INACTIVE DIRECTORS - UNDER ATTACK

by

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Introduction

One of the principal attractions of the corporate entity has been the inability of creditors to make the directors of the firm liable for the debts incurred by the company. The company is a separate legal entity[1] and is solely liable for its debts. While this statement may have represented the position throughout most of this century, changes are under way. Both at a statutory level and at common law, directors are increasingly being held liable for debts incurred by them on behalf of the company. The purpose of this paper is to examine one aspect of this modern formulation of directors' liability to creditors. This being the directors' liability to creditors pursuant to s.592[2] of the *Corporations Law*.[3] Importantly this section has been used with increasing frequency to make inactive non-executive directors liable for debts incurred on behalf of the company by executive directors.[4] The inactive director being unaware that the debt was incurred.

The Legislation

592(1) [Liability for debts etc.] *Where:*

(a) a company has incurred a debt;

(b) immediately before the time when the debt was incurred:

(i) there were reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or

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1 *Salomon v. Salomon & Co Ltd* [1897] AC 22

2 The predecessor to s.592 was s.556 of the *Companies (Tas) Code* 1981. S.592 is substantially unchanged from s.556.

3 At common law the courts have extended the range of persons to whom the directors must consider when discharging their duties. See *Walker v. Wimborne* (1976) 137 CLR 1, *Nicholson v. Permakraft NZ Ltd (in liq)* [1985] 1 NZLR 242, *Winkworth v. Edward Barron Development Co Ltd* [1987] 1 All ER 114 and *Jeffree v. National Companies and Securities Commission* (1989) 15 ACLR 217; See also R. Sappideen 'Fiduciary Obligations to Corporate Creditors' (1991) *J. Bus. L.* 202

4 For example, on the 3 July 1991 in the Victorian Supreme Court, damages were awarded in the sum of $97ml. against a Mr. Eise in an action brought under the predecessor to s.592, s.556. The action was brought by the Commonwealth Bank and related to the collapse of the Victorian division of the National Safety Council. Mr Eise had worked in an honorary capacity for 25 years and there was no evidence of any fraud committed by Mr. Eise, the fraud being perpetrated by the executive director, the late Mr. John Friedrich. (*Commonwealth Bank v. Friedrich & Ors* (1991) 9 ACLC 946, Tadgell J.) Discussed below.

(ii) there were reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and

(c) the company was, at the time when the debt was incurred, or becomes at a later time, a company to which this section applies;

any person who was a director of the company, or took part in the management of the company, at the time when the debt was incurred contravenes this subsection and the company and that person or, if there are 2 or more such persons, those persons are jointly and severally liable for the payment of the debt.

592(2) [Defence] *In any proceedings against a person under subsection (1), it is a defence if it is proved:*

(a) that the debt was incurred without the person's express or implied authority or consent; or

(b) that at the time when the debt was incurred, the person did not have reasonable cause to expect:

(i) that the company would not be able to pay all its debts as and when they became due; or

(ii) that, if the company incurred that debt, it would not be able to pay all its debts as and when they became due.[5]

The history and policy of section 592

Liability on directors for trading whilst insolvent has developed from the original idea of making directors liable for fraudulent trading. In 1926 the Greene Committee[6] recommended that directors should be liable for debts incurred when the company was trading fraudulently. They also recommended that criminal sanctions should be available.[7] The fraudulent trading provisions were first adopted in Queensland in 1931 and subsequently by other states. In 1961 the Uniform Companies Legislation introduced the criminal offence whereby an officer of the company would be held liable if that officer was party to the incurring of a debt by the company without a

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5 While this paper will be focussing on the use by creditors of this section it should be noted that the section also creates criminal liability. The penalty is a fine of $5000 or imprisonment for 1 year or both. The interaction of the criminal and civil components of s.592 can create some problems. For example can a director refuse to provide an affidavit of documents in a civil matter, on the basis that to do so, might incriminate him/her? Contrasting decisions have been given on this point. The Full Court of the Victorian Supreme Court in *E.L. Bell Packaging Pty. Ltd. v. Allied Seafoods Ltd.* (1990) 4 ACSR 85; 8 ACLC 1135; considered that a defendant was entitled to object to discovery on the ground that it might incriminate them. Rolfe J. in the New South Wales Supreme Court in *Southern Star Group Pty Ltd. v. Taylor* (1991) 4 ACSR 133; 9 ACLC 386; doubted the reasoning of the Victorian Supreme Court and ordered discovery to go ahead. The Victorian Court gave the privilege against self-incrimination a higher status than given it by Rolfe J..

6 *Report of Company Law Amendment Committee*, HMSO, London, 1926 (Cmd 2697) (Greene Report)

7 Green Report, para. 62

reasonable expectation that the debt could be paid.[8] In 1962 the Jenkins Committee[9] recommended the introduction of a provision which would make directors liable in a winding up, without limitation, where the business had been carried on in a reckless manner.[10] This recommendation was adopted in 1964 in Australia whereby civil liability was introduced if an officer of a company incurred a debt on behalf of the company without a reasonable expectation of payment.[11] Liability was dependant upon a conviction for the associated criminal offence. The legislation was amended again in 1981 so that there was no longer a requirement for a prior conviction before action could be brought by a creditor.[12] No substantial amendments were made with the introduction of the *Corporations Law* in 1991.

