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Director Liability for Insolvent Trading: Why a Business Judgment Rule is Appropriate

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I INTRODUCTION

On 19 January 2010, the Department of Treasury released a discussion paper questioning whether either a business judgment rule or a moratorium should be introduced in respect of the insolvent trading provisions[1] of the *Corporations Act*.[2] In 2007, the *Review of Sanctions* paper sought input on the suitability of a general defence.[3] Despite a majority of respondents to both papers favouring reform, no action has been taken to temper what are perhaps the harshest insolvent trading provisions in the world.[4]

The proposal of this paper is that existing insolvent trading law is flawed; that it should be amended to allow directors, in suitable circumstances, to trade through insolvency or otherwise restructure the firm; and, that the most appropriate means of allowing this is an extension and modification of the business judgment rule. It is clear that dishonest or fraudulent behaviour, or the taking of excessive risk, would not attract business judgment protection,[5] and so the extent of the reform would be to excuse from liability directors of those companies that restructure or trade while insolvent, provided that it is done in good faith, for a proper purpose, and in the best interests of creditors.

Chapter II outlines the rationale for insolvent trading provisions. Chapter III demonstrates that the theoretical underpinning of insolvent trading law—creditor protection and the prevention of excessive risk near insolvency—is misconceived. Chapter IV argues

[1] *Corporations Act 2001* (Cth) pt 5.7B div 3('*Corporations Act*').

[2] Department of Treasury, *Insolvent Trading: A Safe Harbour for Reorganisation Attempts Outside of External Administration* (2010) ('*Safe Harbour Paper*').

[3] Department of Treasury, *Review of Sanctions in Corporate Law* (2007) ('*Review of Sanctions Paper*').

[4] Wayne Martin, 'Official Opening Address' (Speech delivered at the 16th National Conference of the IPA, Burswood Entertainment Complex, 28 May 2009) 14 <http://www.supremecourt.wa.gov.au/publications/pdf/Insolvency_Practitioners_Assoc_National_Conference_28May09.pdf>.

[5] As it would not under the *Corporations Act* s 180(2).

that, beyond non-necessity, such stringent provisions are in fact undesirable and harmful to stakeholders. Chapter V canvasses reform proposals, and argues that the most appropriate reform would excuse those directors who satisfy a business judgment rule in respect of insolvent trading.

II INSOLVENT TRADING IN AUSTRALIA

The role of corporate law is to fill in blanks and oversights 'with the terms that people would have bargained for had they anticipated the problems.'[6] Schwartz and Scott argue that 'drafters should be reluctant to enact default standards without first asking why the standards were missing from private contracts,'[7] that the best inference to draw from the absence of a particular term is that it has been rejected, and that standards will ordinarily be inefficient.[8] Similarly, Coase contended in his seminal article that 'direct governmental regulation will not necessarily give better results than leaving the problem to be solved by the market or the firm,'[9] and that in the absence of transaction costs and where allocation of property rights is certain, economic optimality will be achieved irrespective of the initial allocation of those rights: enterprise will naturally gravitate to the most efficient form.[10] The risk borne by creditors in insolvency is therefore not an externality, but the parties' deliberate choice designed to achieve the most efficient allocation of risk.[11] Thus, legislative mandating of personal liability for insolvent trading is warranted where this is what parties would privately

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[6] Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991) 34; See also Royce de R Barondes, 'Fiduciary Duties in Distressed Corporations: Second-Generation Issues' (2007) 1 *Journal of Business and Technology Law* 371, 375–376.

[7] Alan Schwartz and Robert E Scott, 'Contract Theory and the Limits of Contract Law' (2003) 113 *Yale Law Journal* 541, 602.

[8] Ibid.

[9] Ronald H Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, 18.

[10] Ibid.

[11] See, eg, John Elofson, 'The Dilemma of Changed Circumstances on Contract Law: An Economic Analysis of the Foreseeability and Superior Risk Bearer Tests' (1997) 30 *Columbia Journal of Law and Social Problems* 1.

bargain for; where non-inclusion in private contracts is due to systemic imbalance of power or inequity; or where—notwithstanding that parties of equal power contracting at arm's length would not so bargain—overarching principles of justice demand such a course.

Equity owners are the residual risk-bearers of a solvent corporation: they bear the risk of decreased profitability or loss. In insolvency, however, shareholders rank last in the distribution of assets, and so their investment has failed.[12] The residual risk is borne by the corporation's creditors, who effectively become the new stockholders.[13] Since creditors' returns are fixed (and therefore they stand to gain nothing beyond receipt of the specified interest rate), and since shareholders have nothing further to lose, shareholders would receive the benefit of extremely risky transactions whereas the risk of failure is borne by creditors.[14] Thus, creditors are principally concerned with controlling the potential for loss.[15]

Insolvent trading rules are therefore predicated on 'concern for the welfare of creditors exposed to the principle of limited liability … when the prospect of that principle resulting in loss to creditors has become real,'[16] because of financial mismanagement of directors.[17] The trend of legislation has been to increase directorial obligation in the twilight zone of insolvency,[18] and particularly in relation to the incurring of debts.[19] This has largely

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[12] *Corporations Act* s 556.

[13] Merton H Miller, ' Leverage' in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press, 1996) 3, 6.

[14] Frank H Easterbrook and Daniel R Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89, 103–4; See generally Andrew Keay, 'The Director's Duty to Take Into Account the Interests of Company Creditors: When is it Triggered?' (2001) 25 *Melbourne University Law Review* 315, 315–318.

[15] Frederick Tung, 'Gap Filling in the Zone of Insolvency' (2007) 1 *Journal of Business and Technology Law* 607, 619–20.

[16] *Woodgate v Davis* (2002) 55 NSWLR 222, 231.

[17] Christopher F Symes and John Duns, *Australian Insolvency Law* (LexisNexis Butterworths Australia, 2009) 335.

[18] *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405 (Ormiston J) ('*Statewide Tobacco*').

[19] Niall F Coburn, *Coburn's Insolvent Trading: Global Investment Fraud and Corporate Investigations* (Lawbook Co, 2nd ed, 2003), 17–18.

entailed decreasing the threshold of awareness required for liability,[20] and the removal of the authority/consent provisions,[21] which allowed directors to use a lack of involvement in the affairs of the company as a defence.[22] The theme is that 'directors are expected to make inquiries and to place themselves in a position to guide and monitor the management of the company.'[23] This is based on the fear that insolvent trading would occur by reason either of a director's negligence, oversight, or dishonesty.[24] It was stated in the Harmer report: 'it is one thing to trade with shareholders' money. It is another thing to trade relying on credit provided by third parties.'[25] What was presumed to follow from this statement, however—that creditors are therefore deserving of extra protection, and that this protection should come in the form of liability imposed on directors in insolvency—is not self-evident.[26]

III CREDITOR PROTECTION

A *Overcompensation of Creditors*

A rationale commonly advanced in favour of a duty to prevent insolvent trading is that excessive risk-taking near insolvency occasioning loss to creditors is unjust and

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[20] *Corporations Act* s 588G(1)(c): 'suspect' insolvency; *Corporations Law* (Cth) s 592(1)(b)(i); *Companies Act 1981* (Cth) s 556(1)(b)(i): 'expect' insolvency; See also Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) ('*the Harmer Report*').

[21] See eg *Companies Act 1981 (Cth)* s 556(2)(a).

[22] Explanatory Memorandum, Corporate Law Reform Bill 1992 (Cth) 1082. It was also said that the modern expectation on directors was that they acquaint themselves with the general position of the company and take positive steps to protect members and creditors: at 1086. In response to *Metal Manufacturers Ltd v Lewis* (1988) 6 ACLC 725.

[23] Rosemary Langford, 'The New Statutory Business Judgment Rule: Should it Apply to the Duty to Prevent Insolvent Trading' (1998) 16 *Companies and Securities Law Journal* 533, 536; See also *Najjar v Haines* (1991) 25 NSWLR 224, 267; *Morley v Statewide Tobacco Services Ltd* (1992) 8 ACSR 305, 320; *Statewide Tobacco* (1990) 2 ACSR 405, 431.

[24] Helen Horsington, *Directors' Duties during Insolvency* (Lawbook Co, 2001) *vi*.

[25] *The Harmer Report*, above n 20, [304].

[26] Mark Byrne, 'An Economic Analysis of Directors' Duties in Favour of Creditors' (1994) 4 *Australian Journal of Corporate Law* 275, 275.

undesirable.[27] Although it is clear that liability is just if loss is caused dishonestly, negligently, or as a result of manifestly excessive risk-taking, it is less clear that compensation to creditors is justified in the absence of these factors.

There are a number of risks associated with voluntarily extending credit to a corporation. The corporation might become insolvent and hence unable to effect full repayment, or, near insolvency, it might increase leverage or the risk of its investments.[28] The creditor thus receives compensation beyond the riskless interest rate for information costs,[29] opportunity cost, and the risk of incomplete repayment.[30] Thus, higher-risk loans attract higher interest rates:[31] 'returns on financial claims are positively correlated to risk.'[32] Lenders (particularly those with sophistication and bargaining power) are often in a position to appraise and set compensation for risk, and to limit that risk through incorporation of protective clauses into lending agreements (for instance, debt covenants, management guarantees, or charges),[33] and diversification of their risk portfolio.[34] If unsecured lenders choose a riskier investment (in comparison to, for instance, Government bonds), in exchange for higher interest,[35] and subsequently benefit from directorial personal liability pursuant to s

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[27] See, eg, Tung, above n 15, 605; Langford, above n 23, 537; Leanne Whitechurch, 'Should the law on insolvent trading be reformed by introducing a defence akin to the business judgment rule' (2009) 17 *Insolvency Law Journal* 25, 32.

[28] Easterbrook and Fischel, 'Limited Liability', above n 14, 105.

[29] Richard A Posner, *Economic Analysis of Law* (Wolters Kluwer, 7th ed, 2003) 428–429.

[30] Richard A Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499, 501.

[31] Robert K Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press, 1996) 395, 395.

[32] William H Meckling, 'Financial Markets, Default, and Bankruptcy: The Role of the State' (1977) 41 *Law and Contemporary Problems* 13, 21 n 20.

