voluntary administration, encourage qualified people to take up directorships and promote the genuine operation of workout attempts when a company is in the twilight zone of insolvency.

I INTRODUCTION

In 2008, Kevin Rudd, the then Prime Minister of Australia announced that Australia was facing 'a financial crisis of truly global proportions.'[1] In response to this crisis he identified that the challenge was to 'reform financial markets and regulatory systems, to reduce the chances of these events repeating themselves'.[2] On 19 January 2010, the Commonwealth Treasury released a discussion paper entitled *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* ('Treasury discussion paper').[3] In what can only be described as a necessary step by the government, the Treasury discussion paper raises a number of

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1 Kevin Rudd, 'General Debate of the 63rd Session - Millennium Development Goals' (Speech delivered at the United Nations General Assembly, New York, 25 September 2008).

2 Ibid.

3 Commonwealth of Australia, The Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, Discussion Paper (19 January 2010).

pertinent issues surrounding the operation of Australia's insolvent trading regime. Of particular interest is the proposed extension of the 'business judgment rule', found in s 180(2) of the *Corporations Act 2001* (Cth) ('the Act'), to circumstances of insolvent trading.

In accordance with s 588G of the Act, a director of a company has a duty to prevent the company from trading while insolvent.[4] A director will contravene this duty when he or she incurs a debt and is aware (or ought reasonably to have been aware) that the company is, or would become insolvent as a result of incurring the relevant debt.[5] The operation of this provision makes life difficult for a director, especially in the period leading up to insolvency. In this precarious period of twilight, the director will be forced to make an almost spontaneous decision concerning the company's future. The first option available to the director is to attempt to trade the company out of financial difficulty. Although tempting, it is not advisable to take this path as it is paved with the prospect of personal liability, civil penalties, disqualification and even criminal prosecution.[6] As the director has a personal incentive not to be prosecuted, the director will be motivated to pursue an alternative option. Fortunately for the director, the Act provides a simple way out - the director can stop trading and transfer the company to a third party to handle its affairs, through the external mechanisms of administration or liquidation. Although this decision appears to be a safe option for the director, in reality this impetus to avoid personal liability may represent a direct conflict of interest between the director's personal interests and those of the company and its creditors, with the ultimate result being a significant loss of enterprise value.[7]

The purpose of this paper is to investigate whether a third option, namely the proposed extension of the business judgment rule as raised in the Treasury discussion paper, should be made available to the director. Part II of this paper sets out briefly this option. Part III explores the historical and theoretical background to the current insolvent trading provisions. Part IV discusses the statutory defences that relate to these provisions, highlighting that they are of limited use to directors who wish to trade out of financial difficulties. Part V evaluates how companies unnecessarily lose value when nearing insolvency. Specific attention is given to the concern that the law fails to promote entrepreneurial

4 In accordance with s 588M of the Act, if all of the elements of s 588G are established, and none of the defences are proven, the director may be personally liable for the debt.

5 Section 588G(2) of the Act.

6 See, Part 9.4B of the Act, ss 1317E(1)(e), 1317G, 1317H. For disqualification, see Part 2D.6, s 206C.

7 'Enterprise value' represents the market value of a company's equity less its net debt.

risk-taking and innovation by directors. Part VI discusses in detail the proposed new defence. It is argued that directors should be shielded from liability if they make a bona fide attempt at restructuring and have a reasonable belief that the company will emerge from the restructuring in better shape. Importantly, the defence allows a director to use his or her business judgment during the twilight zone of insolvency, thus striking the necessary balance between entrepreneurial risk-taking, preservation of enterprise value and creditor protection. Part VII addresses the important issues raised in the 2009 Federal Court decision of *McLellan in the matter of The Stake Man Pty Ltd v Carroll* ('*McLellan case*').[8] Part VIII examines the insolvent trading prohibition through the eyes of a director. Part IX concludes the discussion under this paper.

II Proposed Option - Extension of Business Judgment Rule

As proposed by the Treasury discussion paper, a director would be relieved of his or her duty not to trade whilst insolvent, if the following elements of the proposed extension of the business judgment rule are satisfied:

> (a) the financial accounts and records of the company presented a true and fair picture of the company's financial circumstances at the time that the rule was invoked;
> (b) the director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time;
> (c) it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring; and
> (d) the restructuring was diligently pursued by the director.[9]

The proposed extension of the business judgment rule and its elements will be explored in detail in Part VI.

III Current Insolvent Trading Provisions

This Part provides a summary of the current insolvent trading provisions in Australia, including its origins, enactment into legislation and the rationale behind its implementation.

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8 *McLellan case* [2009] FCA 1415 (30 November 2009) (Goldberg J).

9 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3.

A *Humble Beginnings*

In 1983 the Australian Law Reform Commission commenced a comprehensive five year inquiry into Australia's corporate insolvency laws. In 1988 it issued the 'General Insolvency Inquiry Report',[10] which was nicknamed the 'Harmer Report', after its chief author. This report made a number of recommendations on insolvency issues, including the reform of director liability under s 556 of the then *Companies Act 1981* (Cth). Paragraph 279 of this report claimed that

> [a]t no stage since its introduction in 1961 ha[d] the liability of a director for incurring debts without a reasonable prospect of payment been in a form appropriate for giving creditors … a suitable remedy.[11]

Paragraph 280 of the report outlined that there was a need for provisions that turned the minds of directors to their responsibilities when incurring debts.[12] Moreover, it was signalled that the responsibilities of directors with regard to insolvent trading should be 'expressed as a positive duty owed to the company to prevent the company from engaging in that activity.'[13] In 1992 the majority of the Harmer Report's findings were tabled before Parliament in the Corporate Law Reform Bill 1992 (Cth). This Bill was passed in 1993 and became known as the *Corporate Law Reform Act 1993* (Cth). Currently, the insolvent trading provisions are set out in Division 3 of Part 5.7B[14] of the Act. These provisions are discussed in more detail below.

B *Director's Duty to Prevent Insolvent Trading*

The provisions outlined in this section illustrate how directors can become personally liable in terms of civil[15] and criminal penalties,[16] where they permit a company to incur debts while insolvent.[17] If insolvent trading occurs and there are no applicable defences, the director is said to be 'walking a legal tightrope'[18] if he or she attempts to keep the business

10 Australian Law Reform Commission, *General Insolvency Inquiry,* Report No 45 (1988).
11 Ibid.
12 Ibid.
13 Ibid [280].
14 See ss 588G - 588H of the Act.
15 See s 588G(2) of the Act.
16 See s 588G(3) of the Act.
17 See s 588J of the Act which empowers the court to make an order that the director pay the company compensation, equal to the amount of the loss of damage, if the court is satisfied that the director has contravened s 588G. See also s 588M(3) of the Act.
18 Heather Hansen, *Tough Insolvent Trading Laws Hinder Corporate Restructuring* (2009) McCullough Robertson Lawyers <http://www.mccullough.com.au/articles/news.aspx?p=410&itm=2511>.

afloat rather than declare insolvency. Consequently, directors have a tendency to place a company into voluntary administration or liquidation in circumstances even where there is a prospect that the company might be able to trade out of its financial difficulties.

Pursuant to s 588G(1) of the Act, a director of a company has a duty to prevent the company from trading while insolvent.[19] A director will contravene this duty when he or she incurs a debt[20] and is aware (or ought reasonably to have been aware) that the company is, or would become insolvent as a result of incurring the relevant debt.[21]

1 *Director*

Section 588G solely applies to a person who is a director at the time when the debt is incurred. A director is defined in s 9 of the Act and includes a person occupying the position of director. Therefore, a person acting in the position of a director ('de facto director'), or a person in accordance with whose directions or instructions the directors of a company are accustomed to act ('shadow director') are also subject to the duty.

2 *Company is Insolvent*

Prior to 1993 no statutory definition of insolvency existed. Section 95A of the Act now defines 'solvency' and 'insolvency' in the following terms:

> (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.

This very broadly construed definition provides little guidance on what specific financial position will constitute 'insolvency' for the purposes of the provision. Accordingly, the courts have often grappled with the difficulty of interpreting and applying this definition.[22] In the 2008 judgment of *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*[23] Owen J indicated that the 'cash flow' test is the appropriate test for determining solvency. However, he added that the 'balance sheet' test should not be dismissed as irrelevant:

19 In accordance with s 588M of the Act if all of the elements of s 588G are established, and none of the defences are proven, the director may be personally liable for the debt.

20 The term 'debt' is not specifically defined in the Act. However, there are certain guidelines set out in s 588G (1A) that provide when a debt is said to be incurred by a company.

21 Section 588G(2) of the Act.

22 See for eg, *Re Timbatec Pty Ltd and the Companies Act* [1974] 1 NSWLR 613.

23 (2008) 225 FLR 1.

> [I]n the light of commercial reality, all things considered, could the company pay its debts as and when they become due? Such an approach includes the balance sheet test, and other commercial realities such as access to money from third parties, raising capital or credit and financial support are all relevant considerations in determining a company's ability to pay debts.[24]

In response to the issue of 'insolvency', the Australian Securities & Investments Commission ('ASIC') makes the important point that a director should not have a 'head in the sand' attitude.[25] Moreover, it provides a number of indicators of corporate insolvency, including evidence of the following - ongoing losses; poor cash flows; lack of budgetary forecasts; and increasing debt.[26] In the interests of avoiding personal liability, directors are therefore encouraged to err on the side of caution when making decisions regarding continued trading, especially if the company is in a state of dire illiquidity.[27]

3 *Awareness of State of Insolvency*

The explanatory memoranda of the Corporate Law Reform Bill 1992 states that in making the assessment as to deemed awareness of insolvency, the court should take into account the following - the size, type, business, constitution, composition of board; and what a reasonable person in the director's position would be expected to do to ensure he or she was aware of insolvency issues.[28] In the case of *Credit Corp Australia Pty Ltd v Atkins,* O'Loughlin J held that the term 'reasonable grounds' imports an objective test.[29] Further, his Honour stated that the term denotes

> grounds that should be adjudged 'reasonable' according to the standards of a director of ordinary competence - one who is expected to be capable of reaching a reasonably informed opinion about the financial capacity of the company.[30]

The objective test will include consideration of matters the director ought reasonably to have known in founding a suspicion of insolvency.[31] Therefore, despite a lack of any actual awareness of a state of insolvency, a

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24 *The Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 225 FLR 1, 118 (Owen J), quoting Niall Coburn, *Coburn's Insolvent Trading: Global Investment Fraud and Corporate Investigations* (Lawbook Co, 2nd ed, 2003) 66.