In effect what has occurred is that the provisions relating to fraudulent trading[13] have been extended to include liability for insolvent trading. The reason for this extension and the policy behind the introduction of the insolvent trading section was stated by McHugh J. in *Metal Manufactures Ltd v. Lewis;*[14]

> to require directors and those who take part in the management of companies to scrutinise carefully the circumstances in which the company incurs debts. The section reinforces that policy by making every director and participant in management personally liable for any debt incurred by the company if it becomes one to which the section applies.

Elements of s.592

There are four elements necessary to establish[15] liability under s.592. They are:

(i) that the company falls within the scope of s.592,

(ii) that the action is brought against a person who is within the scope of s.592,

(iii) that the company incurs a debt,

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8 See s.303(3), later s.374(C) of the *Uniform Companies Act*, 1961

9 *Report of the Company Law Committee*, HMSO, London, 1962 (Cmnd 1749) (Jenkins Report)

10 Jenkins Report, para. 503

11 See, s.304(1A), later s.374D of the *Uniform Companies Act* 1961

12 See ss.556-557 of the *Companies (Tas) Code* 1981

13 The provisions relating to fraudulent trading are now contained in s.592(6) and s.593(2).

14 (1988) 6 ACLC 725, p. 735

15 As s.592 imposes both criminal and civil liability, the burden of proof will vary according to the nature of the proceedings. Where a director is being prosecuted, the burden of proof will be on the Crown, and the onus of proof, beyond reasonable doubt. If the director is being sued, the burden of proof will be on the creditor, and the onus of proof, balance of probabilities. The defences listed in s.592(2) need only be established on the balance of probabilities, irrespective of the matter being criminal or civil. See s.592(4) of the *Corporations Law* and *3M Australia Pty Ltd v. Kemish* (1986) 4 ACLC 185

(iv) that immediately before the debt was incurred, either;

a) there were reasonable grounds to expect that the company would not be able to pay all its debts as and when they become due; or

b) there were reasonable grounds to expect that after incurring this debt the company would not be able to pay all its debts as and when they become due.

(i) That the company is within the scope of s.592

S.592 applies to a company that comes within the terms of s.589. Essentially the company must be in some form of insolvency administration, such as liquidation, receivership, scheme of arrangement or official management. S.592 will also apply to a company that has been, or is under investigation, in addition to a company that has ceased to carry on business or is unable to pay its debts.[16]

(ii) That the person against whom the action is brought is within the terms of s.592

S.592 imposes liability not only on directors,[17] but also on those who take part in the management of the company. An illustration of this latter aspect can be seen in the New South Wales Supreme Court decision of *3M Australia Pty Ltd v. Kemish.*[18]. In this case an accountant who progressed from preparing the accounts of a company to working full time in the management of the business, even though not appointed as a director, was held liable for debts incurred by the company when the business was insolvent. It should also be noted that a receiver and manager of all the property, undertaking, and assets of a company, and an official manager, have been held to be people who cannot be made liable under s.592.[19] Policy grounds support this conclusion because if s.592 did apply to insolvency administrators, then it is possible that no person would be prepared to take on the role of a liquidator, receiver, scheme administrator or official manager.[20] The risk of incurring liability for trading whilst

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16 S.589(4) provides the definition of when a company will be deemed to be unable to pay debts. It reads:

For the purposes of this Part, a company shall be deemed to be unable to pay its debts if, and only if, execution or other process issued on a judgment, decree or order of a court (whether or not an Australian court) in favour of a creditor of the company is returned unsatisfied in whole or in part.

17 The term 'director' is given an expansive interpretation by s.60 of the *Corporations Law*

18 (1985) 10 ACLR 371

19 *Re North City Developments Pty Ltd; ex parte Walker* (1990) 8 ACLC 1004 and *Fliway Transport v. Soper* (1988) 14 ACLR 690

20 See the comments in *Fliway Transport v. Soper* (1988) 14 ACVLR 690, p.695

insolvent would obviously be substantial where the company is already in some form of insolvency administration.[21]

(iii) That the company has incurred a debt

Under s.592 it will be important to determine the actual point in time when the debt was incurred. It is this point in time when a court will be required to ascertain whether the director had reasonable grounds to expect that the company would be unable to pay its debts as and when they fell due. This point was considered in the decision of *Hussein v. Good*.[22] The facts of this case are straightforward. On 12 November 1987 Hussein ordered $12092 worth of clothing products from the respondent. The goods were delivered in May 1988. Only $3000 was paid. The respondent then sued Hussein for the balance, the company in question having been placed in liquidation. The issue before the court was whether the debt was incurred in November 1987, when the goods were ordered, or in May 1988, when the goods were delivered. The importance of this is that in November 1987, the director would not be liable because there was insufficient evidence at that time to establish reasonable grounds to expect that the company would be unable to pay its debts as they fell due. The court held that the debt was incurred when the goods were delivered, and accordingly, as at May 1988, there were reasonable grounds to expect that the company would be unable to pay its debts, the director was therefore liable. The reasoning behind this is that until delivery occurs, no action in debt can arise.[23] This decision can be contrasted with *Russell Halpern Nominees Pty Ltd v. Martin & Anor*.[24] In this case it was held that where a tenant defaults on monthly rental payments the debt is incurred not when the failure to pay occurs, but when the lease is entered into. The court stated that:

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21 See also *Versteed v. R (No.2)* (Unreported Court of Criminal Appeal, Western Australia 82/1988). It should be noted that a liquidator does not have standing to bring an action under the legislation. The liquidator is not regarded as the agent of the creditors and therefore is not entitled to sue on their behalf. *Ross McConnell Kitchen & Co Pty Ltd (in liq) v. Ross & Ors (No.2)* (1985) 1 NSWLR 238

22 (1990) 8 ACLC 390

23 It is beyond the scope of this paper to examine whether an argument could be mounted that the contract would be void for supervening illegality; but in P. Gillies *Business Law* 3rd. ed. Federation Press 1990, p.223 the test is stated as follows:

> where the performance of the contract involves an offence, [was] the penalty...intended to be the full extent of the legal sanctions applying (so that the parties would be exposed to prosecution but the status of their contract would not be affected), or whether the legislature intended the contract to be void as well.

As s.592 creates both civil and criminal liability it would appear that the intent of the legislature was to provide for both the penal sanction and possible civil consequences. Nevertheless it could be submitted that the only civil consequences contemplated by the statute were civil proceedings pursuant to the legislation. Therefore civil proceedings outside the legislation, on the basis of breach of contract, would not be permitted.

24 (1986) 4 ACLC 393

> To hold otherwise would be to say that if a company when in all respects financially sound were to enter into a lease for a term of years and at some time thereafter and for reasons which could not be anticipated it were to fall on bad times and be unable to pay its debts, the directors would thereafter and on every rent day within the remainder of the term be guilty of an offence for the reason that on that rent day the company 'incurs a debt'. I am unable to accept that.[25]

This case was distinguished in *Hussein v. Good* on the basis that in a lease situation, the tenant will enjoy a right of possession from day one, whereas with a supply of goods, neither party will receive a benefit or suffer a detriment until delivery of the goods. This point of distinction has been criticised by Antrobus[26] in the following terms:

Whilst it is true that on the particular facts in *Hussein* neither party apparently benefitted nor suffered detriment until delivery occurred, it is not difficult to imagine an altered factual situation where the manufacturer seller would suffer a detriment by incurring expense in manufacturing the goods prior to delivery or by forgoing other sales with respect to the particular goods.[27]

This aspect of s.592 awaits further consideration. It will be difficult, if not impossible to have a general rule which is applicable to all factual situations. Each particular set of circumstances will give rise to its own problem in determining when the debt was incurred.[28]

(iv) Reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due.

There are two aspects to this fourth requirement. One, what test is imposed by the term 'reasonable grounds to expect', and two, when does a debt 'become due'.

(a) Reasonable grounds to expect

Before a director can be found liable under s.592 there must be reasonable grounds to expect that the company would not be able to pay all its debts as and when they become due. S.592 when it speaks of reasonable grounds;

> [I]s not speaking of grounds personal to the defendant. It is speaking of grounds which should be adjudged

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25 (1986) 4 ACLC 393, p.396

26 T. N. Antrobus 'Section [592] - When does a company incur a debt' (1990) 8 *Company & Sec. L. J.* 324

27 Antrobus, p.326

28 *Russell Halpern Nominees* was followed in *John Graham Reprographics Pty Ltd v. Steffens &Anor* (1987) 5 ACLC 904 with the result that periodic interest on a trading account was a debt incurred at the time the account was agreed upon, not when the interest accrued.

> '*reasonable*' according to the standard of a director or manager of ordinary competence....the word '*reasonable*' ...imports an objective test of reasonableness.[29]

Furthermore in *3M Australia Pty Ltd v. Kemish* it was stated that the term expect goes beyond a mere hope or possibility. In the context of s.592 it is synonymous with predicting.[30]

Finally in determining whether reasonable grounds exist the factors to be considered include; 'the availability or potential availability of loan funds, the adequacy of such funds to ensure payment of all debts at the proper time, a promise to lend and the reliability of such a promise'[31], plus any arrangement that the debtor may make with the creditors.[32]

(b) The company will not be able to pay all its debts as and when they become due.