[33] Justin J Mannolini, 'Creditors' Interests in the Corporate Contract: A Case for the Reform of our Insolvent Trading Provisions' (1996) 6 *Australian Journal of Corporate Law* 14, 24.

[34] Tung, above n 15, 619.

[35] Thomas H Jackson and Robert E Scott, 'On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain' in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press, 1996) 141, 145.

588G,[36] this is an 'enforcement windfall to which their bargain with the firm does not entitle them.'[37] If, for example, a creditor contracts with a company that the creditor knows to be near insolvency, and is therefore able to demand a high interest rate, the benefit provided by insolvent trading provisions is a 'second bite at the cherry':[38]the creditor is, on a risk-adjusted basis, overcompensated.[39] It is only where creditors bear risk for which they have not been compensated that they suffer.[40]

Not all creditors, however, are alike. A common critique is that smaller trade creditors require legislative protection owing to lack of sophistication, bargaining power, or both.[41] It is less commonly stated that directors frequently share these characteristics.[42] It is typically the directors of small, closely-held corporations (usually a husband and wife)[43]—those least likely to be insulated from personal liability—that are the subject of proceedings.[44] As a matter of policy, moreover, it is not clear that unsophisticated creditors or those who negligently fail to adequately self-protect should have the ability to redirect loss to the director.[45] As Kilpi argues, 'it is hard to see how moral blame can arise if [creditors] simply are not competent enough and the imprudence imposes the harm upon themselves. Should

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[36] *Corporations Act* s 588G.

[37] Anna M Dionne, 'Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency' (2007–2008) 13 *Stanford Journal of Law, Business and Finance* 188, 189.

[38] Byrne, above n 26, 281.

[39] Mannolini, above n 33, 30.

[40] Byrne, above n 26, 276.

[41] Cory D Kandestin, 'The Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction' (2007) 60 *Vanderbilt Law Review* 1235, 1262; Helen Anderson, 'Corporate Social Responsibility—The Case for Unsecured Creditors' (2007) 7 *Oxford University Commonwealth Law Journal* 93, 104–105; Michelle J White, 'The Corporate Bankruptcy Decision' (1989) 3 *The Journal of Economic Perspectives* 129, 132.

[42] See, eg, *Commonwealth Bank v Friedrich* (1991) 5 ACSR 115 ('*Friedrich*').

[43] Irene Trethowen, 'Directors' Personal Liability to Creditors for Company Debts' (1992) 20 *Australian Business Law Review* 41, 51.

[44] Mannolini, above n 33, 32.

[45] Ibid.

that not be their business?'[46] As creditors' returns are not dependent on profit and they rank ahead of equity in insolvency,[47] morally speaking, a joint and voluntary agreement is not unfair, and whatever is lost is 'scrupulous'.[48] No moral blame can be assigned to the debtor (let alone the director of the debtor).[49] Kilpi concludes:[50]

> [T]he best judgment as to the acceptable amount of future chance is the subjective valuation of … the creditor and the debtor. … [I]nclination to risk gives no reason to impose punishment on those who make a mistake in their valuation and go broke. If the debtor has … acted within the covenants of the creditor contract, he has only exercised his rights to control the borrowed asset. This cannot be a cause for moral blame.

Even unsophisticated creditors, moreover, can protect themselves by selling to many customers and by extending credit for only short periods of time.[51] Additionally, though complex and detailed investigations into the capital structure of a prospective debtor may be prohibitively expensive, a credit check or ASIC search to determine capitalisation can be performed at relatively low cost.[52] Moreover, if the borrower's ability to repay remains doubtful the lender may seek personal guarantees, insert retention-of-title clauses, or increase interest rate to reflect uncertainty. If, because of lack of bargaining power or otherwise, none of this is possible, the lender can simply reject the transaction.[53]

[46] Jukka Kilpi, *The Ethics of Bankruptcy* (Routledge, 1998) 113.
[47] *Corporations Act* s 556.
[48] Kilpi, above n 46, 97.
[49] Ibid.
[50] Ibid 110–111.
[51] Posner, *Economic Analysis of Law*, above n 29, 425.
[52] Mannolini, above n 33, 25
[53] Ibid.

Furthermore, where the risk premium is set by informed voluntary creditors, 'it is irrelevant whether each voluntary creditor is informed. Each is protected by the market price.'[54] Similarly, as the price of credit is fully elastic,[55] a greater number of insolvencies will result in a higher price of credit, and so the price of insolvency is borne by debtors as a group rather than by the creditors.[56] Additionally, it is not in the interests of directors or the company to conceal the true extent of risk. Uncertainty will cause a lender to elevate interest rates, and so disclosure minimises finance costs.[57] It might be said against this that the failure of a corporation to disclose information relevant to interest-rate calculations could be mistaken by the lender as an implication that there is no such information to disclose. If this corporation survives, however, it will be charged a premium in respect of future credit; if it fails, non-disclosure likely vitiates the requirement for business judgment protection of good faith, or that of acting in the company's interest.[58] In either scenario, the director suffers as a result of concealment, and thus has incentive to make relevant disclosure on request. Whitechurch's conclusion—that 'insolvent trading provisions … provide the only protection for unsecured creditors' funds'—is therefore not entirely accurate.[59] It would be more correct to say that the insolvent trading provisions provide the only *legislatively imposed* protection.

Thus, Posner concluded that society should care about the prevalence of corporate bankruptcy because of the effect on involuntary creditors and the costs to the court system, but not because of the effect on voluntary creditors.[60] Where the creditor is able to calculate

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[54] Easterbrook and Fischel, 'Limited Liability', above n 14, 105.

[55] Kilpi, above n 46, 71; Meckling, above n 32, 21.

[56] Kilpi, above n 46, 71.

[57] Byrne, above n 26, 276.

[58] Which, as will be discussed, includes the interests of creditors.

[59] Whitechurch, above n 27, 32.

[60] Richard A Posner, 'Foreword' in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press, 1996) xi.

risk with some degree of accuracy, and sets his interest rate accordingly, there is no externality:[61] that creditor has been compensated for the risk of non-repayment.[62]

1 *Whincop's Critique*

Whincop argues that if creditors are able to calculate the risk of underpayment in insolvency, they should also be able to account for the loss-offsetting effect of the insolvent trading provisions, and price credit accordingly.[63] Such a calculation, however, would require a number of impracticable computations. It cannot be predicted whether a director will cause a company to trade while insolvent,[64] have reasonable grounds to suspect solvency,[65] or have the ability to make out another defence.[66] It will be similarly difficult to determine whether the director will be sufficiently wealthy to pay any compensation ordered. Indeed, it is also possible that the director will be replaced between the extension of credit and insolvency, rendering this calculation completely impossible.

Moreover, the suggestion that a creditor, having calculated an interest rate that reflects risk of underpayment, would deduct that rate based on a contingent and undeterminable ability to recover from a director in insolvency, does not accord with commercial reality. The more likely scenario is that creditors, not knowing whether it will be necessary or possible to invoke insolvent trading provisions, or the extent of compensation, will assume that there will be no recovery and price credit accordingly. Any sum recovered from the director, then, is in

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[61] Posner, 'The Rights of Creditors', above n 30, 501.

[62] Easterbrook and Fischel, 'Limited Liability', above n 14, 105.

[63] Michael J Whincop, 'Taking the Corporate Contract More Seriously: The Economic Cases Against, and the Transaction Cost Rationale For, the Insolvent Trading Provisions' (1996) 5 *Griffith Law Review* 1, 13, citing M Polinsky, *An Introduction to Law and Economics* (Little & Brown, 2nd ed, 1989) 122–3.

[64] *Corporations Act* s 588G(1)(a)–(c).

[65] Ibid s 588H(2).

[66] Ibid s 588H(3)–(5).

addition to the interest rate calculated to reflect risk of non-repayment. Thus, *contra* Whincop, there *is* reason 'to suspect that *systematic* overcompensation prevails.'[67]

Additionally, pricing credit by reference to unquantifiable future criteria is clearly less precise than determining the probability of a corporation's failure and debt non-repayment, and therefore seems an undesirable system to promote. Finally, Whincop allows earlier (albeit in a different context) that 'it is unclear why directors should be regarded as entrepreneurs but lenders should not, since both are in the business of risk-taking.'[68] As this is so, it is also unclear why the legislature should afford special protection to creditors in the absence of clear justification, and why it should be presumed that creditors are unable to protect themselves and are undercompensated for risks they bear.[69]

The Effect on Risk-Taking

Thus, creditors are compensated in respect of the first risk to which they are exposed near insolvency—debt non-repayment—and to the extent that they are not, it is not clear that the failure of a creditor to adequately self-protect should result in directorial liability. The second risk is purported to be that there is incentive for directors to increase the riskiness of a near-insolvent company's transactions. Even if this is so, it is limitable through use of debt covenants to prevent borrowers incurring superior-ranking debts or increasing leverage beyond a certain level.[70] Additionally, interest rate may be linked to leverage ratio, or lenders may contract for the ability to monitor the firm's activities, for instance, by requiring the

[67] Whincop, above n 63, 14.

[68] Ibid 12–13.

[69] See also David Morrison, 'The Economic Necessity for the Australian Insolvent Trading Prohibition' (2003) 12 *International Insolvency Review* 171, 177.

[70] Mannolini, above n 33, 23.

provision of independently audited accounts.[71] Moreover, although it is true that to the extent creditors fail to protect themselves in this way or to predict excessive risk, undercompensation is possible, the claim that companies' strategies become increasingly risky near insolvency is not supported theoretically, nor is it evidenced empirically in countries without insolvent trading provisions.

1 *Excessive Risk-Taking in Theory*

Directors of financially sound companies have no incentive to take inordinate risks. The utility of the director personally is directly linked with that of the company: should the company fail, the director enters the competitive corporate management employment market with the disadvantage of having overseen a corporation's failure. Additionally, taking actions that the market perceives to be excessively risky causes decreased share value and undervaluing of the company, which can result in the replacement of a director (or other remedial action) by shareholders, a decrease in remuneration, or indeed the takeover of the company.[72]

Near insolvency, however, it is claimed that shareholders, having nothing to lose, may prefer a strategy of excessive risk. As this, however, would only advantage the company (and hence the shareholders) in the short term, there is unlikely to be incentive to this effect. Any return to the credit market will yield prohibitively high interest costs, as a result of this earlier behaviour.[73] This causes increased agency cost to shareholders, and is accordingly not in

[71] Meckling, above no 32, 30.