25 ASIC, *Insolvency: A Guide for Directors* (2008) 3.

26 Ibid.

27 Note that a temporary lack of liquidity does not amount to insolvency: *Sandell v Porter* (1966) 115 CLR 666, 671 (Barwick CJ).

28 Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth) [1083]-[1089].

29 (1999) 30 ACSR 727, 741.

30 Ibid.

31 See, *Australian Securities and Investments Commission v Plymin, Elliott and Harrison* (2003) 175 FLR 124, 225 (Mandie J); *Queensland Bacon Pty Ltd v Rees* (1965) 115 CLR 266, 303 (Kitto J).

director who fails to inform himself or herself adequately of the financial status of a company can be found in breach of this duty.[32] A useful, but not definitive list of factors to take into account when considering whether a company is insolvent can be found in *ASIC Regulatory Guide 217 – Duty to Prevent Insolvent Trading: Guide for Directors.*[33]

C *Reach of the Provisions*

The reach of the provisions is such that a liability may be imposed despite the director having no knowledge of the debt, and even if the director had no capacity to prevent the debt being incurred.[34] The provision is also contravened when the director recognises that the company is facing financial problems and incurs a debt in an attempt to rescue the business from formal insolvency.[35] The scope of the provisions is indeed very wide and serves an active deterrent to any form of risk-taking by directors should they suspect financial difficulty.

D *Rationale behind s 588G*

The overwhelming rationale behind the implementation of s 588G is creditor protection.[36] This viewpoint was perhaps 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.[37]

Therefore, when a company is solvent a director does not need to protect creditors' interests as their debts are being sufficiently fulfilled in accordance with contractual obligations. Conversely, when a company is insolvent or is approaching insolvency the interests of creditors become

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32 *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405; LexisNexis Australia, *Halsbury's Laws of Australia* (1997), 120-7525.

33 ASIC, *Regulatory Guide 217 – Duty to Prevent Insolvent Trading: Guide for Directors* (2010).

34 *Elliot v Australian Securities and Investments Commission* (2004) 205 ALR 594.

35 See, Jason Harris, 'Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?' (2009) 23 *Australian Journal of Corporate Law* 266, 272.

36 *Walker v Wimborne* (1976) 137 CLR 1.

37 (1986) 4 NSWLR 722, 730. Note that although this quote is in regards to the insolvent trading provisions prior to s 588G, the same rationale for creditor protection applies.

paramount as they have a right to be fully informed regarding the company's financial position. As the company is unable to pay its debts when they fall due, creditors are no longer provided with a fixed return and become claimants on the company's residual resources.[38]

It is apparent that when a company is teetering on the verge of insolvency, or is in the 'twilight zone', there is a fine line between paramount interests - should the director focus on the interests of the shareholder or the creditor? The quandary faced by directors was enunciated in the 2007 case of *Hall v Poolman*,[39] where Palmer J stated:

> [I]t is sometimes a difficult decision for a director… to decide whether, and when, to abandon hope of a change in the company's fortunes and to summon the administrators. There are often pressing interests involved in the decision: the jobs of employees will be lost, the investment of shareholders will evaporate… On the other hand, the livelihood of creditors whose businesses depend on reasonably prompt payment may also be ruined if a company continues to trade while insolvent.[40]

The complexities surrounding this decision will be discussed further in Part VI. It will be proposed that in a situation such as this, the director should be able to use his or her business judgment to ensure that both parties' interests are best served. Ideally, directors should refrain from proceeding down a path that has the potential to adversely affect the interests of either the shareholders or the creditors.

IV Current Statutory Defences

This Part sets out the current statutory defences and then highlights how these defences are applied and where they may prove to be ineffective.

A *Defences Available to a Director*

It has been said that s 588G and the penalties associated with contravention[41] are the strictest provisions in the 'Anglo-American

38 See, Helen Anderson, 'Directors' Personal Liability to Creditors: Theory Versus Tradition' (2003) 8(2) *Deakin Law Review* 209, 219.

39 (2007) 215 FLR 243.

40 Ibid 318, 319 (Palmer J).

41 There are three primary consequences for breach of s 588G(1). These include: 1) compensation order (ss 588J, 1317H); 2) pecuniary penalty order (s 1317G); and 3) disqualification from managing a corporation (s 206C). (Section 558G(3) refers to criminal consequences.)

world'.[42] The above analysis illustrates that this is mainly due to the way in which s 588G prohibits any adverse risk-taking. Currently, there are four purpose built sources of relief available to directors when contravention of s588G has occurred,[43] as well as two general relief provisions found in ss 1317S and 1318 of the Act. As was explained in the 2007 discussion paper, *Review of Sanctions in Corporate Law*,[44] these defences are aimed at 'assisting directors who have acted diligently and actively participated in the management of the company, but have not been able to prevent incurring the debt'.[45]

1 *Reasonable Grounds to Expect the Company was Solvent*

It is a defence to a breach of the insolvent trading prohibition if the director had reasonable grounds to expect' that the company was solvent at the time the debt was incurred.[46] An expectation in this sense means more than a mere hope or possibility, or suspicion.[47] In the case of *Hall v Poolman*,[48] Palmer J outlined a useful yardstick in assessing whether a director expected that the company was insolvent when the debt was incurred. He stated that a reasonable director would ask:

> How sure are we that this asset can be turned into cash to pay all our debts … within three months? Is that outcome certain, probable, more likely than not, possible, possible with a bit of luck, possible with a lot of luck, remote, or is there no real way of knowing?[49]

In answer to these questions his Honour reasoned that if the answer is "certain" or "probable", the director can have a reasonable expectation of solvency';[50] if the answer lies between being '"possible" to "no way of knowing", the director can have no reasonable expectation of solvency';[51] and if the answer is '"more likely than not", the director runs the risk that a court will hold to the contrary in any subsequent

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42 See, generally, United Kingdom (UK) *Insolvency Act 1986* ss 214(2), 214(6)); New Zealand (NZ) *Companies Act 1993* s 136 – note particularly the use of the word 'believes', compared with the term 'suspecting' in s 588G of the Act; The United States (US) corporate and bankruptcy laws do not make directors liable for insolvent trading; creditors protect their interests through contract.

43 Section 588H of the Act. Note that these defences do not apply to a criminal offence under s 588G(3).

44 Commonwealth of Australia, *Review of Sanctions in Corporate Law*, Discussion Paper (2007).

45 Ibid [3.13].

46 Section 588H (2) of the Act.

47 *Tourprint International Pty Ltd (in liq) v Bott* (1999) 32 ACSR 201.

48 (2007) 215 FLR 243.

49 Ibid 305 (Palmer J).

50 Ibid.

51 Ibid.

insolvent trading claim'.[52] The question of whether the director could have held this expectation is considered in light of all the circumstances of the company, including that it is operating in a practical business environment.[53] In *Tourprint International Pty Ltd (in liq) v Bott* Austin J noted that:

> A director cannot rely on a complete ignorance of or neglect of duty… and cannot hide behind an ignorance of the company's affairs which is of their own making or, if not entirely of their own making, had been contributed to by their own failure to make further necessary inquiries.[54]

This defence is imposed in light of the positive duty extended by s 588G to monitor the company's financial position in terms of its ability to repay debts.[55] A failure to meet this obligation will exclude the availability of this defence.[56]

2 *Reliance on Another Person*

A defence is available under s 588H(3) if a director can prove that at the time when a debt was incurred, he or she:

> (a) had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing them with adequate information regarding the company's solvency;
> (b) that the competent and reliable person was fulfilling that responsibility; and
> (c) the director expected, on the basis of the information supplied that the company was solvent and would remain solvent even if the debt was incurred.[57]

This is quite a high standard to fulfil as the director must prove that he or she took an active interest in the company, oversaw the activities of the competent person and put checks in place to ensure that the information was reliable.[58] A useful analysis of the defence was undertaken by Young CJ in *Manpac Industries Pty Ltd v Ceccattini*, who articulated that

> the prime thrust of the defence is to cover the situation where there is a large corporation with bulky accounts and where there is a system in place of competent accountants, credit controllers and financial management and the board has a regime whereby those people, provided they are competent and responsible, will report to the board any problems that the board may pick up.[59]

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52 Ibid.

53 See, *New World Alliance Pty Ltd, Re; Sycotex Pty Ltd v Baseler [No 2]* (1994) 51 FCR 425; LexisNexis Australia, *Halsbury's Laws of Australia* (1997), 120-7530.

54 (1999) 32 ACSR 201, 215.

55 *Group Four Industries Pty Ltd v Brosnan* (1992) 59 SASR 22.

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

57 Section 588H(3) of the Act.

58 *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.