There are two conflicting approaches to determine when a debt becomes due. In *Pioneer Concrete Pty Ltd v. Ellston*[33] a strict approach was preferred. In this case Carruthers J. considered that the question of whether a debt was due was to be considered by the terms of the agreement made between the debtor and the creditor. Any arrangement by the creditor with the debtor, allowing an extension of time was to be ignored. This can be contrasted with the approach of Foster J. in *3M Australia Pty Ltd v. Kemish.*[34] He considered that a flexible approach should be adopted which would 'take into account arrangements made by the company with the creditor for extended time for payment, even where such arrangements would not be contractually binding upon the creditor.'[35] *3M Australia Pty. Ltd. v. Kemish* has been recently followed by the Supreme Court of Western Australia in *Williams v. NCSC; Lockyer v. NCSC.*[36] In this case the two appellants had been found guilty on 28 counts of contravening the insolvent trading legislation. They appealed on the basis that because their banker, Westpac, was prepared to support the company, there were reasonable grounds to expect that the company would be

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29 *3M Australia Pty Ltd v. Kemish* (1985) 10 ACLR 371, p.376 This was followed by Tadgell J., in *Commonwealth Bank v. Friedrich & Ors* (1991) 9 ACLC 946, p.953

30 See the comments by Foster J. in *3M Australia Pty Ltd v. Kemish* (1985) 10 ACLR 371, p.378; Contrast the approach of Tadgell J. in *Commonwealth Bank v. Friedrich & Ors.*where his honour criticised the approach of substituting one verb for another. He stated:

> In its extended idiomatic form 'expect' is often used to convey the sense of 'expect to find', or 'expect that it will turn out that'...A measure of confidence is built in. I take it to mean neither more nor less in s.[592]. (1991) 9 ACLC 946, p.956

31 (1985) 10 ACLR 371, p.378

32 (1985) 10 ACLR 371, p.378

33 (1985) 10 ACLR 289

34 (1985) 10 ACLR 371

35 (1985) 10 ACLR 371, p.378

able to pay all its debts as and when they fell due. The Court accepted that directors may have regard to promises of support and of assurances of further financial assistance when they are determining the ability of the company to pay its debts. 'Such assurances must, however, be clearly defined and funds likely to eventuate.'[37] On the facts of the case the alleged assurance from Westpac, that it would not act on its security and that it would refrain from calling in the overdraft, was at best, tenuous, and even if it did exist, the company was still in a situation of trading whilst insolvent. It is still to be determined which approach will be followed by an appellate court.[38]

Defences

S.592 provides for two defences. The first defence is that the debt was incurred without the person's authority or consent. The second defence allows the directors to exculpate themselves if they can establish that they did not have reasonable cause to expect the company would not be able to pay all its debts as and when they became due. Each of these defences will be considered.

S.592(2)(a) - that the debt was incurred without the person's authority or consent.

This defence has been considered in two important decisions. These being the decision of the New South Wales Court of Appeal in *Metal Manufacturers Ltd v. Lewis*[39] and the Victorian Supreme Court decision in *Statewide Tobacco Services Ltd v. Morley*.[40]

Metal Manufacturers Ltd v. Lewis

A wife and husband were the sole shareholders and directors of a company. The husband was the managing director. The wife took no active part in the management of the business apart from the signing of unread documents and receiving some communications from creditors. Although she was concerned about the financial position of the company, her husband had indicated that times were difficult and that she should not concern herself. She was unaware that the company had reached a position where it could not pay its debts as they fell due. The managing director ordered goods worth $104,000, the creditor never received payment. Within a year, the company

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36 (1990) 2 ACSR 131

37 K.J. Bennetts 'Expectations of Financial Support-Grounds for Avoidance of Directors' Liability Under Section 592, Corporations Law' (1991) *Company and Sec. L.J.* 268, p. 271

38 It is possible that this debate will be (or has been) overtaken by developments in the law of promissory estoppel. In *Walton Stores v. Maher* (1988) 76 ALR 513 it was recognised by the High Court of Australia that the law of promissory estoppel is based on unconscionability and as such it is arguable that a creditor would not be permitted to renege on a representation allowing a debtor extra time to pay.

39 (1988) 13 ACLR 357, special leave to appeal to the High Court was refused (1988) 17 Leg Rep SL3

40 (1991) 2 ACSR 405

was wound up. Both the husband and the wife were sued by the supplier. The husband consented to judgment being entered against him, the family assets however, were solely in the wife's name. The majority of the New South Wales Court of Appeal held that the wife was not liable. The reasoning of Mahoney and McHugh JJ.A. was that the appointment of the wife to the position of director did not mean that she was thereby giving authority or consent to the incurring of the debt in question. A majority considered that she had merely acquiesced in her husband acting as managing director and that as she had no power to prevent the particular debt in question being incurred, she could not be said to have authorized the debt.