[72] Mannolini, above n 33, 25, See also Ronald J Gilson and Reinier H Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 *Virginia Law Review* 549.

[73] Byrne, above n 26, 277.

their interests.[74] Whincop, however, suggests that this is not sufficient disincentive because the company can only be punished through higher interest rates if it survives. To the extent, however, that companies generally are excessively risky and insolvency becomes more frequent, the general price of credit will rise and thus shareholders generally incur increased costs.[75] It is thus contrary to the interests of shareholders to contribute to such an increase through taking excessive risk.[76] As Meckling puts it, increases in the cost of insolvency (for creditors) will be 'borne by shareholders in the form of higher borrowing costs and reduced credit.'[77] Directors of closely-held companies can be punished for excessive risk by higher interest rates in their present enterprise, if it survives, or through any subsequent enterprises if it does not.

Directors can derive immediate benefit from excessive risk and, where they own less than one hundred per cent of shares, are able to externalise increased finance costs to shareholders.[78] These benefits are illusory beyond the short term, however, in that they are offset by a diminishment in remuneration and in job security. Managers are inherently over-invested in firms, in that they rent to it their human capital,[79] the value of which is determined by reference to business practices and the success or failure of the firm.[80] Given the stigma attendant on managing a company into insolvency, a director will have less value

[74] Easterbrook and Fischel, 'Limited Liability', above n 14, 95; Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 307–309.

[75].Jensen and Meckling, above n 74, 307–309.

[76] Except in respect of one-time shareholders: a limited category.

[77] Meckling, above n 32, 33.

[78] Adolf A Berle and Gardiner C Means, *The Modern Corporation and Private Property* (Legal Classics Library, Special ed, 1993) 121–124; Mannolini, above n 33, 21.

[79] Michael J Whincop, 'The Economic and Strategic Structure of Insolvent Trading' in Ian M Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (CCH Australia, 2000) 43, 52.

[80] Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *The Journal of Political Economy* 288, 292.

on the labour market, and thus suffer diminished remuneration:[81] 'the wage revision process is sufficient to neutralise his incentive to deviate.'[82] Indeed, a 1993 study of American CEOs found that in a given year around default, one third of CEOs were replaced, and that substantial reductions in compensation occurred.[83] The inability of the director to diversify the risk of termination and diminution in compensation[84] entails that the director has significant motivation to adopt conservative, long-term strategies rather than spectacularly risky ventures.[85]

2 *Empirical Evidence Regarding Risk-Taking*

Were excessive risk-taking pervasive in jurisdictions without provisions analogous to s 588G,[86] one would expect that corporate failure would often be attributable either to overextension or managerial error. A 1995 study of failed American firms, however, found that only eight per cent attributed failure to 'ambitious expansion', and another eight per cent to managerial actions or error: thus, eighty-four per cent of firms failed without having taken inordinate risks.[87] Moreover, it is not clear even in the sixteen per cent of companies wherein managerial action contributed to failure that excessive risks were taken. Another study concluded that the extent to which directors of near-insolvent firms take measures to mitigate

[81] Tung, above n 15, 607.

[82] Fama, above n 80, 297.

[83] Stuart C Gilson and Michael R Vetsuypens, 'CEO Compensation in Financially Distressed Firms: An Empirical Analysis' (1993) 48 *The Journal of Finance* 425, 426.

[84] Royce de R Barondes, 'Fiduciary Duties of Officers and Directors of Financially Distressed Corporations' (1998) 7 *George Mason Law Review* 45, 59.

[85] Tung, above n 15, 623.

[86] *Corporations Act* s 588G.

[87] Sudip Datta and Mai E Iskandar-Datta, 'Reorganisation and Financial Distress: An Empirical Investigation' (1995) 43 *Journal of Financial Research* 15, 18, cited in Barondes, 'Fiduciary Duties of Officers and Directors', above n 84, 61.

risks to creditors correlates positively with the size of a potential investment.[88] Thus, Barondes said in the American context that 'the empirical evidence … strongly supports the conclusion that distressed corporations do not engage in excessive risk-taking predicted by the "overinvestment" theory.'[89]

3 *The Effect on Interest Rates*

If business judgment protection in respect of insolvent trading occasioned excessive risk-taking, the resulting diminished returns to creditors in insolvency would cause an increase in the price of credit. Thus, the fact that the United States, Canada, New Zealand, and the UK do not have prohibitively high interest rates notwithstanding that they also do not have insolvent trading provisions analogous to those of Australia supports the postulate that excessive risk near insolvency is not a significant problem. Decreased stringency resulting in closer alignment with other Western economies would be unlikely to result in excessively high interest rates, where this has not occurred in those jurisdictions.[90]

Australian Empirical Evidence

Notwithstanding (or perhaps because of) the lack of both theoretical and international empirical support for the excessive risk theory, a number of commentators have made the case against business judgment protection by reference to Australian evidence. It is purported to follow from unsecured creditors having received little in certain windings-up (ostensibly because of excessive risk-taking) that, absent insolvent trading provisions, risk-taking would

[88] Steven S Dionne, *The Impact of Prior Experience on Acquisition Behaviour and Performance: An Integrated Examination of Corporate Acquisitions in the USA and UK* (D Phil Dissertation, University of Oxford, 2007) 290, 292, 298–300 as cited in Dionne, above n 37, 215.

[89] Barondes, 'Fiduciary Duties of Officers and Directors', above n 84, 62.

[90] See Jason Harris, 'Director Liability for Insolvent Trading: is the Cure Worse than the Disease?' (2009) 23 *Australian Journal of Corporate Law* 266, 276–81; But see Whitechurch, above n 27, who questions the efficacy of international comparisons.

increase and 'directors would undoubtedly abuse an extended business judgment rule.'[91] This claim is based, perhaps, on managers' conduct in proceedings for breach of s 588G,[92] which is commonly 'sufficiently unsavoury that several other causes of action are also clearly available.'[93]

This reasoning appears circular. Directors who are guilty of insolvent trading are either unaware that they have committed an offence, because of negligence, or ignorance of law or fact; aware that they have committed an offence and have done so dishonestly or recklessly; or aware that they have committed an offence, but believe their actions to have been in the best interests of the company. Given the personal liability attendant on the latter course of action, this third category of director is unlikely to be numerically significant. The claim that directors of companies that trade while insolvent are dishonest or negligent is accordingly something of a truism. To paraphrase the cliché, if insolvent trading is outlawed, only outlaws will trade while insolvent. This does not justify the extended claim that if insolvent trading were excusable in certain circumstances, directors that take advantage of this would also be dishonest. In any event, as it is not sought through business judgment protection to excuse dishonest or negligent directors, the deterrent and punitive effects of the corporations law in respect of these two classes will not be diminished.

IV Policy Arguments

[91] Whitechurch, above n 27, 35.

[92] *Corporations Act* s 588G.

[93] Tung, above n 15, 623; Paul James, Ian Ramsay, and Polat Silva, 'Insolvent Trading—An Empirical Study' (2004) 12 *Insolvency Law Journal* 210, 223.

The doctrine of limited liability has been said to be 'one of the greatest ideas devised by English law,'[94] 'the greatest single discovery of modern times,'[95] and 'indispensible to the functioning of an efficient capital market.'[96] This enthusiasm stems from the catalytic effect the doctrine has on entrepreneurial risk-taking, the benefit of which is relatively uncontested. It will be argued that the risk of personal liability causes directors to eschew reasonable risks, which distorts and detracts from optimum market efficiency, causes the untimely demise of viable businesses, and thus undermines the principle and purpose of limited liability.

A *Legal and Factual Uncertainty in the Twilight Zone*

There is a great deal of commentary on the concept of a 'zone'[97] of insolvency in the United States, where in some jurisdictions it has been held that company managers owe a fiduciary duty to creditors as the firm enters the zone.[98] In Australia, the zone is less significant. Duties are owed to the company, and though this requires taking into account creditors' interests near insolvency, it does not give rise to a directly enforceable duty.[99] Nonetheless, entrance into the zone is significant because it triggers a director's duty to consider creditors' interests, and because the company's nearness to insolvency entails increased risk of personal liability. As insolvent trading liability turns on and is determined

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[94] Lord Wilberforce, 'Law and Economics' in B W Harvey (ed), *The Lawyer and Justice* (London, Sweet and Maxwell, 1978) 73, 75.

[95] Nicholas Murray Butler, as quoted in Roger E Meiners, James S Mofsky, and Robert D Tollison, 'Piercing the Veil of Limited Liability' (1979) 4 *Delaware Journal of Corporate Law* 351, 351; Butler was President of Columbia at the time. President Eliot of Harvard expressed similar views: at 351.

[96] Paul Halpern, Michael Trebilcock, and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117, 124; See also Byrne, above n 26, 275; Easterbrook and Fischel, 'Limited Liability', above n 14, 89.

[97] Dionne, above n 37, 188.

[98] Ibid.

[99] *Walker v Wimborne* (1976) 137 CLR 1; *Geneva Finance Ltd v Resource & Industry Ltd* (2002) 169 FLR 152; *Spies v R* (2000) 201 CLR 603; *Re New World Alliance Pty Ltd (rec and mgr apptd); Sycotex Pty Ltd v Baseler* (1994) 51 FCR 425; *Bell Group Ltd (in liq) v Westpac Banking Corp (No 9)* (2008) 70 ACSR 1 ('*Bell Group*'); *Downey v Crawford* (2004) 51 ACSR 182.

by reference to solvency, it is critical that directors be able to determine a company's solvency with certainty and reasonable ease.

There exists something approaching a consensus that the simple syntax of s 95A[100] belies the nebulousness and obscurity of solvency-test jurisprudence.[101] In particular, although the courts draw a distinction between temporary illiquidity and insurmountable endemic insolvency,[102] the determination of this in real time presents significant difficulty for managers of financially distressed corporations.[103] Palmer J observed that '[i]t is easy enough to tell the difference in hindsight, when the company has weathered the storm or foundered with all hands; sometimes it is not so easy when the company is still contending with the waves.'[104] The Insolvency Practitioners of Australia (IPA) submitted to the *Safe Harbour* paper that although, at law, a corporation is either solvent or insolvent, in practice, 'determining whether any business of even moderate size is insolvent is difficult unless it is clearly insolvent,'[105] and that 'while ever "insolvency" is the threshold test, the law will be inherently unclear.'[106] This uncertainty is amplified in assessing whether the company has entered the zone of insolvency, since this requires a director to determine the size and possible effect of transactions that could cause insolvency in addition to a standard solvency

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[100] *Corporations Act* s 95A.