59 [2002] NSWSC 330 (Unreported, Supreme Court of New South Wales, Young CJ, 23

Therefore, in terms of taking steps to protect themselves, it is vital that directors consistently obtain advice from a 'suitably qualified, competent and reliable person about the financial position of the company and how the financial difficulties can be addressed'.[60] Generally, this will be a person who is 'specifically responsible for providing information about the company's solvency to the director (eg, another director, chief financial officer or internal/external accountant).'[61] It is important that directors refrain from blindly relying on the advice of others and take proactive steps to ensure that any reliance is reasonable.[62]

3 *Absence from Management*

The third available defence comes about when the director did not take part in the management of the company 'because of illness or for some other good reason' at the time when the company incurred the debt in question.[63] This defence hardly provides a 'step' that the director can take to avoid s 588G, as it accounts for the situation where a director was not actively involved in the management of the company at the time the debt arose, due to ill health.[64] Nonetheless, the requirement is that the director be so sick as to not be involved in the management of the company. Therefore, if the director does fall so ill as to not be able to fully perform his or her duties, it would be important to abstain from the management function altogether, for any presence at the premises could be construed as involvement and leave this defence unavailable.[65]

4 *Reasonable Steps to Prevent Debt Being Incurred*

The fourth defence is available if the director can prove that he or she took all reasonable steps to prevent the company from incurring the debt when there were reasonable grounds to suspect that the company was insolvent.[66] In determining whether the defence has been proved, s 588H(6) directs the court to have regard to whether the director took any action to appoint an administrator, when such action was taken, and the results of such action.[67] Consequently, this defence will be relevant if it can be established that the director unsuccessfully attempted to

April 2002) [54].

60 ASIC, *Regulatory Guide 217 – Duty to Prevent Insolvent Trading*, above n 33.

61 Ibid.

62 Anil Hargovan, 'Directors' Liability for Insolvent Trading under Part 5.7B of the Corporations Act' (2009) *Keeping Good Companies* 160, 163.

63 Section 588H(4) of the Act.

64 Section 588H(4) of the Act.

65 *Williams (as liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* [2008] QCA 94 (Unreported, Keane, Muir JA, Mackenzie AJA), 18 April 2008).

66 Section 588H(5) of the Act.

67 Section 588H(6) of the Act.

convince the board to place the company into voluntary administration, or if the board resolved to place the company into voluntary administration 'but the creditors, pursuant to s 439C decide[d] that the company should be wound up'.[68] If a director believes that insolvent trading is occurring and other directors do not agree with this opinion, the director should either resign or have the company wound up.[69] In the case of *Byron v Southern Star Group Pty Ltd* it was suggested that simply voicing displeasure of the decision is not enough.[70]

5 *General Relief Provisions - Sections 1317S and 1318*

Sections 1317S and 1318(1) provide relief to a director where the person has acted reasonably, honestly and, having regard to all the circumstances of the case, the person ought fairly to be excused.[71] As with s 588H(5) above, the court takes into consideration the following - whether any action was taken to appoint an administrator; when such action was taken; and the results of such action.[72] In effect, these relief provisions are only relied on after the court has concluded that a breach of s 588G has occurred.

B *Are these Defences Effective?*

Despite the fact that there are several defences that aim to protect a director from liability, it is actually quite difficult for directors to fall under their umbrella. This claim is further supported by recent empirical evidence which illustrates that attempts to make use of these defences have proved largely unsuccessful. Explicitly, the study found that in superior courts reliance on defences to s 588G failed in more than 75 per cent of cases argued.[73] The following sections explore the more substantive defences and outline where they may prove to be ineffective.

1 *Reasonable Grounds to Expect the Company was Solvent*

The first defence requires that a director had an 'expectation' of solvency at the time the debt was incurred.[74] This 'expectation' implies a measure

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68 Abe Herzberg, 'Is Section 588G a Paper Tiger?' (Speech delivered at the Corporate Law Teachers Conference, Flinders University, 9 February 1998).

69 See, *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405, 422.

70 (1997) 73 FCR 264.

71 Sections 1317S, 1318 of the Act. It should be noted that honesty alone will be insufficient for an excuse by the court: *Williams (as liquidator of Scholz Motor Group Pty Ltd (in liq)) v Scholz* [2008] QCA 94 (Unreported, Keane, Muir JA, Mackenzie AJA), 18 April 2008).

72 Section 1317S(3) of the Act.

73 Paul James, Ian Ramsay and Siva Polat, 'Insolvent Trading - An Empirical Study' (2004) 12 *Insolvency Law Journal* 210, 234-235.

74 Section 588H (2) of the Act.

of confidence that the company is currently solvent, which is a much higher degree of certainty than a 'suspicion' of insolvency found in the duty provision itself.[75] Although the director can be in breach of the duty to prevent insolvent trading where he or she suspects insolvency, the defence is only available where the director expected that the company would remain solvent.[76] This principle was examined by Goldberg J in the 2009 *McLellan case.*[77] His Honour stated that:

> It is apparent from the statutory scheme… that a director can, at one and the same time, have a 'suspicion' of insolvency and also an 'expectation' of solvency. Reasonable grounds for 'suspecting' that a company is insolvent does not require the same degree of satisfaction as is required to determine if a director has reasonable grounds 'to expect' solvency.[78]

Accordingly, this defence does not provide much comfort as it is unlikely that a director will have a reasonable expectation of solvency during circumstances of financial distress.[79]

2 *Reliance on Another Person*

The second defence allows the director to avoid liability when a competent and reliable person has provided him or her with adequate information regarding the company's solvency.[80] As articulated above, this defence is usually only relevant to directors of large corporations. Moreover, the requirements of the defence are quite difficult to establish. A notable recent example of where this defence was unsuccessfully argued was in the case of *Australian Securities and Investments Commission v Plymin.*[81] In this case Mandie J held that Mr Elliott, a non-executive director, had failed to prevent a company from incurring debts at a time when the company was insolvent. Her Honour concluded that she was not satisfied that Mr Elliott had reasonable grounds to expect that the company was solvent. This was based on the notion that other directors and management were not fulfilling their responsibility to provide Mr Elliott with adequate information regarding the company's solvency.[82] Therefore, it is evident that the courts are willing to impose increasingly

75 See, Kylie Downs and Scott Butler, 'Insolvent Trading' (2009) 29(7) *Proctor* 31, 33.

76 *Scott v Williams* [2002] SASC 424 (12 December 2002) (Lander J).

77 [2009] FCA 1415 (30 November 2009) (Goldberg J).

78 Ibid [169].

79 Harris, 'Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?'above n 35, 283. Also see for eg, *McLellan case* [2009] FCA 1415 (30 November 2009) (Goldberg J) [168-185].

80 Section 588H(3) of the Act.

81 (2003) 175 FLR 124; Affirmed in *Elliott v Australian Securities and Investments Commission* (2004) 205 ALR 594.

82 Ibid 261 (Mandie J).

high standards of conduct on all directors.[83] Ultimately, when a company is facing financial difficulty it is important to ensure that non-executive directors have an objective basis for concluding that the company is solvent.[84]

3 *Reasonable Steps to Prevent the Debt Being Incurred*

The final substantive defence requires every reasonable step to be taken by the director to avoid the debt being incurred. The major problem with this defence is that it is contradictory to the aim of preserving going concern and enterprise value by continuing to trade or restructure.[85] To achieve the aims of the legislation, this defence should account for steps not just to avoid debt, but those taken in good faith to preserve value where there is due diligence by the director.[86] Despite some offer of protection for directors reasonably seeking to restructure a business, the wording of the provision is uncertain, and offers protection at the most uncertain of times – once liable and when the court is exercising a residual discretion.[87] If directors were to use this defence as a form of protection when undertaking bona fide restructuring they would need greater confidence in its scope before attempting to rely on it. Alternatively, this defence could exist in its current form and work in tandem with the proposed new business judgment rule defence, which will be discussed in Part VI.

One final aspect to note is that this defence imposes a significant impediment on the prospect of exploring informal corporate workouts and restructuring as it is designed specifically to promote transition into voluntary administration. As the director has a personal incentive not to be prosecuted, the director will be motivated to explore voluntary administration and will generally elect this path. The connection between this defence and voluntary administration is discussed further in the subsequent Part.

4 *General Relief Provisions - Sections 1317S and 1318*

As alluded to above, the operation of the general relief provisions are useful to directors after a prima facie case has been made out against them. On this basis they operate as a 'safe harbour' for honest and reasonable business decisions. Despite the forgiveness offered by the

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83 See, Arsalidou Demetra, 'To be Active or Inactive': Is this a 'New' Question for Company Directors?' (2003) 8(2) *Deakin Law Review* 335, 347.

84 Ibid 347.

85 See Harris, 'Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?', above n 35, 283.

86 Ibid 283.

87 Ibid 284.

court, it is important to note that the court has complete discretion and will not always provide relief. Consequently, directors cannot be instilled with confidence that their claim will always be defended if they act honestly and reasonably. Furthermore, even if a director is relieved of liability there is still the issue of reputational damage. As the director has broken the law, it will be difficult to continue in the current role and/or obtain future director-related positions.[88]

V Concerns that Current Statutory Defences Prevent Informal Workouts and Lead to Destruction of Value

This Part examines and evaluates how companies unnecessarily lose value when nearing insolvency. Specific focus is given to voluntary administration ('VA'), the current statutory defences and informal corporate workouts.

A *'Premature' Administration*

Pursuant to s 435A of the Act, the primary objective of VA is to 'maximise the chances of… [insolvent or near-insolvent companies] continuing in existence'.[89] If these companies cannot be salvaged, the administrator will attempt the secondary objective which is to provide the best possible return for its creditors and members above that which would result from immediate winding up.[90] Given the possibility that directors will be prosecuted for breach of s 588G, the commencement of VA and the appointment of an administrator would ordinarily occur via resolution of the board of directors.[91] Appointment can also be initiated by a secured creditor[92] or by the company's liquidator.[93] During this process directors' powers are suspended, leaving the administrator in control of the company.[94]

The motivation for appointment via resolution of the board of directors is directly related to the operation of s 588H(5) and s 588H(6) of the Act. As alluded to in Part IV, these defence provisions are designed specifically to promote (or perhaps mandate) transition into VA. In determining whether a director has taken all reasonable steps to prevent a company

88 See, Australian Institute of Company Directors, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) 2.

89 Section 435A(a) of the Act.

90 Section 435A(b) of the Act.

91 Section 436A of the Act.

92 Section 436B of the Act. Note that the secured creditor must be entitled to enforce a charge on the whole or substantially the whole of the company's property.