This case was subject to a strong dissent by Kirby P. He considered that s.592 was a 'novel and exceptional provision'[41] which was introduced by parliament to provide a greater responsibility and accountability on the part of company directors and that by allowing the wife to escape the consequences of personal liability by taking no active interest in the affairs of the organisation frustrated the intention of parliament. He stated:

> It seems scarcely credible that parliament would have intended the blanket operation of this defence, to the frustration of the obvious scheme of the section and the achievement of its purposes, by the simple expedient of a director surrendering all of his or her powers to a co-director or managing director. This would involve the possibility of completely frustrating the operation of the Act in every case by the single device of donning the blinkers of indifference to, and assuming the bridle of neglect of, the interest in the company's affairs.[42]

The decision in this case has to be contrasted with the judgment of Ormiston J. in *Statewide Tobacco Services v. Morley*.[43]

Statewide Tobacco Services v. Morley

The defendant Mrs Morley had been a shareholder and director of a small family company since 1959. For 20 years from 1959 the company had been controlled by her husband and he had acted as governing director. The company was primarily involved in the running of tobacco kiosks. In 1979 when Mrs Morley's husband died, her son took over the management of the company until the company was wound up in 1988. The son was not formally appointed to the position of managing director, though he exercised similar powers. The son never kept Mrs Morley informed of developments concerning the company and she was ignorant of the financial difficulties of the company. At no stage did Mrs Morley ever request further information about the financial state of the company. During the 1980's Mrs Morley only completed a small number of formal activities on behalf of the company, including signing certificates for inclusion in the company's annual return as well as making the required statement for inclusion in the filed annual accounts. From May to July 1988 the company had become

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41 See his comments at 'Personal Liability of Officers' (1988) *Butterworths Company Law Bulletin No. 12* [276]

42 (1988) 13 ACLR 357, p.363

43 (1991) 2 ACSR 405

insolvent and some 21 cheques drawn on the company's account were referred to the drawer. The supplier of tobacco products during this period sued Mrs Morley for debts totalling $165,209.05. Ormiston J. held that she was liable for the debts incurred and that it could not be said that the debt was incurred without her express or implied authority or consent. His honour considered that the essential question was whether 'the defendant director [could] show that debts of this kind were incurred without his express or implied authority, when he was unaware that the particular transaction was being entered into?'[44]

Ormiston J. undertook an extensive analysis of authorities on agency and considered that the term should not be read narrowly.[45]

> Accordingly, he held that 'express or implied authority' within the meaning of s. [592(2)(a)] includes all that authority communicated by words or conduct (including silence or acquiescence which is consistent only with the conferring of authority) and also what is regarded as 'usual' or 'incidental' authority.[46]

Ormiston J. then concluded:

> [I]t follows that authority was conferred by the defendant in the present case and she is not entitled to rely upon the defence set out in para (a) of s [592(2)]. It is sufficient to repeat that she and her daughter agreed in 1979, albeit informally, with their co-director Mr. Ian Morley that he should continue to manage the company on their and its behalf. The general authority so conferred was sufficient to authorise the incurring of the debts which the plaintiff now seeks to enforce against the defendant pursuant to s.[592].[47]

Ormiston J. considered that he was not bound to follow the New South Wales Court of Appeal decision in *Metal Manufacturers v. Lewis* as there was no clear ratio from the majority judgments,[48] and the case could be distinguished on its facts. *Metal Manufacturers* concerning a a managing director whereas *Statewide Tobacco Services* involved a director acting in a managerial capacity. The point of distinction being that a managing director derives his authority from the appointment to office, whereas other directors derive their authority from the consent or authority of the appointing directors.[49] Ormiston J. did express some reservations about this distinction

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44 (1991) 2 ACSR 405, p.416

45 R J Burrell and S S Long 'Apathetic Directors Beware - Recent Case Developments' (1991) 21 *Queensland Law Society Journal* 5, p.17 comment that 'it is fair to say that the decision in *Morley's* case has attempted to 'integrate the interpretation [s.592] into the wider scope of director's duties generally as they exist under the Code, at law, and in equity.'

46 R.Burrell and S.Long, p.10

47 (1991) 2 ACSR 405, p.426

48 (1991) 2 ACSR 405, p.425

49 Examples of the implied authority given to managing director by their appointment to office are the power to borrow money and give security over the company property (*Biggerstaff v. Rowatt's Wharf Ltd* [1986] 2 Ch 93), guarantee loans made to company's subsidiaries (*Hely-Hutchinson v. Brayhead Ltd* [1968] 1 QB 549) and engage others to provide services to the company: *Freeman & Lockyer v. Buckhurst*

stating that 'I am not entirely persuaded that the kind of office held by a managing director is such that the directors can claim that his acts are performed without their express or implied authority.'[50]

S.592 (2)(b) - That at the time the debt was incurred, the person did not have reasonable cause to expect that the company would not be able to pay all its debts as and when they became due.

In *Metal Manufacturers v. Lewis*, paragraph (b) of s 592(2) was not considered by the Court of Appeal. However this defence had been considered by the trial judge Hodgson J.[51] and his reasoning was not disapproved by the appellate court.[52] In *Statewide Tobacco Services v. Morley*,[53] the reasoning of Hodgson J. was adopted by Ormiston J. His Honour considered that 'reasonable cause to expect' requires consideration of facts and circumstances actually known to the director and also consideration of facts and circumstances which the director ought to have known.[54] Ormiston J. commented:

Park Properties (Mangal) Ltd [1964] 2 QB 480. See the discussion in H A J Ford *Principles of Company Law* 5th ed. Butterworths 1990, p.92ff.