[101] Although detailed analysis of solvency-test jurisprudence is beyond the scope of this paper, see generally *Melbase Corporation Pty Ltd v Segenhoe Ltd* (1995) 17 ACSR 187; *Standard Chartered Bank of Australia v Antico (Nos 1 and 2)* (1995) 38 NSWLR 290 ('*Antico*'); *Sandell v Porter* (1966) 115 CLR 666, 670*; Taylor v Australian and New Zealand Banking Group Ltd* (1988) 13 ACLR 780*; Re Newark Pty Ltd (in liq)* [1993] 1 Qd R 409; *Sheahan v Hertz Australia Pty Ltd (1995) 16 ACSR 765*; *Bank of Australasia v Hall* (1907) 4 CLR 1514, 1528; *Norfolk Plumbing Supplies Pty Ltd; Re Norfolk Plumbing Supplies Pty Ltd v Commonwealth Bank of Australia (1992) 6 ACSR 601*; *Guthrie v Radio Frequency Systems Pty Ltd* (2000) 34 ACSR 572, 575.

[102] *Southern Cross Interiors v Deputy Commissioner for Taxation* (2001) 39 ACSR 305, 316–17; *International Business Strategies Pty Ltd v Lucas* (1995) 17 ACSR 269.

[103] Coburn, above n 19, 146; Nuncio D'Angelo, 'What Directors Need to Consider Before Calling in an Administrator—and it's not just Solvency…' (2006) 24 *Company and Securities Law Journal* 7, 8; Whitechurch above n 27, 28; Stephen R McDonnell, 'Geyer v Ingersoll Publications Co: Insolvency Shifts Directors' Burden from Shareholders to Creditors' (1994) 19 *Delaware Journal of Corporate Law* 177, 196; Keay, above n 14, 324.

[104] *Hall v Poolman* (2007) 65 ACSR 123, 181 ('*Poolman*').

[105] IPA, Submission to *Safe Harbour Paper*, 18 March 2010, 4.

[106] Ibid 6.

calculation.[107] Such doubt is clearly undesirable given that a corporation 'navigating in the zone of insolvency ... is one in most need of effective and proactive leadership.'[108]

1 *Undue Risk-Aversion and Prevention of Reasonable Entrepreneurialism*

Of course, the postulated effects of this uncertainty—undue risk aversion and premature administration[109]—can exist only if directors are aware of, and concerned about, the potential for personal liability. Indeed, a Department of Treasury survey of company directors found that 78.2 per cent of respondents believed the risk of personal liability for good faith decisions was medium to high.[110] More than 64 per cent of respondents to a 2010 survey conducted by the Australian Institute of Company Directors (AICD) reported that they were 'seriously concerned' about the risk of personal liability.[111]

Given the potentially ruinous consequences of personal liability, and particularly in firms that are 'near the red' for much of the time,[112] where directors have a 'slight opinion … without sufficient evidence'[113] that a firm is insolvent, or where solvency cannot readily be ascertained, they are likely to assume that the firm is insolvent and cause it to be put into

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[107] See eg Law Council of Australia, Insolvency Practitioners Association of Australia, and Turnaround Management Association Australia, Submission to *Safe Harbour Paper*, 2 March 2010, 4–5 ('*Safe Harbour Joint Submission*'); Australian Bankers' Association, Submission to *Safe Harbour Paper*, 4 March 2010, 3–4.

[108] *North American Educational Programming Inc v Gheewalla*, 930 A 2d 92, 100 (Del Supr Ct, 2007).

[109] See, eg, Bernard Black, Brian Cheffins, and Michael Klausner, 'Outside Director Liability' (2006) 58 *Stanford Law Review* 1055, 1117; Mark Byrne, 'Directors to Hide from a Sea of Liabilities in a New Safe Harbour' (2008) 22 *Australian Journal of Corporate Law* 255, 256.

[110] Department of Treasury, *Survey of Company Directors* (18 December 2008) <http://www.treasury.gov.au/content/Company_Directors_Survey/SurveySummary.html> ('*Survey*').

[111] AICD, *Impact of Legislation on Directors* (November 2010) 34 <http://www.companydirectors.com.au/Director-Resource-Centre/Governance-and-Director-Issues/Director-Liability/~/media/Resources/Media/Media%20Releases%20and%20Speeches/2010/The%20impact%20of%20legislation%20on%20directors_November%202010.ashx> ('*Impact of Legislation*').

[112] For instance highly solvent firms engaging in risky ventures or start-up firms: Roger A Lane, 'Direct Creditor Claims for Breach of Fiduciary Duty: Is they Is, or Is They Ain't?' (2007) 1 *Journal of Business and Technology Law* 483; Dionne, above n 37, 215; See also *In re Healthco Int'l Inc,* 208 BR 288 (Bankr. D. Mass. 1997).

[113] *Queensland Bacon v Rees* (1966) 115 CLR 266, 303.

administration or liquidation.[114] Indeed, administration appears to have been intended by the legislature to be a first resort,[115] notwithstanding that not all troubled firms are insolvent or unviable. Dabner argues that to extend liability to directors based on suspected (rather than expected or probable) outcomes promotes too risk-averse a culture, and is an 'obtuse responsibility.'[116] As noted previously, the extent of the duty of the director to take into account the interests of creditors correlates with the proximity of the firm to insolvency. Given that this nearness is difficult or impossible to calculate, and given the risk of liability that attaches even in respect of transactions of not-unreasonable risk, the director of a firm in the zone of insolvency is likely to superordinate the interests of creditors and act with risk-averse caution.[117] This 'results in the inability of directors to take risks … for the purpose of extinguishing or minimising the firm's temporary financial distress.'[118]

The Treasury survey found that 65.3 per cent of respondents had occasionally taken an *overly* cautious approach to decision-making (though this was not specifically stated to be near insolvency), and 12.9 per cent had frequently done so.[119] This risk-aversion causes firms to habitually operate at suboptimal level,[120] which detracts from profitability and may cause the foregoing of positive net present value (NPV) investments.[121] Indeed, 64.2 per cent of

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[114] Richard M Cieri and Michael J Riela, 'Protecting Directors and Officers of Corporations that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions' (2004) 2 *DePaul Journal of Business and Commercial Law* 295, 311.

[115] D'Angelo, above n 103, 14; Whitechurch, above n 27, 28; AICD, Submission to *Safe Harbour Paper*, 2 March 2010, 3; See also *Corporations Act* ss 588(5)–(6).

[116] Justin Dabner, 'Trading While Insolvent—A Case for Individual Creditor Rights Against Directors' (1994) 17 *University of New South Wales Law Journal* 546, 562.

[117] Vladimir Jelisavcic, 'Corporate Law: A Safe Harbour Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the "Vicinity of Insolvency:" Credit Lyonnais v Pathe' (1993) 18 *Journal of Corporate Law* 145, 159.

[118] Anne C Stilson, 'Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors' (1995) 20 *Delaware Journal of Corporate Law* 1, 91.

[119] Department of Treasury, *Survey*, above n 110.

[120] Dionne, above n 37, 194.

[121] Mannolini, above n 33, 29.

directors reported that the fear of personal liability inhibited an optimal business decision by a medium to large degree.[122]

Finally, if a director incorrectly considers that the company is viable and that continued trade will not result in insolvency, the promotion of the interests of shareholders will occasion a breach of s 588G[123] and may constitute a breach of the duty to consider the interests of the creditors. On the other hand, if the director incorrectly believes that, or (having doubt) acts as though, the corporation is near insolvency and places the firm into administration or is excessively risk-averse, this may constitute breach of the duty to shareholders.[124] Alternatively, unwarranted risk-aversion may jeopardise the director's future employment or diminish remuneration.[125] Dionne terms this an 'impossible position'.[126]

Diminishing Pool of Directors

As s 588G[127] personal liability is dependent on insolvency, managerial positions in firms that are near insolvency or occupy the twilight zone as a matter of course are inherently risky, which may discourage potential or existing managers from taking or continuing in the job. Although this discouragement will be particularly pronounced in borderline-solvent companies, all directors bear at least some risk of personal liability. Thus, potential directors,

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[122] Department of Treasury, *Survey*, above n 110.

[123] *Corporations Act* s 588G.

[124] Barondes, 'Fiduciary Duties of Officers and Directors', above n 84, 76; AICD, *Impact of Legislation*, above n 111, 22.

[125] Dionne, above n 37, 218, Barondes, 'Fiduciary Duties of Officers and Directors', above n 84, 76.

[126] Dionne, above n 37, 218.

[127] *Corporations Act* s 588G.

confronted with the possibility of undiversifiable risk of unlimited personal liability, may decline the position in favour of safer employment,[128] a result to be avoided.[129]

The hypothesised effect—declining interest in board positions—will vary based on the financial position of the company, the remuneration offered, and other factors, and thus is difficult to quantify. It is this difficulty of quantification that leads some commentators to argue that there is an 'absence of evidence' for this effect.[130] Whitechurch, for instance, cited the submission of the AICD to the *Review of Sanctions* paper[131] that 'there is no shortage of directors willing to … lead major Australian companies',[132] but did not note that this was immediately followed by:[133]

> [h]owever, more senior and experienced directors and potential directors … are shying away from taking on high profile positions … because of concerns of potential personal risks of liability or, even if they are to defeat claims, of severely damaged reputations.

The AICD also said, 'many directors are forming the view that there is no longer a fair balance between risk and reward ... [and] the consequence is likely to be a smaller and potentially less experienced pool of company directors.'[134] Korda Mentha submitted to the *Safe Harbour* paper that 'a competent director or senior manager would not knowingly

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[128] Dionne, above n 37, 192.

[129] *State Bank of South Australia v Marcus Clarke* (1996) 19 ACSR 606, 643.

[130] Whitechurch, above n 27, 30. It may be trite to observe that the absence of evidence is not the evidence of absence, and therefore that this argument is not an answer to the theory of discouragement.