93 Section 436C of the Act.

94 Section 437C of the Act.

from incurring a debt whilst insolvent,[95] s 588H(6) directs the court to have regard to:

> (a) whether the director took any action to appoint an administrator;
> (b) when such action was taken; and
> (c) the results of such action.[96]

For that reason, it is evident that the current laws cause companies to be prematurely placed into external administration by directors who fear exposure to personal liability. This represents a direct conflict between the directors' personal interests and those of the company and its creditors.[97] Interestingly, studies have shown the resumption of normal trading post VA only occurs approximately 10 per cent of the time.[98] In a four-year study of companies that had entered into VA, 17 per cent were deregistered, 8 per cent had an administrator appointed, 21 per cent were subject to a deed of company arrangement[99] and the remaining 44 per cent had a liquidator appointed.[100] These figures highlight that the majority of companies that enter into VA are liquidated and fail to return to normal trading.

B *'Loss' Resulting from Premature Administration*

While VA allows for business rescue attempts where a company is insolvent, invoking the procedure can result in permanent damage to the company's tangible and intangible value.[101] This damage is perhaps most evident in four situations.

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95 Section 588H(5) of the Act.

96 Section 588H(6) of the Act.

97 Henry Davis York Lawyers, Interview with Chris Bowen, the Minister for Financial Services, Superannuation and Corporate Law (Sydney, February 2010).

98 Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (2005) [5.12]. Of the 5760 companies that entered into voluntary administration over the four years from 1993 to 1997, 592 resumed normal trading.

99 In recent years, the percentage of companies that have entered into VA and then successfully made a compromise in the form of a deed of company arrangement ('DOCA') has improved. In the period up to November 2009, 39% of companies that entered into VA successfully approved a DOCA. This figure can be compared to the recent average of approximately 25%. Despite this, it is argued that the success rate is still considerably poor. See generally Cliff Sanderson, *The Business Stress Report (January)* (2010) Restructuring Works <http://www.restructuringworks.com.au/downloads/Business%20Stress%20Report%20January%202010.pdf> at 30 July 2010.

100 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: A Stocktake*, above n 98, [5.12]. These figures are calculated over the four years from 1993 to 1997. Although these figures are somewhat out-dated, they generally hold true in the current climate.

101 See, Scott Butler, *Insolvent Trading - Proposed Safe Harbour for Directors* (2010) McCullough Robertson Lawyers <http://www.mcculloughrobertson.com.au/downloads/2801Insolvency%20-%206%20April%202010.pdf>.

1 *Negative Perceptions of the Company*

The first major problem associated with VA is the manifestation of a negative stigma that attaches to the company when an administrator is appointed. Pursuant to s 450E(1) of the Act, '[a] company under administration must set out, in every public document and negotiable instrument, after the company's name where it first appears, the expression ("administrator appointed").'[102] This requirement is akin to a brand on the hind of livestock, as outsiders perceive that the company is in a herd of irretrievably insolvent enterprises. This is particularly evident in enterprises that are dependent on 'goodwill or public sentiment' (for example, a travel company that requires advance payment for services).[103] This 'brand' issue creates a cumulative effect whereby the distressed company loses consumer and creditor confidence, and ultimately, company value.[104]

2 *Immediate or Optional Termination through 'Ipso Facto' Clauses*

The second major problem relates to a default or termination clause that is inherent in most modern commercial contracts. This default provision is known as an 'ipso facto clause' and entitles a party to terminate a contract where a counterpart is placed into VA.[105] In the case of small and medium sized enterprises the termination of contracts will generally lead to the deterioration of company value. For example, a manufacturer of shoes may have a number of contracts with suppliers for raw materials. If these contracts are terminated the result for the shoe manufacturer can be quite drastic. Firstly, the company loses key contracts with suppliers which will result in the company no longer having raw materials to service future product sales. Secondly, the company will have to re-negotiate new terms with the supplier, provided, of course, that the supplier is still willing to transact with the company. If terms are re-negotiated, the supplier will be in a significantly higher bargaining position as it will be conscious of the company's strained financial position. As a result, more stringent terms may be placed in the new contract which will intentionally favour the position of the supplier.

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102 See s 9 of the Act for the definitions of 'public document' and 'negotiable instrument'.

103 See, Korda Mentha, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) 3.

104 Generally, the company will lose a substantial proportion of 'goodwill'. This is an intangible asset that represents reputation that a company has acquired.

105 Depending on how the clause is drafted, it is also possible that a default might trigger additional obligations or dispossess a party of a property right. In the High Court case of *Pan Foods Co Importers & Distributors Pty Ltd v Australia and New Zealand Banking Group Ltd* (2000) 170 ALR 579 the court held that ipso facto clauses are valid.

It is also evident that ipso facto clauses have the potential to cause significant value destruction in larger corporations, particularly where the corporation has limited physical assets.[106] The damaging consequence of ipso facto clauses was evident in the collapse of the telecommunications retailer, One Tel Limited. When the company was placed into VA in 2001, the presence of ipso facto clauses enabled their major suppliers, Optus and Telstra, to terminate their supply contracts. This effectively put the 'nail in the coffin' for the company, as without these supply contracts, the company could no longer function as a going concern.[107]

3 *Less the Optimal Timeframe to Restructure, Sell the Company or its Assets*

The third situation of loss arises as a result of the limited timeframe allowed for the VA process. The key tasks required by the administration process are designed to be completed as swiftly as possible, meaning that the administration process generally takes 28-35 days from appointment through to conclusion.[108] Although there are merits to a limited timeframe,[109] it creates problems for administrators as they do not ordinarily have sufficient time to sell the company or its assets.[110] While it is recognised that the sale of assets often needs to reflect the realities of a distressed situation, assets are commonly sold under the connotation of a 'fire sale' where their true value is substantially neglected.[111] This was evident in the VA of the airline, Ansett Australia,[112] where the company's administrators admittedly sold Ansett's assets at 'break-neck speed[s]'.[113]

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106 See, Joint Submission to Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) 3.

107 John Melluish, *The Solvency Question: Is it Time to Change the Law?* (2009) Ferrier Hodgson <http://www.ferrierhodgson.com/en/Publications/Newsletters/Ferriers%20Focus/2009%2010%20-%20October>.

108 Note that these timeframes can be extended. See for eg, s 439A of the Act.

109 For eg, i) pressure is placed on all parties concerned to make a decision about the company's future; ii) the short timeframe ensures that creditors, particularly secured creditors, are not unduly prejudiced by the moratorium; and iii) limits are put on administrator costs to prevent cost blow outs.

110 See, generally s 437A (1) of the Act: 'While a company is under administration, the administrator: (a) has control of the company's business, property and affairs; and (b) may carry on that business and manage that property and those affairs; and (c) may terminate or dispose of all or part of that business, and may dispose of any of that property'.

111 This is compounded by the fact that there is no duty to sell company property at the best possible price (subject of course to subject to the fiduciary duties and statutory duties of care, diligence and good faith). See generally ss 180 and 181 of the Act.

112 Previously trading as Ansett Australia Pty Ltd.

113 The Korda Mentha Research Unit, *Large and Complex Administrations - The Courts and Ansett* (2003) Korda Mentha, [1] <http://www.kordamentha.com/

On appointment, the administrators were forced to deal with the ramifications of the September 11 terrorist attacks and the resultant decline in the aviation industry, meaning that market prices were well below previous years.[114] In the sale of the airline's Sydney terminal, the administrators chose not to comply with the regular sale process (ie, advertising, due diligence etc) as to do so would take too long and would result in the triggering of certain contractual 'buy-back' provisions.[115] Although the sale occurred swiftly, the valuation of the distressed assets did not represent its true worth.

4 *Employee Uncertainty and Loss of Key Staff*

The fourth situation arises after considering the effect VA has on key company stakeholders,[116] particularly employees. As employees are at the forefront of company operations, they are generally the first stakeholders to notice when a company is having cash flow difficulties. This creates uncertainty as employees become somewhat concerned about their future livelihood. The implementation of the moratorium period during the VA process also adds to this uncertainty as employees typically become concerned about their personal entitlements, specifically, wages; accrued wages; superannuation; and leave entitlements. Although there are provisions within the Act that seek to ensure that these payments are paid out in priority to other unsecured creditors,[117] employees may understandably become anxious about the troubled times ahead. A usual consequence of this uncertainty is the self-termination of contracts by key staff members.[118] Without these people the general day-to-day running of the company is somewhat jeopardised as the company loses a large proportion of its valuable human capital.

In the high profile insolvency of Ansett Airlines, over 16,000 employees were left with an estimated $686m worth of unpaid employee entitlements,[119] while in the case of OneTel Limited a total of $19m

downloads/ResearchUnit/Publication%20303%20-%20Large%20and%20Complex%20 Administration-The%20Courts%20&%20Ansett%20-%20August%202003.pdf>.

114 Ibid [9].

115 Ibid.

116 Other stakeholders may include: shareholders, creditors and the broader community.

117 See generally s 556 of the Act. An employee may also be covered by the Australian government General Employee Entitlements and Redundancy Scheme ('GEERS'). Note also that if a deed of company arrangement is agreed upon, the priority in which employee entitlements are paid will depend on the terms of the deed.

118 For eg, accountants and company managers.

119 See, *Re Ansett Australia Ltd and Others and Mentha and Another (as admin) (No V 3045 of 2001)* (2001) 39 ACSR 355, 359. Note that this figure was that assessed by the administrators in the early days of their appointment. See also Steve O'Neill, *Corporate Insolvencies and Workers' Entitlements* (2004) NSW Parliamentary Library Research Service <http://www.aph.gov.au/library/intguide/econ/insolvencies.htm>.

was owed in accrued entitlements to some 1,400 employees.[120] These examples illustrate that employees have the right to be concerned about their entitlements.