50 (1991) 2 ACSR 405, p. 423. This defence was also considered in the Tasmanian Supreme Court decision of *Coates v. Hardwick* (1987) 12 ACLR 657. In this case the defence was successful, Cosgrove J. following the decision of Hodgson J. at the trial level in *Metal Manufacturers v. Lewis*. In *Coates v. Hardwick*, the director, (who was a practising accountant in Victoria, but had a major financial interest in the Travellers Rest Hotel in Sandy Bay) had given express instructions to the hotel manager of the Travellers Rest not to operate on a credit basis. It was this fact, plus the lack of any knowledge of the debt being incurred, that permitted the director to successfully plead the equivalent of s.592(2)(a). It is submitted that a director today would not only be required to prove an express instruction that the company was to operate on a cash basis, but that the director had taken reasonable steps to monitor the company's financial position.

51 (1986) 11 ACLR 122

52 See the comments by Ormiston J. in *Statewide Tobacco Services v. Morley* (1991) 2 ACSR 405, pp.429-430

53 (1991) 2 ACSR 405

54 (1991) 2 ACSR 405, p.430

> Because the defendant must prove a negative and one related to the ability of the company generally to pay its debts as and when they become due, the question of the director's reasonable cause of expectation is not related to a specific debt but to the financial position of the company generally. Thus the issue is directed to what the director might reasonably know and understand of the company's general financial position at the relevant time. In the light of the various duties now imposed upon the directors, it would not appear unreasonable that they should apply their minds to the overall position of the company....What is reasonable, therefore, is related in part to the extent of the inquiries that the director has made and should have made about the company's solvency. A director should not in those circumstances be entitled to hide behind ignorance of the company's affairs which is of his own making or, if not entirely of his own making, has been contributed to by his own failure to make further necessary inquiries.[55]

In the instant case Mrs Morley's failure to take a day to day interest in the affairs of the company, her absence from board meetings and the failure to ascertain further financial information resulted in the conclusion that her cause to expect that the company was solvent, was not in the circumstances, reasonable. Ormiston J. concluded that 'if people choose to use a corporate vehicle to carry on their business activities, then they must accept the consequential responsibilities imposed by law.'[56]

S.592(2)(b) was also considered in the Victorian Supreme Court decisions of *Heide Pty Ltd t/a Farmhouse Smallgoods v. Lester & Anor*[57] and *Commonwealth Bank v. Friedrich & Ors.*[58]

The *Farmhouse Smallgoods* case involved a family run delicatessen which went into receivership. Mr. Lester and his wife operated a delicatessen, owned by Snowdeli Pty Ltd, a company of which they were both directors. Mrs. Lester acted as the receptionist-secretary, opening the mail and answering the telephone. Because she listened to the complaints of creditors over the phone, she was aware of the increasing financial difficulties that the company faced. Upon receivership the company owed Farmhouse Smallgoods, $285000. Mr. Lester was found liable for the full amount, however Mrs. Lester was only liable for the debts incurred after a meeting at which the deteriorating financial position of the company was revealed by the accountants. The evidence established that until this meeting she would not have had reasonable cause to expect that the company was in a situation where it would not have been able to pay its debts as they became due. Accordingly she was held liable for approximately $67000.[59]

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55 (1991) 2 ACSR 405, pp.430-431

56 (1991) 2 ACSR 405, p.432

57 (1990) 8 ACLC 958

58 (1991) 9 ACLC 946

59 The s.592(2)(a) defence was also raised by Mrs. Lester, but it was dismissed by O'Brien J. on the basis that her duties and presence in the office led to the conclusion that she had consented or approved the incurring of the debt. Other cases which have

In *Commonwealth Bank v. Friedrich & Ors.*, Max Eise was the honorary and part-time chairman of the Victorian Division of The National Safety Council of Australia. The late John Friedrich was the chief executive officer of the National Safety Council. From May 1988 to April 1989 substantial amounts of money were lent to the Council by the State Bank of Victoria, (which was later taken over by the Commonwealth Bank). As a result of the fraudulent activity of Friedrich the 1986 and 1987 accounts of the National Safety Council showed an excess of assets over liabilities. In fact there was a substantial shortfall of assets in relation to liabilities. Qualified auditor's reports were given in respect of the accounts. In early 1988 Mr. Eise signed the directors' report and directors' statement in respect of the 1987 accounts without viewing the auditor's report. The National Safety Council was ordered to be wound up in April 1989. Subsequent to this, claims against the directors of the National Safety Council pursuant to the then equivalent of s.592, were instituted. All of the directors except Eise settled. In holding Mr. Eise liable in the amount of $97ml., Tadgell J. held that the defence in s.592(2)(b) was not established. His honour followed the decision of Ormiston J. in *Statewide Tobacco Services v. Morley*[60] and found that Eise had acted contrary to the Code,[61] and to common sense, in