[131] AICD, Submission to *the Review of Sanctions Paper*, 2007, 2.

[132] Ibid 2.

[133] Ibid.

[134] AICD, Submission to *Safe Harbour Paper*, above n 115, 3.

subject themselves or their personal assets to the risk associated with taking a new appointment with a company in the "twilight zone".'[135]

This hypothesis is supported by evidence provided by Australian company directors. 71.1 per cent of directors reported that they had declined a directorship primarily because of the risk of personal liability.[136] 62.9 per cent of respondents reported that a board of directors on which they sat had lost a potential or suitable candidate for that reason.[137] Finally, 87.6 per cent, 63.9 per cent, and 75.3 per cent respectively of directors reported that they knew of other people who had declined, retired from, or resigned from a position as company director as a result of the risk of personal liability.[138] A survey conducted by the AICD in 2010 found that these numbers had decreased somewhat (56.8 per cent declined; 52.2 per cent resigned) but were nonetheless significant.[139] Moreover, 74 per cent of those who identified themselves as aspiring directors reported that the fear of personal liability caused them to reconsider directorship as a career.[140]

The apparent effect of personal liability, therefore, is to reduce the size and quality of the pool of potential directors.[141] This will be particularly pronounced where the company is operating near insolvency; consequentially, those companies most in need of strong and experienced leadership are deprived thereof. Where the fate of a company in the twilight zone

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[135] Korda Mentha, Submission to *Safe Harbour Paper*, 2 March 2010, 3; See also Australian Bankers' Association, above n 107, 7; Tamar Lewin, 'Director Insurance Drying Up', *The New York Times* (New York, New York) 7 March 1986, 1; Roberta Romano, 'What Went Wrong with Directors' and Officers' Liability Insurance' (1989) 14 *Delaware Journal of Corporate Law* 1.

[136] Department of Treasury, *Survey*, above n 110.

[137] Ibid.

[138] Ibid.

[139] AICD, *Impact of Legislation*, above n 111, 31–32.

[140] Ibid 42.

[141] Department of Treasury, *Survey*, above n 110.

'could have gone either way,' as is often the case,[142] the unavailability of experienced directors will compound the existing predisposition of directors, fearing personal liability, to prematurely place into external administration or liquidate companies, destroying enterprise value.

Destruction of Going Concern and Enterprise Value

The foregoing sections argue that the insolvent trading provisions increase risk-aversion and decrease the quality and size of the managerial pool. The risk is that viable corporations will more frequently be placed into administration or liquidation than would otherwise be the case, which causes diminution or destruction of the value of a corporation. The result is that stakeholders incur the costs of winding-up and the loss of the going-concern value of the corporation.

A business that is liquidated will realise less in asset sales than its value as a solvent going concern, owing to the loss of such assets as goodwill, work in progress, book debts, future profit potential.[143] Administration also causes this loss where it results in liquidation—which is more often than not.[144] Although liquidation sometimes follows administration because the corporation is unviable, in at least some cases, the very fact of entrance into administration causes devaluing of an otherwise viable corporation sufficient to render a solvent company insolvent, or an insolvent company hopelessly so. This is because placing a company into administration, irrespective of whether liquidation follows, reduces enterprise value in that asset sales take on the connotation of 'fire sales', realising lower prices; the

[142] Korda Mentha, above n 135, 2.

[143] Harry Rajak, 'Rescue Versus Liquidation in Central and Eastern Europe (1998) 33 *Texas International Law Journal* 162; Douglas C Baird, 'A World Without Bankruptcy' in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press, 1996) 30, 33.

[144] Michael Sloan, 'Close but No Cigar: Reform not Rescue' (2008) 20(1) *Australian Insolvency Journal* 6, 6.

ability to hold assets until the market improves is reduced; goodwill is lessened by diminishing brand value and trading reputation, and because customers fear that warranties will be dishonoured; [145] and because of the professional and other fixed costs of administration.[146] Finally, *ipso facto* clauses,[147] though illegal or regulated in comparable jurisdictions by reason of their capacity to destroy value,[148] are unregulated in Australia.[149] Particularly in respect of businesses that derive revenue from management contracts, the termination of contracts pursuant to *ipso facto* clauses can be devastating, as it was for One.Tel,[150] Babcock & Brown, Allco Finance, Timbercorp, and Great Southern.[151]

In the administration of small firms, the fixed costs alone may consume the entirety of the remaining value of the firm;[152] larger firms can be rendered hopelessly insolvent by the associated diminution of value. For this reason, it may be in the interest of general creditors (not to mention non-owner stakeholders such as employees and other businesses dependant on the firm)[153] to allow the firm to continue in business.[154] By way of illustration, the

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[145] Kathryn Neilson, Submission to *Safe Harbour Paper*, 13 February 2010, 18.

[146] Lawrence A Weiss, 'Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims' (1990) 27 *Journal of Financial Economics* 285, 288–289; *Safe Harbour Joint Submission*, above n 107, 3; Miller, above n 13, 6.

[147] Clauses that provide for automatic termination of executory contracts upon the appointment of an administrator: Harris, above n 90, 275.

[148] Notably Canada: *Bankruptcy and Insolvency Act* RSC 1985, s 65.1; *Company Creditors Arrangement Act* RSC 1985, s 34(1).

[149] The question whether this should be reformed is beyond the scope of this paper, but it is noted in passing that such regulation would arguably be an unjustified restriction on the freedom of creditors to contractually protect themselves against the insolvency of their debtors: The Australian Government, *Government Response to the Report of the Parliamentary Joint Committee on Corporations and Financial Services: 'Corporate Insolvency Laws: A Stocktake'* (2004) 22 'Recommendation 55'; But see Parliamentary Joint Committee, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (2004) 217; *The Harmer Report*, above n 20, Vol 1 286–287 [703]–[705], Vol 2 140–141 cl AT-10.

[150] Australian Bankers' Association, above n 107, 2; *The Safe Harbour Joint Submission*, above n 107, 3; Neilson, above n 145, 13–14.

[151] Harris, above n 90, 275.

[152] Ibid.

[153] Douglas C Baird and Thomas H Jackson, 'Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *University of Chicago Law Review* 97, 101.

directors of the Henry Walker Eltin group of companies, concerned about personal liability, placed the group into administration. In subsequent liquidation, creditors were in fact paid one hundred cents in the dollar, so the destruction of enterprise and going concern value was needlessly experienced by shareholders, employees, and other stakeholders.[155] A 'safe harbour', on the other hand, allowed General Motors to trade for several months while insolvent, during which time a plan was negotiated and presented to the courts.[156] Such restructures are ordinarily unviable[157] or impossible[158] in Australia, because s 588G prevents trade during insolvency,[159] and restructuring in insolvency is possibly only by entering administration (which damages the firm and allows stakeholders to negotiate greater concessions).

This was aptly summarised extra-curially by Chief Justice Martin, who stated that the 'regulatory regime encourage[s] resort to insolvent administration, even in cases in which there is a real prospect that a financial restructure and altered business plan might save the entity involved.'[160] The detriment to non-creditor stakeholders that results from premature corporate demise is indisputable. What is more, it does not appear that this loss is offset or otherwise justified by some gain by or prevention of loss to creditors. Empirical evidence indicates that judicious use of restructuring and continued trade results in higher returns to creditors and is generally of benefit to all parties.

The Benefits of Restructuring

[154] Jackson and Scott, above n 35, 144; Elizabeth Warren, 'Bankruptcy Policy' (1987) *The University of Chicago Law Review* 775, 801.

[155] *The Safe Harbour Joint Submission*, above n 107, 7–8; See also Patrick J Lewis, 'Insolvent Trading Defences after Hall v Poolman' (2010) 28 *Company and Securities Law Journal* 396, 398.

[156] *The Safe Harbour Joint Submission*, above n 107, 10.

[157] Lewis, above n 155, 400.

[158] Ibid; *The Safe Harbour Joint Submission*, above n 107, 10.

[159] *Corporations Act* s 588G.

[160] Martin, above n 4, 13.

The purpose of reorganisation is to allow breathing space to enable the rescue of viable firms in financial distress,[161] and to 'prevent the creditors' individual (or collective) interests from destroying a firm as a going concern by forcing it to liquidate piecemeal, destroying both jobs and assets in the process.'[162] It is, of course, possible for a firm to be insolvent and still economically viable.[163] Where there exist objectively reasonable grounds for an expectation that the firm will return to solvency within a reasonable period of time (and the director has a corresponding subjective belief), it is in the interests of all parties to allow this. Restructure can be effected in a number of ways. First, where short term losses have caused insolvency but in the medium-term the business is viable, the firm can simply continue to trade despite insolvency. Second, the business can be 'sold' to existing participants: those who hold claims against or interests in the company.[164] This allows for alteration of management structure and firm strategy, and results in higher returns to creditors where the going concern value of the corporation exceeds its piecemeal value or where a buyer cannot immediately be found for the firm.[165] Alternatively, an insolvent corporation may be sold as a going concern on the open market with proceeds distributed according to the insolvency rules (or pursuant to an agreement reached by the parties).[166]

Provided that reorganisation is used in the appropriate case of a viable firm, finding buyers or negotiating a debt-for-equity arrangement with creditors, 'may not be more difficult, more expensive, or more error prone than the alternatives.'[167] Easterbrook, relying

[161] White, above n 41, 138.

[162] Douglas G Baird, 'The Uneasy Case for Corporate Reorganisation' (1986) 15 *The Journal of Legal Studies* 127, 133; Miller, above n 13, 6.

[163] Posner, *Economic Analysis of Law*, above n 29, 433.

[164] Lucian A Bebchuk, 'A New Approach to Corporate Reorganisations' in Jagdeep S Bhandari and Lawrence A Weiss (eds), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press, 1996) 370, 370.

[165] Ibid.

[166] White, above n 41, 148.

[167] Baird, above n 162, 136.

on studies performed by Weiss,[168] and Gilson, John and Lang,[169] concludes that because of the direct and indirect costs associated with formal insolvency proceedings, 'private restructuring is superior to bankruptcy ... [which may] damn the bankruptcy process, or ... show only that people choose restructuring when that is cheaper and choose bankruptcy when the legal process holds the advantage in cost.'[170] Whichever is true, it is clear that the use of restructuring where appropriate is advantageous to creditors and other stakeholders.