5 *Support of the Profession and Other Situations of Loss*

The arguments raised in this Part are well supported by those who work in the insolvency profession. In a joint submission to the Treasury ('Joint Submission'),[121] made by the Law Council of Australia,[122] the Insolvency Practitioners Association of Australia,[123] and the Turnaround Management Association Australia,[124] it was indicated that 'by avoiding formal insolvency appointment, the risks of enterprise value destruction [would be] largely avoided or diminished'.[125] In addition to the four situations of loss mentioned above, the Joint Submission indicated that value can also be lost through:

> (a) 'customers… shun[ning] a product or brand… when concerned about future servicing or warranty issues;
> (b) the costs involved in the insolvency process; and
> (c) the crystallisation of contingent liabilities'.[126]

The above submission illustrate that insolvency practitioners have an apparent concern as to whether the current provisions are effective in preserving enterprise value.

C *Potential Benefits of Informal Workout and Restructuring Procedures*

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120 Jeannette Anderson and Kevin Davis, 'Employee Entitlements and Secured Creditors: Assessing the Effects of the Maximum Priority Proposal' 34(1) (2009) *Australian Journal of Management* 51.

121 Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106.

122 The Law Council of Australia is 'comprised of legal practitioners across Australia who specialise in the insolvency and restructuring field, and includes many of Australia's leading practitioners in this area': ibid 1.

123 The Insolvency Practitioners Association of Australia ('IPA') 'is the peak professional body representing company liquidators, trustees in bankruptcy, other insolvency professionals, financiers and academics. The IPA and its members necessarily have extensive knowledge of and expertise in insolvency law, policy and practice and in the particular issues of insolvent trading': ibid 1.

124 The Turnaround Management Association Australia 'is made up of professionals practising in turnaround management, law, insolvency, accounting, management consulting, banking, finance and private equity': ibid 1.

125 Ibid 3.

126 Ibid 4.

The following headings will explore the alternative concept of informal workouts and attempt to explain how they have the potential to preserve enterprise value and promote positive entrepreneurial risk-taking.

1 *What is an Informal Workout?*

In general terms, an informal workout exists where a company reaches consensual arrangements with creditors in an attempt to restore financial viability to an enterprise.[127] It is a process outside the formal insolvency regime that can be used as an effective tool in helping to rescue a company that is facing financial distress or difficulty.[128] A workout typically involves restructuring and will be implemented to achieve the following three main alternatives, depending on the circumstances of the company:

(a) 'a return to viability for the company';
(b) 'a return to sustainable facility levels for lenders'; or
(c) 'a reasonable return to creditors'.[129]

Typically, through negotiation, a workout will require creditors to forego their legal rights under contract and refrain from enforcing specific debt covenants.[130] Some commonly used restructuring mechanisms include 'asset sales, discounted debt sales, debt write-offs, debt rescheduling, enterprise restructurings and exchange offerings.'[131] While discussion regarding specific workout mechanisms is beyond the scope of this paper, it is worth noting that the chosen mechanism will depend largely on the position and circumstances affecting the company at a particular point in time.

2 *Potential Preservation of Value Associated with Workouts*

In jurisdictions outside of Australia informal workouts have become important alternatives to formal insolvency regimes. As observed by Gudgeon and Joshi, in their article, *The Restructuring and Workout Environment in Europe*:

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127 See, Ian Walker, *Cross-border Restructuring and Insolvency Handbook* (2010) Practical Law Company <http://www.minterellison.com/public/resources/file/ebe5d40810a85fe/CrossBorderRestructuringQ-A.pdf>.

128 See, Financial Services International, *Informal Workouts and Debt Restructuring* (2008) Financial Services International (Australia) <http://fsia.com.au/Informal-Workouts-Debt-Restructuring.html>.

129 Ibid.

130 Walker, above n 127.

131 The World Bank Group and the United Nations Commission on International Trade Law, *Creditor Rights and Insolvency Standard* (2005) The World Bank Group <http://siteresources.worldbank.org/GILD/Resources/FINAL-ICRStandard-March2009.pdf>.

> Over the past several years many jurisdictions have attempted to move away from regimes that have almost seemed to encourage liquidation in any bankruptcy towards regimes that encourage business rehabilitation.[132]

Clint Hinchen, a partner at Allens Arthur Robinson, affirmed this observation stating that 'currently, Australia's insolvent trading laws are more severe than those of other jurisdictions, which often require some element of fault or knowledge'.[133] He suggested that the insolvent trading laws 'present a strong disincentive for informal workouts of companies which are actually insolvent or close to insolvency, and are an area of considerable concern for directors of companies in financial difficulty.'[134] This is a view that is held and well supported by the International Bank for Reconstruction and Development ('the World Bank'), which introduced a set of principles and guidelines aimed at promoting effective insolvency systems and debtor-creditor regimes in response to the 1997-1998 financial crises.[135] Specifically, the World Bank recognised that policymakers needed a source of guidance when making national laws and accordingly produced the *Creditor Rights and Insolvency Standard.*[136] Within this standard, the World Bank proposes that legislation governing the liability of directors for detrimental decisions made when a company is insolvent (or nearing insolvency) 'should promote responsible corporate behaviour while fostering reasonable risk taking'.[137] It is important to note here that any form of risk-taking should be aimed at supporting viable businesses, and accordingly a line needs to be drawn where businesses have no potential to survive into the future. As articulated by Kylie Lightman:

> It is clear that some businesses become redundant. Insolvency is a means of removing businesses that fail to remove themselves.[138]

In the Treasury discussion paper, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, the Treasury declared that there are potential advantages for both the company and its creditors if a director is allowed to engage in reasonable risk-taking.[139] Specifically, the paper proposed that pursuing informal

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132 Ben Larkin (ed), *Restructuring and Workouts – Strategies for Maximising Value* (Globe Law and Business, 1st ed, 2008) 7.

133 This was quoted in Pauline Renaud, *Insolvency Law Reform In Australia* (2010) Financier Worldwide <http://financierworldwide.com/article.php?id=6351>.

134 Ibid.

135 Larkin, above n 132, 15-17.

136 World Bank Group and the United Nations Commission on International Trade Law, *Creditor Rights and Insolvency* Standard, above n 131.

137 Ibid.

138 Kylie Lightman, 'Voluntary Administration: The New Wave or the New Waif in Insolvency Law' (1994) 1 *Insolvency Law Journal* 59, 71.

139 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3.

workouts, as opposed to transferring the company into external administration, can aid in preserving enterprise value by:

(a) retaining and utilising existing management who have crucial knowledge of the company and its operations;
(b) reducing any negative impacts on goodwill and other assets values;
(c) avoiding fatal contractual triggers such as ipso facto clauses;
(d) creating the opportunity to negotiate with key creditors (rather than all creditors);
(e) limiting the requirement to appoint external insolvency practitioners to deal with the company; and
(f) enabling management to develop flexible and viable rescue solutions.[140]

Furthermore, enterprise value will be preserved by avoiding many of the problems associated with premature administration. The Treasury discussion paper also mentions two obvious disadvantages of pursuing informal workouts. Firstly, there is the direct risk of exposure to director liability (which has been articulated above) and secondly, there is a lack of transparency and accountability brought about by the absence of a formal 'disclosure and supervisory regime'.[141] Part VI will explore these disadvantages in more detail and will propose that a director should be able to pursue restructuring if certain safeguards are first met.

3 *Is an Appropriate Balance Achieved?*

Perhaps an appropriate way to end this Part is by posing a question – do the current statutory provisions provide an appropriate balance between promoting good corporate behaviour and ensuring directors are willing to take sensible commercial risks? Based on the above discussion, a quick and easy answer to this question would be - no. If a director failed to maintain solvency when attempting a workout the director would face the prospect of being liable for insolvent trading. At present, there is no incentive for the director to take any form of sensible commercial risks. Directors are effectively forced to put the company 'to the sword even where there may be prospects for future prosperity'.[142]

VI Proposed Reform – A New Defence

The preceding Parts have established that directors are reluctant to pursue workouts/restructuring as a result of both the prohibitions against insolvent trading and the limited ambit of the defences available. This Part evaluates whether a modified business judgment rule ('MBJR') should be introduced into the current insolvent trading regime. It is reasoned that the

140 Ibid 11, 12.
141 Ibid 12, 13.
142 Harris, 'Director Liability for Insolvent Trading: Is the Cure Worse than the Disease?' above n 35, 286.

proposed defence should be implemented, provided that it is tailored to address the specific elements of the insolvent trading prohibition.

A *Previous Attempts at Reform*

Since the inception of s 588G in 1993 there has been constant criticism regarding a director's inability to 'stay the course' and responsibly trade out of financial difficulty.[143] The threat of personal liability for directors has been seen as a burden on 'their ability or desire to engage in appropriate and commercial risk taking'.[144] In 2006 the Treasury sought comments on the merits of a 'general defence' for directors in the discussion paper entitled, *Corporate and Financial Services Regulation Review*.[145] This paper proposed that a general defence would relieve directors of liability for decisions made where they acted:

> (a) 'in a bona fide manner;
> (b) within the scope of the corporation's business;
> (c) reasonably and incidentally to the corporation's business; and
> (d) for the corporations benefit.'[146]

In 2007, the Treasury readdressed this proposal in the discussion paper entitled, *Review of Sanctions in Corporate Law*.[147] The majority of submissions received by the Treasury supported the implementation of this general defence and highlighted that the insolvent trading prohibition causes directors to be too cautious when a company is experiencing liquidity problems.[148] Consequently, they felt that directors often 'call[ed] in an administrator before the company [wa]s insolvent'.[149] This ultimately led to the view that 'the interests of shareholders would be better protected by continuing to trade.'[150] Importantly, the submissions emphasised that reform had the 'potential to improve the balance between deterring wrongdoing and ensuring that directors [were] not unduly constrained in acting in the best interests of the company'.[151]

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143 See for eg, Taskforce on Reducing Regulatory Burdens on Business, Parliament of Australia, *Rethinking Regulation* (2006) 90.