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considered s.592 (or its predecessor, s.556) include *Williams v. NCSC* (1990) 2 ACSR 131, *Re Spika Trading Pty Ltd* (1990) 8 ACLC 310, *Southern Star Group Pty Ltd v. Taylor* (Unreported Supreme Court NSW, 18/2/1991, Rolfe J.) *Castrisios v. McManus* (1991)4 ACSR 1, *Coates v. Hardwick* (1987) 12 ACLR 657, *Lange & Co. v. Bird* (1991) 4 ACSR 715 and *Cooper & Dysart Pty Ltd v. Sargon & Anor.* (1991) 4 ACSR 649. The New Zealand courts have also adopted a strict interpretation of their equivalent provision, s.320 *Companies Act* 1955 (N.Z.). See *Vinyl Processors v. Cant* [1991] NZLR 416, following the Australian decision of *3M Australia Pty Ltd v. Kemish* (1986) 4 ACLC 185. The material aspect of the New Zealand legislation provides for liability where an officer incurs debts and and he/she did not at the time the debt was contracted 'honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment. The equivalent English section, s.214 of the *Insolvency Act* 1986 holds directors liable where the director 'knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.' See *Re Produce Marketing Consortium Ltd (No.2)* [1989] BCLC 520. The ALRC *General Insolvency Inquiry*, Report No. 45 AGPS 1988, para. 302ff recommended that there should be no defence that the debt was incurred without the director's authority or consent. They considered that three defences should be available. These being;

reasonable grounds to expect that the company would have been able to pay its debts from its own resources,

reasonable steps to minimise loss to creditors,

non-participation in management as a result of illness or other sufficient cause.

The Australian Law Reform Commission also considered that there should be placed on directors the positive duty not to engage insolvent trading. The Commission considered that this would focus the director's attention on the overall financial position of the company, rather than requiring the director to pay attention to the occurring of a specific debt. See ALRC *General Insolvency Inquiry*, Report No. 45 AGPS 1988, para. 272ff. This writer considers that the common law developments have imposed an obligation on directors to consider the overall financial position of the company and thus there is in place a common law requirement that directors do not engage in insolvent trading. See the comments by Ormiston J. in *Statewide Tobacco Services v. Morley* (1991) 2 ACSR 405, p.431 where he states that the 'issue is directed to what the director might reasonably know and understand of the company's general financial position at the relevant time.'

60 (1991) 9 ACLC 946, p.958

61 See ss.292ff of the *Corporations Law*

signing the directors statements' and by failing to inform himself of the contents of the auditor's report.[62]

Conclusion

The decision in *Statewide Tobacco Services v. Morley* has a number of important ramifications, particularly for the non-executive director. If this case is followed[63] there will be no place for the inactive non-executive director. Directors will be expected to take an active interest in the financial affairs of the company, and will be required to inform themselves that the accounts as prepared represent a true and fair view of the company's financial position.[64] If the information is not forthcoming from the executive directors, the obligation on the director will be, at a minimum, resign,[65] and in appropriate circumstances, notify the Australian Securities Commission.

Another possible effect of this increase in potential liability for the non-executive director is that they;

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62 It was also argued that Mr. Eise should be relieved from liability pursuant to the precursor of s.1318 of the *Corporations Law*. This section allows the court to relieve a person from liability if the court is satisfied that the person has acted honestly and that having regard to all the circumstances of the case, the person ought fairly to be excused. Tadgell J. considered that that the defence should not be available to Mr. Eise. His honour considered that the application of s.1318 to the facts of this case would be performing a disservice to the administration of company law and the commercial community. Tadgell J. stated that;

> [L]iability under [s.592 (1)] is not made to depend on a breach by the defendant of any provision of the Code; a case to answer may be made against him under [s.592(1)] whether or not any breach by him of a provision is demonstrated; and equally the plaintiff may fail to make a case to answer against him under [s.592(1)] even though there are breaches by him of other provisions of the Code....Liability under the subsection is simply a liability for the payment of a debt that was incurred by the company. (1991) 9 ACLC 946, p.1007ff.

63 It should be noted that the decision is on appeal, the comments stated must therefore be read in that light. Importantly, the South Australian Supreme Court has adopted a narrower construction of the defences under s.592 of the Corporations Law. In *Groups Four Industries Pty Ltd v. Brosnan* (16 August 1991, Duggan J., to be reported,(1991) 5 ACSR), a husband and wife were the sole shareholders and directors of Madras Pty Ltd, a family company. The wife had only a limited involvement in the business and because she had no knowledge of the particular debts, she was held not liable under the predecessor to s.592(2)(a). The defence under s.592(2)(b) was also established, the court considering that as the section contemplates criminal conduct, liability should not be established on facts that the defendant *ought* to have known. With these conflicting authorities, it is obviously important that an appellate court determine the breadth of the defences.