Thus, even accepting for the sake of argument that the increasing preoccupation with creditor protection near insolvency is sound policy, it has been demonstrated both that the protection of creditors does not require that directors be personally liable for honest and good faith business judgments made by directors of near-insolvent companies.[171] More damningly, it has been argued that the effect of existing insolvent trading provisions, in firms that are suitable for reorganisation or restructure, is a diminution in returns to general creditors.

V Reform Options for Insolvent Trading Provisions

A *Excusing Directors from Liability*

Contra Langford,[172] it is possible for a director to form a reasonable view that it is in the interests of the company to reorganise, restructure, or trade through insolvency while meeting certain criteria necessary for business judgment protection: honesty, good faith,

[168] Weiss, above n 146.

[169] Stuart Gilson, Kose John, and Harry H P Lang, 'Troubled Debt Restructurings: An Empirical Study of Private Reorganisation of Firms in Default' (1990) 27 *Journal of Financial Economics* 315.

[170] Frank H Easterbrook, 'Is Corporate Bankruptcy Efficient?' (1990) 27 *Journal of Financial Economics* 411, 412.

[171] At present, though a reasonable expectation of solvency is a defense: s 588H(2); as is the taking of reasonable steps to prevent insolvency: s 588H(5); there is no defense in relation to an objectively honest and good faith belief that continued trade is best for the company.

[172] Langford, above n 23, 555–556.

having the purpose of returning the company to profitability, lacking conflicting interest, and having been appraised completely of the financial situation of the company. The foregoing sections have argued that the proffered justification for s 588G—creditor protection—is not defensible or necessary, and has results contrary to the interests of the company. This Chapter will therefore argue that the optimal reform is the extension of business judgment protection to directors that meet the aforesaid criteria.

The Business Judgment Rule

The business judgment rule exists for the purpose of protecting directors and excusing them from liability for decisions made in good faith, with due care,[173] without material personal interest, for a proper purpose, and with the rational belief that the judgment is in the best interests of the corporation.[174] It has been argued above that the insolvent trading provisions are too harsh and that directors should be excused from liability in the appropriate case—which is essentially where a director rationally makes a *bona fide* decision (after consideration of relevant material) that it is in the best interests of the corporation (including the creditors) to continue trading or restructure in insolvency. Accordingly, there is a correlation between the elements of the statutory business judgment rule and the circumstances in which a director should be excused from liability, suggesting that the appropriate course is the extension of business judgment protection to this category of director.

Some commentators have rejected this, arguing that the purpose of business judgment protection is to foster entrepreneurship and encourage responsible risk-taking, whereas the

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[173] Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1998 (Cth) 17 [6.3].
[174] *Corporations Act* s 180(2).

purpose of insolvent trading provisions is to protect creditors and deter risk-taking near insolvency.[175] Thus, they argue, the aims of the two rules are incompatible, and extension of the business judgment rule would be nonsensical.[176] This line of argument, however, disregards that though one aim of the business judgment rule is to encourage entrepreneurialism, this is secondary to an overarching principle that it is unjust, unwise, and undesirable for a court to *ex ante* review the 'honest, informed, and rational business judgments' of a director that turn out to be wrong.[177] This 'reflects the fact that ours is an economic order in which investment choices and implementing business decisions are chiefly made by private persons, not by government functionaries or judges.'[178]

> Because businessmen and women are correctly perceived as possessing skills, information, and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith.[179]

Additionally, *ex post facto* litigation is both an undesirable and 'a most imperfect' device for the evaluation of the decisions of directors.[180] It is undesirable because it may encourage creditor indolence: creditors may plan to rely on *ex post facto* litigation rather than

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[175] Langford, above n 23, 559; Whitechurch, above n 27, 33; CPA Australia, Submission to *Review of Sanctions Paper*, 1 June 2007, 9.

[176] Ibid.

[177] Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1998 (Cth) 17 [6.1], [6.4].

[178] William T Allen, 'Investment Bankers' and Judicial Review of Corporate Action to Defeat Hostile Takeovers: Comments on Chapter 5' in Arnold W Sametz and James L Bicksler (eds) *The Battle for Corporate Control: Shareholder Rights, Stakeholder Interests & Managerial Responsibilities* (1991) 131, 134–135 as cited in Dennis J Block, Stephen A Radin and Michael J Maimone, 'Chancellor Allen, the Business Judgment Rule and the Shareholders' Right to Decide' (1992) 17 *Delaware Journal of Corporate Law* 785, 790.

[179] *In re JP Stevens & Co Shareholders Litigation*, 542 A 2d 770, 780 (Del Ch 1998); See also William A Knepper and Dan A Bailey, *Liability of Corporate Officers and Directors* (The Mitchie Company, 4th ed, 1988) 182; Harold A J Ford, *Principles of Company Law* (Butterworths, 4th ed, 1986), where it was said in the Australian context, 'courts do not exert close control over the way in which boards exercise their discretions: judges are not necessarily skilled in matters of business ...': at 383 [1503].

[180] Knepper and Bailey, above n 179, 183.

negotiation of contractual protections.[181] It is imperfect because, near insolvency, quick decisions will often be called for, and such decisions will necessarily be made without all the relevant information.[182] Thus, 'a reasoned decision at the time may seem a "wild hunch" years later against a background of perfect knowledge'.[183] The court in *Harlowe's Nominees* said:[184]

> Directors in whom are vested the right and the duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.

It is therefore incorrect to say that the sole purpose of the business judgment rule is to encourage risk-taking, whereas that of the insolvent trading provisions is to prevent it—and that the two concepts are thus incompatible. Indeed, the exclusion of insolvent trading from protection in Australia is not reflected in comparable common law jurisdictions: in the UK, liability requires more than mere trading while insolvent,[185] and in New Zealand, the critical concept is the reasonableness of the risk taken.[186] The Delaware Court of Chancery said in *Trenwick America*:[187]

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[181] Morrison, above n 69, 177; Dionne, above n 37, 213.

[182] Knepper and Bailey, above n 179, 183.

[183] *Joy v North*, 692 F 2d 880, 886 (2d Cir 1982) as cited in Knepper and Bailey, above n 179, 183.

[184] *Harlowe's Nominees Pty ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483, 493. See also Ford, above n 176, 383; Bernard Keller, 'Australia's Proposed Statutory Business Judgment Rule: A Reversal of a Rising Standard in Corporate Governance' (2000) 4 *Deakin Law Review* 125, where it was said that as in the US, 'England and Australia have allowed boards a wide freedom to make errors of judgment in business matters': at 128; Lewis, above n 155, 399.

[185] See eg *Secretary of State for Trade and Industry v Gash* [1997] BCC 172, 178; *Re Hawkes Hill Publishing Co Ltd (in liq)* [2007] EWHC 3073, [41] *Re Continental Assurance Company of London Plc* [201] BPIR 733, [281].

[186] See eg *Lower v Traveller* [2005] 3 NZLR 479; *Re South Pacific Shipping (in liq)* (2004) 9 NZCLC 263,570, [125]; *Fatupaito v Bates* [2001] 3 NZLR 386; *Nippon Express v Woodward* (1998) 8 NZCLC 261,765, 261,773.

[187] *Trenwick America Litigation Trust v Ernst & Young LLP*, 906 A.2d 168 (Del, 2006) [195].

> The business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and ... the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.

1 *Form of the Business Judgment Rule*

The existing statutory business judgment rule has the following elements: good faith and proper purpose; lack of material personal interest; having informed oneself to the extent one reasonably believes to be appropriate; and a rational belief that the judgment is in the best interests of the corporation.[188] The Treasury proposition would amend this by requiring that financial records presented a true and fair picture of the financial circumstances; that the director was informed by restructuring advice from an appropriately experienced and qualified professional; that it was the director's business judgment that the interests of the company's creditors, as well as members, were best served by pursuing restructuring; and that the restructuring was diligently pursued.[189] The elements of the existing rule should be retained for the sake of uniformity and consistent application, notwithstanding their somewhat strained interpretation in *Rich*.[190] This paper argues that the optimal solution therefore comprises both existing elements (for consistency) and insolvent trading modifications (for specificity). The proposed form appears below.

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[188] *Corporations Act* s 180(2)(a)–(d).

[189] *Safe Harbour Paper*, above n 2, 17 [5.3.6]. It is unclear whether these elements are to be appended to the existing elements or than substituted for them.

[190] *ASIC v Rich* (2009) 75 ASCR 1 ('*Rich*').

588GA (1) **[Business Judgment Rule]** a person who makes a business judgment in relation to the incurring of a debt that, but for this subsection, would constitute a contravention of s 588G(2), is taken not to have contravened that subsection in respect of the judgment if:

(a) at the time the debt was incurred the corporation had financial accounts and records that accurately represented the financial position of the corporation; and

(b) the person makes the judgment in good faith; and

(c) the person informs themselves about the subject matter of the judgment to the extent that they reasonably believe to be appropriate; and

(d) the person is informed by advice from an appropriately experienced and qualified person ('the expert') with access to the financial accounts and records of the corporation as to the means of restructuring, reorganising or trading in insolvency, and as to the prospects of a return to solvency within a reasonable period of time; and

(e) the person rationally believes that the judgment in relation to the incurring of a debt is in the best interests of the corporation; and

(f) the person reasonably expects that the corporation will return to solvency within a reasonable period of time.

588GA (2) **[Rational Belief]** a belief that the judgment in relation to the incurring of a debt is in the best interests of the corporation is rational unless:

(a) the belief was not supported by a reasoning process sufficient to warrant describing it as a rational belief;[191] or

(b) the advice received pursuant to para (1)(d) indicates that:

(i) the corporation is not suitable for restructuring, reorganising, or otherwise trading through insolvency; or

(ii) the expert does not expect that the corporation will return to solvency within a reasonable period of time.

588GA (3) **[Non-Derogation]** this section does not derogate from general law in relation to the duties of a director.

588GA (4) **[Definitions]** in this section

business judgment means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation, including a decision whether or not to incur a debt;

rational means, of a belief, based on reason or reasoning, irrespective of whether 'reasonable' in the objective sense.[192]

588GA (5) **[Onus of Proof]** the onus is on the director to demonstrate the existence of the matters contained in subsections (1) and (2).[193]

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[191] This codifies Austin J's interpretation of s 180(2)(d) in *Rich* (2009) 75 ASCR 1, [7289]–[7291].