144 Mark Byrne, 'Directors to Hide From a Sea of Liabilities in a New Safe Harbour' (2008) 22 *Australian Journal of Corporate Law* 255, 256.

145 Commonwealth of Australia, *Corporate and Financial Services Regulation Review*, Discussion Paper (2006), 38.

146 Ibid.

147 Commonwealth of Australia, *Review of Sanctions in Corporate Law*, Discussion Paper (2007), above n 44.

148 Commonwealth of Australia, The Treasury, *Review of Sanctions in Corporate Law Discussion Paper Summary of Submissions*, (August 2007), 7.

149 Ibid.

150 Ibid.

151 Commonwealth of Australia, *Review of Sanctions in Corporate Law*, Discussion Paper (2007) above n 44, [3.9].

The major problem highlighted by this reform process was that the elements of the provision were seen as being 'insufficiently distinct and specific to the point of becoming a potential source of uncertainty.'[152] Accordingly, the Treasury did not act to implement this defence.

More recently, a number of commentators have advocated that the business judgment rule found in s 180(2) of the Act should be extended to cover instances of insolvent trading.[153] The business judgment rule provides that directors must exercise their powers and discharge their duties with the care and diligence of a reasonable person.[154] Directors who make a business judgment are taken to have met this obligation where: the judgment is in good faith and for a proper purpose; they have no material personal interest; and they believe that the judgment is in the best interests of the corporation.[155]

In February 2008, Dr Ken Henry delivered a speech on behalf of the then Minister for Superannuation and Corporate Law, Nick Sherry in response to this issue. In this speech Dr Henry highlighted that our current regime 'is causing directors to be overly cautious when making decisions, particularly in fast-moving and complex business situations'.[156] Moreover, he stated that:

> The decisions that directors make are central to the efficient operation of companies and the wellbeing of our economy. Therefore, it is vital that directors' duties and the associated sanctions provide the right incentives to create value.[157]

It is contended that the MBJR defence will achieve just this. It will provide significant incentives for directors to revive companies, which in turn will lead to the preservation of present and future value for companies.

B *Overview of the Proposed New Business Judgment Rule Defence*

In addition to the requirements of the existing business judgment rule, the new provision would ensure that directors are relieved of their duty not to trade whilst insolvent if the following elements are satisfied:

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152 Commonwealth of Australia, The Treasury, *Review of Sanctions in Corporate Law Discussion Paper Summary of Submissions*, (August 2007), above n 148, 7.

153 See for eg, Robert Baxt, 'Do We Need a More Extensive Operation of the Statutory Business Judgment Rule or Some Other Defence for Company Directors? Sanctions in Corporate Law under Review' (2007) 3(3) *The Baxt Report* 4.

154 Section 180(1) of the Act.

155 Section 180(2)(a)-(d) of the Act.

156 Ken Henry, 'Keynote Address to ASIC Summer School' (Speech delivered at ASIC Summer School, Melbourne, 19 February 2008).

157 Ibid.

(a) 'the financial accounts and records of the company presented a true and fair picture of the company's financial circumstances at the time that the rule was invoked;

(b) the director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time;

(c) it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring; and

(d) the restructuring was diligently pursued by the director.'[158]

This defence disposes of the current view that early transfer to an 'external administrator will best protect the interests of creditors'.[159] Instead the focus is shifted towards the overarching aim of preserving enterprise value through restructuring. The first two elements incorporate both a subjective and objective assessment of the financial position of the company. With the help of professional advice, an assessment can be made as to whether informal restructuring is a desired outcome. The last two elements endorse the significance of a director's ability to use his or her own personal subjective judgment. Provided that the director acts diligently and takes into account the best interests of both the company's creditors and its members, the director can pursue informal restructuring.

Importantly, this rule provides a safe harbour that can be aligned to the duties from which it will provide protection. In past reforms, this lack of synchronicity was seen as a significant pitfall as the proposed provisions were said to 'bear little resemblance to the elements of the duties'[160] that they related to. Moreover, the provisions were not specific in their application as they resembled an all-encompassing version of current business judgment found in s 180(2) of the Act.

C *The Case for Extending the Business Judgment Rule Defence to Insolvent Trading - An Analysis of the Proposed Defence*

The following paragraphs will discuss the four elements alluded to above in more detail and will highlight, where necessary, areas of the defence that need further clarification or modification. It is important to note that it is not the intention of this paper to cover all of the drafting contingencies associated with the defence. Accordingly, a holistic approach will be taken that summarises the substantial attributes of each of the elements.

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158 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3, 7.

159 Commonwealth of Australia, *Review of Sanctions in Corporate Law*, Discussion Paper (2007) above n 44, [3.15].

160 Byrne, above n 144, 255, 261.

1 *Financial Accounts and Records*

The first element of the defence requires that the 'accounts and records of the company presented a true and fair picture of the company's financial circumstances at the time that the rule was invoked'.[161] The basis for this element is to ensure that any reorganisation or workout attempt uses sufficiently accurate financial information. This element works in conjunction with part (b) of the defence to enable the director to form a view on whether it is feasible for the company to 'remain solvent or… return to a state of solvency within a reasonable time'.[162] While the purpose of the element is logical, it has a number of shortcomings in its current form.

The first shortcoming is the historical focus that this element has on the accounts and records of the company. In practice, historical accounts and records may be of use when trying to explain why a company might become insolvent or why a company is insolvent; however, beyond this, they will provide limited information about the company's future prospects.[163] In a submission to the Treasury by the Australian Bankers' Association[164] they describe the test as being 'backward looking'.[165] Accordingly, it is recommended that the phrase 'financial accounts and records' be replaced by the term 'financial information'.[166] This will require the director to inspect relevant financial information when assessing the company's restructuring prospects. For example, budgets, management accounts and other forecast mechanisms could be used to demonstrate the significance of future cash flows. This rephrasing is particularly significant given the court's interpretation of the test for solvency. As outlined in Part III, the cash flow test is generally the appropriate test for determining solvency.[167]

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161 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3.

162 Ibid [5.3.6].

163 Ferrier Hodgson, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) [9].

164 Note that the Australian Bankers' Association ('ABA') submission is almost identical to the joint submission issued by the Law Council of Australia, the Insolvency Practitioners Association of Australia and the Turnaround Management Association of Australia. The ABA is the peak national representative body of 25 banking institutions that are authorised to carry on banking business in Australia by the Australian Prudential Regulation Authority. The ABA's members frequently find themselves as secured or unsecured creditors of companies encountering financial difficulty. See, Australian Bankers' Association, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010).

165 See, Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [5.9].

166 Ibid [5.9, 5.10].

167 See, *The Bell Group Ltd (in liq) v Westpac Banking Corporation & Ors (No 9)*

The second issue surrounds the desired purpose of the phrase a 'true and fair picture'. In its current form this terminology is confusing. Firstly, it is not known what relationship this element forms with Chapter 2M of the Act. Pursuant to s 286(a) of the Act, directors must 'keep written financial records that… correctly record and explain [the company's] transactions and financial position and performance'. Therefore, it appears as though this element is simply a restatement of s 286. Secondly, it is uncertain whether the phrase is intended to be taken at a specific point in time. When considering the veracity of accounts there is potential for this process to be extremely onerous on directors as the court could disagree with the point in time when a director relied on the defence.[168] Accordingly, the emphasis on 'a true and fair picture of the company's financial circumstances'[169] should be revised to focus on the 'financial information necessary for the provision of restructuring advice'.[170] This phrase incorporates all relevant financial information, rather than just the accounts and records of the company and draws attention to the provision of restructuring advice.

The above discussion highlights that in its current form this element has a number of shortcomings. Consequently, it is proposed that the element be redrafted as follows:

> (a) 'The director has taken all proper steps to ensure that the financial information of the company necessary for the provision of restructuring advice is accurate, or is ensuring that all resources necessary in the circumstances to remedy any material deficiencies in that information are being diligently deployed'[171]

Importantly, this rephrased provision changes the focus from an objective determination of the accuracy of the company's accounts and records, to a position where the director must take appropriate steps to ensure that the financial information is materially accurate.[172] If the director establishes that the financial information is inaccurate, he or she will be given the opportunity to diligently rectify any deficiencies.[173]

(2008) 225 FLR 1 (Owen J).

168 See, Australian Institute of Company Directors – Submission to the Treasury, above n 88, [7].

169 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3, [5.3.6].

170 Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [5.10].

171 Ibid [5.11].

172 Ibid [5.10].

173 Ibid.

2 *Director was Informed*

The second element of the defence requires that before restructuring is undertaken, a director must seek the advice of an 'appropriately experienced and qualified professional'. The professional will provide a merit-based assessment of the financial accounts and records of the company and if this assessment proves to be positive the company can then pursue restructuring (provided, of course, that the remaining elements have been met). Conversely, if the professional determines that restructuring is not a feasible option, this due diligence will prove useful in deciding whether the appointment of an administrator or liquidator is necessary.[174] In its current form, this requirement is sensible and has the potential to positively impact on the prospects of successfully pursuing restructuring. There are, however, a number of ambiguities associated with its construction. These issues are not insurmountable, and accordingly they need to be carefully considered by the legislature to ensure that the provision operates effectively.