64 See s.292 of the *Corporations Law*. See also the comments by Ormiston J. in *Statewide Tobacco Services v. Morley* (1991) 2 ACSR 405, p.431ff

65 In a recent New Zealand decision, *National Mutual Life Nominees Ltd v. Worn* (1990) 5 NZCLC 66,384, Henry J. held that directors who do not actively participate in the careless act may be liable on the basis of their inaction and that resignation by directors will be no defence. It should be noted that the case was principally argued on the basis of common law negligence.

> will be more inclined to resign to protect their own assets rather than remaining on the board of directors, thereby depriving shareholders and creditors of an important limiting factor on the wishes of other directors who may have personal interests which conflict with the interests of the company (and in an insolvency situation, which conflict with the interest of creditors).[66]

Insurance cover will also become more important as more directors attempt to take out a 'directors and officers' liability package. As commented in *The Business Australian*;

> The crux of the new law is that a director, either as an invited board member or a full-time employee, can no longer hide behind the excuse of being away at the time or 'I am only a consultant to the board'. People being offered board seats when they retire will now be looking very hard at the company, to the point that they may conduct their own due diligence and demand some insurance before accepting the position.[67]

Another aspect that needs to be considered with this increase in personal liability for directors is the economic effect. 'The limited liability company [is seen] as a device for encouraging entrepreneurial activity and promoting economic growth.'[68] If we place more responsibility and accountability on directors will this unduly inhibit the entrepreneur? The courts have generally ignored such considerations, but as Kirby states;

> The law makers and judges of the future will need to expose more clearly the policy foundations and implications of their decisions. Then, if it is considered that they are wrong or have undesirable consequences, the law makers and judges who follow can more readily correct them.[69]

One further matter that will need to be analysed is whether any distinction should be made between the small private company and a public company. It has been commented that;

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66 R. Burrell and S.Long, p.17

67 C. Cummins 'Corporate perils force directors to seek safety in insurance' *The Business Australian* 18 February 1991, p.19. The insurance industry is already feeling the impact of the increase in corporate failure. See the comments by T Thomas 'Directors under fire' *Business Review Weekly*, May 31, 1991, p.22. See also D. Forman 'Shock Awakening for Sleepy Directors' *Business Review Weekly*, September 6, 1991, p.84

68 ALRC *General Insolvency Inquiry*, Report No. 45, 1988, AGPS, para. 277

69 M. Kirby, p.238

> The obligations of directors of bigger companies are different from the directors of smaller companies... - directors of smaller companies in many ways have a greater responsibility to be sure of what is going on whereas the directors of a large company or some our big public companies are more likely to be entitled to rely on the structures of audit and other committees that are set up.[70]

There is no doubt that to agree to be a director today is a decision that should not be taken lightly.[71] With the recession that Australia had to have, and the consequent corporate failures, there is increased attention being focused on directors from regulators, the judiciary and the media. This attention has only led to greater accountability, responsibility and risk for directors and this is something that should be of concern for all those taking part in the management of the company, and in particular for the inactive non-executive director.[72]

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70 Anon. 'Uninvolved director liable for debts - full details of new case' [1990] 6 *Company Director* [No.11] 5, p.7. For a similar view see R. Burrell & S. Long, p.17

71 An example of action taken by non-executive directors in response to untoward activity is the resignation by T Harris and F G Davey when the executives of Qintex wanted them to approve payments of $32ml. to the management company of C. Skase and other Qintex executives. As L. Armstrong, Partner, Blake Dawson Waldron stated:

> A directorship is not a reward for having been a good chap. You may need to be quite aggressive in demanding fresh reports to shed light on the issues at the next board meeting. If, despite these demands, the situation is still unsatisfactory, you might as well resign, knowing that you have left a trail of honest intentions. But if you want to go public about it, you had better get some advice on defamation law first. As reported in T Thomas 'Directors under fire' *Business Review Weekly* , May 31, 1991, p.25

72 See the comments by R. Burrell and S. Long, pp.17-18. It should be noted that the ALRC *General Insolvency Inquiry* did consider that there were a number of deficiencies with the legislation and that it should be amended. The amendments recommended that the legislation should place a positive duty on directors not to engage in insolvent trading, to provide that a breach of this duty should give rise to civil liability and not criminal liability, and to give standing to a liquidator to pursue an action. These reforms have not been acted upon. ALRC *General Insolvency Inquiry*, Report No.45, 1988, AGPS,para. 277ff It is also interesting to contrast the attitudes of the courts in the late 1800's. In *Re Denham* (1884) 25 Ch. D. 752 a director who had not attended a single board meeting in four years and had not made a single inquiry into the affairs of the company was held not liable for the fraud committed by the executive directors. Even more alarming is the decision by Stirling J. in *The Marquis of Butes Case* [1892] 2 Ch. 100 where the person stated to be the president of the Cardiff Savings Bank did not attend a board meeting for 17 years. In finding the president not liable for the fraud committed by others, his honour commented:

> To hold that the Marquis was guilty of neglect or omission in respect of this duty, in the absence of any knowledge or notice that it was duly performed, would in my opinion, be to fix him with liability for the neglect and omission of others rather than his own. [1892] 2 Ch. 100, p.110.