[192] Ibid.

[193] Ibid [7258]–[7270].

Some commentators have advocated a requirement that the director have an expectation of a return to solvency within a set (rather than a reasonable) period of time.[194] This is undesirable for a number of reasons. First, what is reasonable or acceptable differs based on trade custom, the particular circumstances of the company, and those of creditors. Second, though again it is true that directors require 'certainty'[195] it is far less clear that an arbitrary time period commencing on insolvency provides this, principally because real-time assessment of solvency, as discussed above, is problematic.

Another contentious question is whether it need be explicitly required that company directors consider primarily the interests of the company's body of creditors.[196] Given that existing case law already requires that a director of a corporation near insolvency consider the interests of creditors,[197] this is superfluous. In fact, the nuance of the common law provides a significantly more precise statement of obligation. Owen J described it thus:[198]

> A director has a duty to act in the best interests of the company. The duty is owed to the company and not to any third parties (including creditors). But in an insolvency context ... the duty entails or includes an obligation ... to take into account the interests of creditors. ... [This is because] any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as the creditors … [including] threats to the very existence of the company: to its ability to continue as a going concern.

[194] Neilson, above n 145, suggests three months: at 44; Tom Lennox, 'Insolvency and the Judgment of Directors', *Lawyers Weekly* (Sydney), 26 June 2009, cited in Neilson, above n 145, 44, suggests six months.
[195] Whitechurch, above n 27, 31.
[196] Harris, above n 90, 282; IPA, Submission to *Review of Sanctions* Paper, 15 June 2007, [85]–[89].
[197] See cases cited above n 99.
[198] *Bell Group* (2008) 70 ACSR 1, 242 [4418]; See also Keay, above n 14, 315.

In *Credit Lyonnais*, Chancellor Allen stated that the director of a troubled company should take whatever action is in the best interests of the company, irrespective of whether creditors or another class of stakeholder may prefer an approach that is of greater benefit to their class.[199] This requires the director to be: [200]

> [C]apable of conceiving of the corporation as a legal and economic entity. Such directors will recognise that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

It is thus desirable to require directors to make decisions with reference to the interests of the corporation, as informed by those of creditors, rather than to simply afford primacy to the interests of creditors. This approach recognises that the interests of creditors in 'splitting an inadequate pie'[201] should be tempered by the interest of the community (not to speak of the other stakeholders) in the survival of the corporation.[202]

Other Alternatives

[199] *Credit Lyonnais Bank Nederland NV v Pathe Communications Corporation* (Del Ch, 12150, December 30 1991) [108] n 55.

[200] Ibid.

[201] Dionne, above n 37, 216.

[202] Pieter Kloppers, 'Judicial Management—A Corporate Rescue Mechanism in Need of Reform?'(1999) 10 *Stellenbosch Law Review* 417, 418.

Though there have been a number of reform proposals,[203] this part will consider only the suitability of s 1318 (the status quo),[204] Harris's proposal, and the moratorium proposal.

1 *Section 1318*

Comparable common law jurisdictions[205] provide varying degrees of forbearance for directors who rationally and in good faith make a judgment that turns out to be wrong. The Australian courts rely on s 1318,[206] which allows the court to excuse any person from liability if in all the circumstances the person ought fairly to be excused.[207] The provision is unsuitable for a number of reasons. First, it 'has ... the sense of taking a burden from a person who has committed a breach. It does not mean that the breach is deemed never to have occurred,'[208] which requires the court to assume, 'ex hypothesi, that [the director] has been guilty of a default or breach of duty.'[209] The director accordingly suffers the stigma of a finding of breach and the cost of bringing the exculpatory application.[210] It is perhaps the former that is most troubling:[211] Palmer J observed in *Poolman* that for a director to be 'publicly branded as "having failed to act honestly", out of context, would be most hurtful, damaging, and unfair'[212] and that 'a judge's choice of words in a judgment can blight a

[203] The general defence proposed by the *Review of Sanctions Paper*, above n 3, 29, will not be considered, as the ramifications of a general defence in relation to any directorial breaches of the Corporations Law are beyond the scope of this thesis; the 'financial judgment rule': IPA, Submission to *Review of Sanctions Paper*, above n 196, [80]–[95] will not be separately considered because the unsuitability of a number of its elements has been discussed above.

[204] *Corporations Act* s 1318.

[205] See above nn 183–7.

[206] See eg *Friedrich* (1991) 5 ACSR 115; *Antico* (1995) 38 NSWLR 290; *Poolman* (2007) 65 ACSR 123.

[207] *Corporations Act* s 1318(1).

[208] *Deputy Commissioner of Taxation v Dick* (2007) 226 FLR 388, 402 ('*Dick*').

[209] *Friedrich* (1991) 5 ACSR 115, 197; See also Lewis, above n 155, 409.

[210] Lewis, above n 155, 409; Harris, above n 90, 285; Larelle Law, 'The Business Judgment Rule in Australia: A Reappraisal since the AWA Case' (1997) 15 *Company and Securities Law Journal* 174, 179.

[211] AICD, Submission to *Safe Harbour Paper*, above n 115, 2.

[212] *Poolman* (2007) 65 ACSR 123, 193 [323].

person's reputation'.[213] This is a concern shared by the business community: nearly sixty per cent of respondents to the AICD survey indicated that they were seriously concerned about damage to their reputation as a director.[214]

The second difficulty with s 1318[215] is that it involves a 'relatively unstructured equitable decision', based on factual minutiae,[216] with the result that directors do not know whether or in what circumstances they will be excused. As insolvent trading is excusable in certain circumstances,[217] it is clearly preferable that a structured defence based on common judicial considerations[218] allow directors to act decisively and confidently, knowing the likely ramifications of their actions.[219] Similarly, though ASIC indicated in 2009 that it would not pursue directors who have acted in good faith,[220] this again lacks the formality and certainty of legislation, and moreover is non-binding on creditors and liquidators.[221]

2 *Harris*

Harris's proposed reform involves extending s 588H(5)[222] to include a defence that the director took all reasonable steps to ensure that the debts incurred were necessary in order to enable restructuring and return to solvency and, in pursuing restructuring, acted in good

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[213] Ibid, 193 [321].

[214] AICD, *Impact of Legislation*, above n 111, 34–36. One respondent said, '[y]ou only have one reputation, the other issues can be managed': at 34; *The Safe Harbour Joint Submission*, above n 107, 8.

[215] *Corporations Act* s 1318.

[216] Neilson, above n 145, 25–26.

[217] See, eg, *Poolman* (2007) 65 ACSR 123; *Powell v Fryer* [2001] SASC 59; *ASIC v Plymin (No 2)* (2003) 21 ACLC 1237; *Dick* (2007) 226 FLR 388.

[218] See Lewis, above n 155, 405–7.

[219] Robert Baxt, 'Editorial' (2009) 27 *Company and Securities Law Journal* 5, 6.

[220] James Eyers, 'ASIC Leniency for Business Failure', *The Australian Financial Review* (Sydney), 28 April 2009, 60, cited in Neilson, above n 135, 22; See also *Corporations Act* s 588J.

[221] *Corporations Act* ss 588M–588U; See also Neilson, above n 145, 22–23.

[222] *Corporations Act* s 588H(5); This subsection necessarily excludes the possibility of trading through insolvency.

faith, in the best interests of the company, and with due care and diligence.[223] The first aspect of this proposal is problematic. The definition of 'necessary' is: 'needed to achieve a certain result or effect; requisite; absolutely essential.'[224] Thus, if a director of an insolvent company that requires one thousand dollars to return to solvency makes a successful investment with NPV of one hundred dollars, and a subsequent successful investment with NPV of ten thousand dollars, then the second investment would have been sufficient to have returned the company to solvency. Accordingly, the first investment was unnecessary, but this was unknowable *ex ante*.

Though the requirement is only that a director 'take reasonable steps to ensure' that debts are necessary, the meaning of this is unclear. Would a 'reasonable step' involve prediction of the likelihood of future, more profitable investments rendering a potential investment unnecessary? As this calculation is difficult if not impossible, and the concept of 'necessity' is undesirably restrictive of directorial discretion, the first aspect of Harris's proposed defence seems unsuitable. Finally, if the aim of reform is to 'reduce the threat of insolvent trading [liability] during a good faith restructuring attempt,'[225] then 'good faith' should be the criterion by which the existence of liability is determined. Surely it is sufficient to exculpate a director (otherwise acting in good faith) that an investment is objectively in the best interests of the company and creditors even if it later proves to have been unnecessary.[226]

3 *Moratorium*

[223] Harris, above n 90, 283.
[224] 'necessary', *Oxford English Dictionary* (Oxford University Press, 1933) Vol VII p 60.
[225] Harris, above n 90, 282.
[226] As in *Poolman* (2007) 65 ACSR 123.

Another option propositioned by the *Safe Harbour* paper is a moratorium on insolvent trading laws.[227] This would require the company to inform the market that the company was insolvent and intended to pursue a work-out.[228] Existing creditors could collectively bring the moratorium to an end if they considered that insolvent trading was against their interests.[229] This proposal, therefore, retains the *status quo*: it affords creditors primacy and superordination in insolvency that was not bargained for *ex ante*, and allows creditors to mandate a decision that may be beneficial neither for the company nor for other stakeholders. At least this aspect of the proposal is therefore undesirable; however, the requirement that a corporation proposing to restructure in insolvency inform the market would, as in American Chapter 11 proceedings,[230] allow prospective creditors to better evaluate risk and could therefore be beneficial.

VI CONCLUSION

The restructuring or continued trade of an insolvent corporation without formal insolvency proceedings is not always viable. When it is viable, however, and it is successfully carried out, 'it invariably produces a superior outcome for all stakeholders,'[231] yet such restructure is presently impossible in Australia because of the duty to prevent insolvent trading. Additionally, insolvent trading provisions have a particularly injurious effect in relation to solvent firms in financial difficulty. Beyond stripping such firms of effective leadership and the ability to take reasonable risks, the fear of personal liability

[227] *Safe Harbour Paper*, above n 2, 19.
[228] Ibid.
[229] Ibid.
[230] 11 USC §§ 1101–74.
[231] Letter from Law Council of Australia to Chris Bowen, 1 July 2009, 2–3 <http://www.lawcouncil.asn.au/shadomx/apps/fms/fmsdownload.cfm?file_uuid=3A035B95-1E4F-17FA-D292-DB5FC99438FA&siteName=lca>.

drives directors to prematurely and unnecessarily commence formal insolvency proceedings, leading ordinarily to the firm's demise.