The first concern is that this requirement fails to specify who is in fact an 'appropriately experienced and qualified professional'. This issue was brought to light in a number of the submissions received by the Treasury. In a joint submission by Dr David Morrison and Dr Colin Anderson, it was highlighted that the 'proposal suffers from the use of phrases that are unclear at least at this stage.'[175] They questioned:

> [W]hat is an appropriately experienced and qualified professional? Is this meant to include only registered insolvency practitioners or does it extend to others such as solicitors? If it does extend to others then a question might arise as to what is the limit of the words appropriately experienced?[176]

In response to these queries, it is proposed that ASIC offers guidance as to what constitutes an 'appropriately experienced and qualified professional'. This guidance would need to encapsulate the problems associated with choosing the appropriate professional for the particular circumstances at hand.[177] For instance, the appropriately experienced and qualified professional required for determining the solvency of a distressed publicly listed company would differ greatly to what may be

174 Australian Bankers' Association - Submission to the Treasury, above n 164, [3.31].

175 Dr David Morrison and Dr Colin Anderson, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) [38].

176 Ibid.

177 Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [5.16].

required when dealing with the solvency issues of a small or medium sized enterprise. Accordingly, it is proposed that ASIC incorporates this guidance within their recently published *Regulatory Guide 217 – Duty to Prevent Insolvent Trading: Guide for Directors.*[178]

The second ambiguity surrounds the independence requirements of the proposed element. Presently, the element does not specify whether a professional is permitted to be a contractor or employee of the company, or whether the professional must be independent of the company. The Joint Submission outlines that in some cases it would be beneficial to have an internal chief restructuring officer ('CRO') who makes recommendations on the feasibility of the restructuring.[179] The obvious advantage of having an internal professional would be his or her prior knowledge of the company.[180] As the CRO would be advising the board of directors, care must be taken to ensure that the professional is not deemed a 'shadow director' of the company.[181] If this is apparent, it would be unlikely that any professional would be willing to assume such a role due to the risk involved.[182]

The third issue that was raised by the Treasury in their discussion paper is whether there is actually a requirement to rely on, or make use of, the professional's advice.[183] The Treasury reasoned that if no such requirement existed, then there would be concern that directors wishing to obtain protection would simply 'go through the motions' of obtaining advice.[184] In response to this concern, it is suggested that the third and fourth elements of the provision will provide enough of a safeguard to ensure that directors make their own assessment as to whether restructuring should be undertaken. If the director considers both the interests of the company's creditors as a whole, as well as its members, he or she will be able to use his or her judgment to assess whether restructuring is appropriate.

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178 Regulatory Guide 217 – Duty to Prevent Insolvent Trading, above n 33.

179 See, Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [5.13].

180 See, the Institute of Chartered Accountants in Australia, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) [2].

181 See, Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [3.26].

182 Ibid [3.25].

183 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3, [5.3.11].

184 Ibid.

The above discussion highlights that in its current form this element causes some uncertainty. Accordingly, it is proposed that the element be redrafted as follows:

> (b) the director was informed by restructuring advice from an appropriately experienced and qualified professional engaged by the company with access to that financial information, as to the feasibility of and means for ensuring that the company remains solvent, or that it is returned to a state of solvency within a reasonable period of time.

The underlined words in the above provision once again reflect the recommendations of the Joint Submission.[185] Overall, it is suggested that the requirement to obtain advice will increase the likelihood of the company surviving, and will provide the director with the opportunity to make informed decisions on the future of the company. The requirement is particularly significant as it meets the important policy objective of early intervention when the company is facing financial distress - early intervention will promote the prospect of a desirable solution being found.[186] Furthermore, the requirement to obtain professional advice serves as a fundamental safeguard against any potential abuse by directors.

3 *A Director's Business Judgment*

The third element of the defence places an onus on directors to use their skills and decision making capabilities to determine whether entrepreneurial risk, through the vehicle of restructuring, has a realistic probability of improving a company's financial position. One of the fundamental safeguards of this element is that a director is required to consider the obligations owed to creditors as a whole, as well as maintaining the ordinary duties already owed to members of the company.[187] Caution must be exhibited here, as it is not the purpose of this element to suggest that 'the interests of creditors are to be weighed against the interests of members.'[188] Accordingly, if there is a reasonable prospect that one of the stakeholders will be unfairly disadvantaged the workout should not proceed.

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185 Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [5.19].

186 See, Australian Bankers' Association Submission to the Treasury, above n 164, [3.31].

187 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3, [5.3.14].

188 Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [5.20].

As outlined in Part III, where a company is insolvent or is approaching insolvency the interests of creditors become paramount.This rationale of creditor protection is fundamental to the operation of s 588G. Accordingly, part (c) of the defence aims to strike a balance between the protection of creditors on the one hand, and encouraging sensible risk-taking on the other. With regard to the interests of the members of the company, the Minter Ellison Submission suggested that the best way to protect members' interests would be to ensure that they are 'no worse off as a result of the restructure.'[189] While this observation may not require legislative attention, it is important that it is taken into account when drafting the provision.This will ensure that the director actively considers the interests of both the creditors and the members of the company. Therefore, the element would remain as follows:

> (c) it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as members, were best served by pursuing restructuring.

4 *Restructuring to be Diligently Pursued*

The final element provides that the restructuring must be diligently pursued by the director.[190] There are two critical issues with the framing of this element. Firstly, the element implies that the director is the person who actually pursues the restructuring. Although the director will normally be the person who initiates the restructuring, the company will be the actual person who pursues the remedial action. Further, in the case of a non-executive director of a large public company, it is unlikely that the director will be involved in any of the day-to-day processes of the restructuring.[191] Secondly, it is unclear what the phrase 'diligently pursued' actually means – does this mean that the director is required to restructure within a certain timeframe? Does the director have to report to ASIC?

Rather than grapple with the difficulty of answering these questions, it is proposed that the element should be rephrased to avoid these problems. As proposed by the Joint Submission the element should be drafted as follows:

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189 Minter Ellison, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) [3].

190 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3, [5.3.6].

191 See, Joint Submission to the Treasury by Law Council of Australia, Insolvency Practitioners Association of Australia, Turnaround Management Association of Australian, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010), above n 106, [5.23].

(d) 'The director took all reasonable steps to ensure that the company diligently pursued the restructuring.'[192]

These minor modifications ensure that an objective view point is taken based on what is considered reasonable in the circumstances. As the restructuring process will usually depend on the size, type and complexity of the organisation an objective 'reasonable' timeframe will be allowed. This will ensure that diligence is upheld and that extended insolvent trading does not incur.[193] Importantly, the element is framed in a way that fosters ethical behaviour by all directors.

VII McLellan Case - The 'Stake Man' Decision

This Part addresses the important judgment of Goldberg J in the *McLellan case*.[194] The decision is fundamental as it provides much needed guidance on the operation of the general relief provisions found in ss 1317S and 1318 of the Act. As discussed in Part IV, these provisions provide relief to a director where the person has acted reasonably, honestly and, having regard to all the circumstances of the case, the person ought fairly to be excused.

A *Background*

Mr Carroll had been the director of The Stake Man Pty Ltd since its incorporation in 1986.[195] Its principal operations included 'purchasing green timber logs… to make unseasoned timber, stakes and flooring materials.'[196] From 1986 until 2004 the company was profitable. However, by the middle of 2005 it became apparent that equipment problems were having an adverse effect on the company's cash flow.[197] In March 2005, the company retained the services of an accountant, Mr Bright, who had previously supplied services to clients in the timber industry.[198] Mr Bright was asked to give advice regarding the company's cash flows, costs and expenses.[199] In June 2005, Mr Bright informed Mr Carroll that the company was close to insolvency and that it needed an injection of capital to address the equipment problems.[200] Funding was raised by the

192 Ibid [5.24].

193 Commonwealth of Australia, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration*, above n 3, [5.3.16].

194 *McLellan case* [2009] FCA 1415 (30 November 2009) (Goldberg J).

195 Ibid [5].

196 Ibid [6].

197 Ibid [6], [29].

198 Ibid [6], [34].

199 Ibid [35].

200 Ibid [37]-[38].

company. However, losses continued. On 10 May 2006 the company was placed into VA and a week later the creditors of the company determined that the company should be would up.[201]

B *Claim and Defences*

Proceedings were commenced by the liquidator, alleging contravention of s 588G. The liquidator also sought an order pursuant to s 588M(2) that Mr Carroll pay the company (and its creditors) the total amount outstanding in respect of debts incurred after December 2005. Mr Carroll defended the action by relying on the defences made available under s 588H of the Act. Specifically, he relied upon ss 588H(2) and 588H(3). In the alternative, Mr Carroll sought protection under the forgiveness provisions found within ss 1317S and 1318 of the Act.

C *Judgment*

Goldberg J concluded that Mr Carroll had contravened his statutory duty not to trade whilst the company was insolvent.[202] His Honour also found that Mr Carroll could not rely on any of the defences made available under s 588H of the Act.[203] Nevertheless, the court excused Mr Carroll from liability pursuant to s 1317S of the Act.[204] In coming to this conclusion, his Honour placed emphasis on the criteria for determining honesty as set out in *Hall v Poolman*.[205] In this case Palmer J stated that:

> [W]hen considering whether a person has acted honestly for the purposes of a defence under the CA, s 1317S(2)(b)(i) or s 1318, the Court should be concerned only with the question whether the person has acted honestly in the ordinary meaning of that term, ie whether the person has acted without deceit or conscious impropriety, without intent to gain improper benefit or advantage for himself, herself or for another, and without carelessness or imprudence to such a degree as to demonstrate that no genuine attempt at all has been to carry out the duties and obligations of his or her office imposed by the CA or the general law.[206]

Goldberg J concluded that Mr Carroll did not profit personally from permitting the company to trade in this way, nor did he disregard the advice of his accountant. In fact, he did the opposite and actively sought advice from the accountant throughout the period of difficulty.[207] His

201 Ibid [65]-[67].

202 Section 588G of the Act. *McLellan case* [2009] FCA 1415 (30 November 2009) (Goldberg J) [145], [146], [159], [207].

203 *McLellan case* [2009] FCA 1415 (30 November 2009) (Goldberg J) [167]-[188].

204 Ibid [207].

205 (2007) 215 FLR 243.

206 Ibid, 318. Referred to in *McLellan case* [2009] FCA 1415 (30 November 2009) (Goldberg J) [190].

207 Simon McConnell, *Court Completely Forgives Director's Insolvent Trading Liability* (2010) Allens Arthur Robinson <http://www.aar.com.au/pubs/insol/foinsolfeb10.

Honour noted that:

> During the relevant period the position was not one where Mr Carroll stood still and did nothing while the cash burned. He was taking active steps to expand sales and he kept on trying to get the kilns to work properly.[208]

Ultimately, the operation of the general relief provision meant that Mr Carroll was relieved 'wholly from any liability to pay the liquidator… in respect of the loss and damage suffered by the creditors.'[209]

D *Relevance to the Proposed Reform*

It has been suggested by some commentators that the *McLellan case*[210] demonstrates that reform to the insolvent trading defences may be unwarranted.[211] This view is formed on the basis that the current defences, in conjunction with the general relief provisions, make it difficult to prosecute a director for insolvent trading.[212] This paper forms the view that the protection offered under these provisions remains inadequate. Although the courts are now adopting a 'commercially sensible approach',[213] the problems associated with the general relief provisions still remain. As discussed in Part IV, ss 1317S and 1318 are discretionary and offer relief after the liability has been incurred. This can result in sustained reputational damage as it will be difficult for the director to continue in his or her current role and/or obtain future director related positions.[214] Furthermore, there is still a lack of guidance as to what criteria actually satisfy the provisions. At the end of the day the director has no guarantees as the court retains discretion over the outcome.

If ss 1317 and 1318 are contrasted with the MBJR, it is evident that they operate in a substantially different manner. The MBJR operates as a true defence that seeks to offer directors up-front comfort or protection if they reasonably seek to restructure a business. Conversely, the general relief provisions operate at the end of trial and provide no guidance in regard to restructuring. On this basis, it is clear that both provisions deliver safe harbours but to a different extent. The MBJR offers a solid

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208 *McLellan case* [2009] FCA 1415 (30 November 2009) (Goldberg J) [196].

209 Ibid [207].

210 Ibid.

211 See for eg, Shine Wong, Submission to the Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (19 January 2010) 7-8.

212 Ibid 7.

213 Jason Harris 'Relief from Insolvent Trading Liability' (2010) 22(1) *Australian Insolvency Journal* 14, 19.

214 Australian Institute of Company Directors – Submission, above n 88, 2.

safe harbour that is supported by a strong anchor. The general relief provisions provide a floating life raft that can only be inflated by a judge.

VIII Director's Perspective Of Insolvent Trading Prohibition

This Part examines the insolvent trading prohibition from a director's perspective. It suggests that too often appropriately qualified people abstain from taking up directorships owing to the prospect of personal liability. It is contended that this disincentive can be circumvented to an extent, if directors are afforded a new safe harbour in the form of the proposed MBJR.

A *Treasury/Australian Institute of Company Directors Survey*

In a recent Treasury/Australian Institute of Company Directors ('AICD') survey of directors from 200 of the top listed companies ('Director Survey'), 78 per cent of directors responded that there was a medium to high risk of being found personally liable for decisions that they or their boards had made in good faith.[215] When questioned on which specific laws caused this overly cautious approach to business decision making,[216] 45 per cent of directors responded that the duty to prevent insolvent trading was responsible on a medium to high degree.[217] Directors were then asked – 'are there reasonable defences and 'safe harbours' for directors under… the duty to prevent insolvent trading… ?'[218] In response to this question almost 46 per cent of respondents answered no.

These figures emphasise two critical points. Firstly, they demonstrate that directors are fearful of the prospects of personal liability and consequently they are forced to yield from making any form of sensible commercial risks. In the minds of directors they must take a very cautious approach to decision making. This is of particular concern as it demonstrates that risk management has become 'more about personal liability than about good business decisions'.[219] Over the years the law has transformed

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215 Commonwealth of Australia, *How Did the Risk of Personal Liability Affect the Decision-Making Process and the Decision?* (2008) The Treasury <http://www.treasury.gov.au/content/Company_Directors_Survey/10_0.html>. On a scale of zero to six: 3% voted 1; 8% voted 2; 11% voted 3; 25% voted 4; 25% voted 5; and 28% voted 6.

216 Ibid.

217 See, Australian Institute of Company Directors – Submission, above n 88, 4.

218 Commonwealth of Australia, *How Did the Risk of Personal Liability Affect the Decision-Making Process and the Decision?*, above n 215.

219 Gabrielle Upton, *AICD Welcomes Findings on Director Liability* (2009) Australian Institute of Company Directors <http://www.companydirectors.com.au/NR/rdonlyres/DE637C8B-A210-48CC-A199-F9AA886BCC81/12625/SUBM2009HumanRightsConsultationattachment.pdf>.

to place more emphasis on protecting citizens and as a result, this has meant increased liability for directors. The 'corporate veil'[220] and limited liability shields citizens from personal liability for debts of the company. Accordingly, it is contended that directors should not be 'guarantors of the performance of any legal obligation by their company under any circumstances.'[221] Ultimately, shareholders and creditors are the parties who benefit from responsible risk taking through the preservation of enterprise value and the continued functioning of the corporation. These stakeholders anticipate risk taking by directors and in the words of Clarke and Sheller JJA in *Daniels v AWA Limited*,[222] they must have 'trust in the capacity of other human beings'.[223] In the event that a responsible risk does fail, stakeholders are assured that directors will be punished if they acted in a dishonest manner.

The second critical point that is raised by the Director Survey is that the prospect of personal liability creates a disincentive for qualified people to take up directorships. The survey claims that over 71 per cent of directors 'declined an offer of a company directorship… primarily due to the risk of personal liability'.[224] These statistics are particularly relevant to the appointment of non-executive directors. The practical utility of a non-executive director is to provide experience, direction and knowledge to the company. If the legislation governing directors' actions is too punitive it has the potential to hamper quality contributions made by appropriately qualified people.[225] When a company is facing financial distress in the twilight zone of insolvency it is common for non-executive directors to resign from the company. This can be detrimental to a company as it is a time when knowledge and experience has the potential to be of significant value.[226] In reality, such an action would also raise alarm bells for investors and creditors and would ultimately jeopardise a company's prospects of survival.

220 The corporate veil essentially implies that a company is a separate legal entity from: (a) the people who created the company ('the promoters'); (b) the people who own it ('the shareholders'); and (c) the people who manage it ('the directors').

221 Australian Institute of Company Directors – Submission, above n 88, 4.

222 [1995] 37 NSWLR 438.

223 Ibid [501].

224 Commonwealth of Australia, *How Did the Risk of Personal Liability Affect the Decision-Making Process and the Decision?*, above n 215. Note that personal liability in this sense was defined as being 'under any law' (ie, not just the duty to prevent insolvent trading).

225 For eg, lawyers, accountants, professors and individuals in other related employment spheres.

226 See, Australian Bankers' Association - Submission to the Treasury, above n 164, [3.15].

B *A Change of Attitude through Reform*

The above discussion is particularly relevant to the current reform process, as directors will be afforded a much needed safe harbour if the proposed defence is implemented. At present, directors have the onus of establishing the ingredients of a defence on the balance of probabilities.[227] This effectively means that if the plaintiff asserts contravention of s 588G the director must prove his or her innocence based on one of the defences available.[228] This is both a costly and time consuming process for directors considering the limited ambit of the current defences available. With the proposed defence, individuals would be encouraged to become involved in directorships as they would be confident that if they honestly believed that restructuring was the appropriate option, and it was diligently pursued, they would avoid prosecution. Importantly, directors would have more of a focus on company operations as opposed to the prospect of personal liability.

IX Conclusion

This paper began with an overview of the current insolvent trading provisions in Australian law and outlined the underlying rationale behind their implementation. It then moved on to discuss the corresponding statutory defences to these provisions and highlighted that despite their availability, it is quite difficult for a director's actions to fall within their scope. The subsequent Part dealt with the concept of informal corporate workouts and explored how the current statutory defences are crafted to promote early transition into VA. It was concluded that this premature handover had the potential to cause significant damage to a company's overall enterprise value.

The paper then moved on to discuss the decisions made by directors when a company is teetering on the verge of insolvency. It was argued that, in their current form, the insolvent trading provisions impede a director's ability to take sensible commercial risks. When faced with decisions concerning the financial viability of the company directors are clouded by the prospects of personal liability and for that reason, directors are forced to abstain from pursing the value-saving processes of informal workouts and restructuring. To counter this conservative approach it was proposed that a more flexible statutory defence be adopted. This defence would allow directors to be more confident in the decisions that they make when faced with situations of temporary illiquidity. Overall, it was contended that such a defence would afford directors a

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227 Section 1332 of the *Corporations Act 2001* (Cth). See also, *Australian Securities and Investments Commission v Rich* (2006) 236 FLR 1, 147 (Austin J).

228 Australian Institute of Company Directors – Submission, above n 88, 6.

new safe harbour which can relax the threat of personal liability, prevent premature transfer to voluntary administration, encourage qualified people to take up directorships and promote the genuine operation of workout attempts when a company is in the twilight zone of insolvency.

In 1988 Mr Harmer, envisaged that voluntary administration would be a success even if only a small proportion of companies were rescued.[229] He commented that 'if you can save just 10 per cent of all insolvent or near insolvent corporations then you are going to be at least nine per cent in front'.[230] In 2010 it is proposed that we expand Mr Harmer's vision and aim for an even greater number of company rescues. Although it is conceded that it is inevitable that companies undergoing symptoms of distress may not always be in a position to recover, it is proposed that the current laws be constructively modified to decrease the likelihood of company failure. With the change in party leadership and the shuffling of cabinet portfolios it is important that the wind is not taken out of the sails of this reform.

229 Australian Law Reform Commission, *General Insolvency Inquiry,* above n 10.

230 Evidence to Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, Canberra, 17 September 2003 (Ronald Harmer) [5.13].