Why, then, does personal insolvent trading liability exist? It is clear, of course, that where a director negligently, dishonestly, or fraudulently incurs debts, this will not be in the interests of stakeholders (particularly creditors) and in any event is likely motivated other than by the firm's best interest and continued solvency. Insolvent trading provisions therefore exist in part to prevent abuse of the corporate form.[232] Nevertheless, it will sometimes be in the company's best interests to continue trading, and a director may wish to pursue this course. The reason typically given for preventing continued trade—indeed the theoretical foundation of Pt 5.7B Div 3[233]—is that, were directors able to trade while insolvent in limited circumstances, the result would be creditor undercompensation and excessive risk-taking. It has been argued above that these rationales are baseless.

Where a default rule imposed in the absence of valid justification prevents the best possible outcome for stakeholders in certain situations and otherwise produces demonstrably deleterious effects, reform is necessary. Here, reform entails enabling directors to pursue commercially reasonable risks in the best interests of the company, which are reasonably likely to result in solvency. The most suitable rule, then, will retain the deterrent effect of personal liability in respect of *mala fide* insolvent trading, but excuse those instances wherein a director believes on reasonable grounds and is advised that the company is viable notwithstanding insolvency, and otherwise acts in good faith having taken into account the interests of the corporation and its stakeholders: in short, a business judgment rule. The

[232] Langford, above n 23, 536.
[233] *Corporations Act* pt 5.7B div 3.

amendment of the *Corporations Act* accordingly would prevent needless loss to corporate stakeholders, including creditors, and therefore is eminently sensible and advisable.

VII Appendix—Current and Former Insolvent Trading provisions

A *Corporations Act 2001* (Cth) s 588G

Director's Duty to Prevent Insolvent Trading by Company

588G (1) [Application]

This section applies if:

(a) a person is a director of a company at the time when the company incurs a debt; and
(b) the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time debts including that debt; and
(c) at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be; and
(d) that time is at or after the commencement of this Act.

588G (1A) [When debt incurred]

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

When debts are incurred		[operative table]
	Action of company	**When debt is incurred**
1	paying a dividend	when the dividend is paid or, if the company has a constitution that provides for the declaration of dividends, when the dividend is declared
2	making a reduction of share capital to which Division 1 of Part 2J.1 applies (other than a reduction that consists only of the cancellation of a share or shares for no consideration)	when the reduction takes effect
3	buying back shares (even if the consideration	when the buy-back agreement is entered

	is not a sum certain in money)	into
4	redeeming redeemable preference shares that are redeemable at its option	when the company exercises the option
5	issuing redeemable preference shares that are redeemable otherwise than at its option	when the shares are issued
6	financially assisting a person to acquire shares (or units of shares) in itself or a holding company	when the agreement to provide the assistance is entered into or, if there is no agreement, when the assistance is provided
7	entering into an uncommercial transaction (within the meaning of section 588FB) other than one that a court orders, or a prescribed agency directs, the company to enter into	when the transaction is entered into

588G (2) [Failure to prevent incurring of debt]

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

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

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

Note: This subsection is a civil penalty provision (see subsection 1317E(1)).

588G (3) [Insolvent trading offence]

A person commits an offence if:

(a) a company incurs a debt at a particular time; and

(aa) at that time, a person is a director of the company; and

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

(c) the person suspected at the time when the company incurred the debt that the company was insolvent or would become insolvent as a result of incurring that debt or other debts (as in paragraph (1)(b)); and

(d) the person's failure to prevent the company incurring the debt was dishonest.

588G (3A) [Absolute liability offence]

For the purposes of an offence based on subsection (3), absolute liability applies to paragraph (3)(a).

Note: For ***absolute liability***, see section 6.2 of the *Criminal Code*.

588G (3B) [Strict liability offence]

For the purposes of an offence based on subsection (3), strict liability applies to paragraphs (3)(aa) and (b).

Note: For ***strict liability***, see section 6.1 of the *Criminal Code*.

588G (4) [Civil penalty provisions]

The provisions of Division 4 of this Part are additional to, and do not derogate from, Part 9.4B as it applies in relation to a contravention of this section.

SECTION 588H DEFENCES

588H (1) [Defences to civil proceedings]

This section has effect for the purposes of proceedings for a contravention of subsection 588G(2) in relation to the incurring of a debt (including proceedings under section 588M in relation to the incurring of the debt).

588H (2) [Reasonable grounds to expect company solvent]

It is a defence if it is proved that, at the time when the debt was incurred, the person had reasonable grounds to expect, and did expect, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

588H (3) [Reliance on other person]

Without limiting the generality of subsection (2), it is a defence if it is proved that, at the time when the debt was incurred, the person:

(a) had reasonable grounds to believe, and did believe:

   (i) that a competent and reliable person (the ***other person***) was responsible for providing to the first-mentioned person adequate information about whether the company was solvent; and

(ii) that the other person was fulfilling that responsibility; and

(b) expected, on the basis of information provided to the first-mentioned person by the other person, that the company was solvent at that time and would remain solvent even if it incurred that debt and any other debts that it incurred at that time.

588H (4) [Illness, etc]

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

588H (5) [Reasonable steps to prevent incurring of debt]

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

588H (6) [Relevant matters]

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

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

(b) when that action was taken; and

(c) the results of that action.

Corporations Act 2001 (Cth) s 1318

Power to Grant Relief

1318 (1) [Relief in relation to existing proceedings]

If, in any civil proceeding against a person to whom this section applies for negligence, default, breach of trust or breach of duty in a capacity as such a person, it appears to the court before which the proceedings are taken that the person is or may be liable in respect of the negligence, default or breach but that the person has acted honestly and that, having regard to all the circumstances of the case, including those connected with the person's appointment, the person ought fairly to be excused for the negligence, default or breach, the court may relieve the person either wholly or partly from liability on such terms as the court thinks fit.

1318 (2) [Relief in relation to anticipated proceedings]

Where a person to whom this section applies has reason to apprehend that any claim will or might be made against the person in respect of any negligence, default, breach of trust or breach of duty in a capacity as such a person, the person may apply to the Court for relief, and the Court has the same power to relieve the person as it would have had under subsection (1) if it had been a court before which proceedings against the person for negligence, default, breach of trust or breach of duty had been brought.

1318 (3) [Trial by jury]

Where a case to which subsection (1) applies is being tried by a judge with a jury, the judge after hearing the evidence may, if he or she is satisfied that the defendant ought pursuant to that subsection to be relieved either wholly or partly from the liability sought to be enforced against the person, withdraw the case in whole or in part from the jury and forthwith direct judgment to be entered for the defendant on such terms as to costs or otherwise as the judge thinks proper.

1318 (4) [Persons entitled to relief]

This section applies to a person who is:

(a) an officer or employee of a corporation; or

(b) an auditor of a corporation, whether or not the person is an officer or employee of the corporation; or

(c) an expert in relation to a matter:

    (i) relating to a corporation; and

    (ii) in relation to which the civil proceeding has been taken or the claim will or might arise; or

(d) a receiver, receiver and manager, liquidator or other person appointed or directed by the Court to carry out any duty under this Act in relation to a corporation.

1318 (5) [Aboriginal and Torres Strait Islander corporation]

This section does not apply to a corporation that is an Aboriginal and Torres Strait Islander corporation.

Note: Similar provision is made in relation to Aboriginal and Torres Strait Islander corporations under section 576-1 of the *Corporations (Aboriginal and Torres Strait Islander) Act 2006*.

Corporations Law s 592

Incurring of Certain Debts; Fraudulent Conduct

592 (1) Where:

(a) a company has incurred a debt before the commencement of Part 5.7B;

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

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

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

(iii) 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) 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.

592 (3) Proceedings may be brought under subsection (1) for the recovery of a debt whether or not the person against whom the proceedings are brought, or any other person, has been convicted of an offence under subsection (1) in respect of the incurring of that debt.

592 (4) In proceedings brought under subsection (1) for the recovery of a debt, the liability of a person under that subsection in respect of the debt may be established on the balance of probabilities.

592 (5) Where subsection (1) renders a person or persons liable to pay a debt incurred by a company, the payment by that person or either or any of those persons of the whole or any part of that debt does not render the company liable to the person concerned in respect of the amount so paid.

592 (6) Where:

(a) a company has done an act (including the making of a contract or the entering into of a transaction) with intent to defraud creditors of the company or of any other person or for any other fraudulent purpose; and

(b) the company was at the time when it does the act, or becomes at a later time, a company to which this section applies; any person who was knowingly concerned in the doing of the act with that intent or for that purpose contravenes this subsection.

592 (7) A certificate issued by the proper officer of an Australian court stating that a person specified in the certificate:

(a) was convicted of an offence under subsection (1) in relation to a debt specified in the certificate incurred by a company so specified; or

(b) was convicted of an offence under subsection (6) in relation to a company specified in the certificate; is, in any proceedings, *prima facie* evidence of the matters stated in the certificate.

592 (8) A document purporting to be a certificate issued under subsection (7) shall, unless the contrary is established, be deemed to be such a certificate and to have been duly issued.

Companies Act 1981 (Cth) s 556

Offences Relating to Incurring of Debts or Fraudulent Conduct

556 (1) If:

(a) a company incurs a debt, whether within or outside the Territory;
(b) immediately before the time when the debt is incurred:
   (i) there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or
   (ii) there are reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and
(c) the company is, at the time when the debt is incurred, or becomes at a later time, a company to which this section applies;

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

Penalty: $5,000 or imprisonment for 1 year, or both.

556 (2) In any proceedings against a person under subsection (1), it is a defence if the defendant proves:

(a) that the debt was incurred without his express or implied authority or consent; or
(b) that at the time when the debt was incurred, he 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.

556 (3) Proceedings may be brought under subsection (1) for the recovery of a debt whether or not the person against whom the proceedings are brought, or any other person, has been convicted of an offence under subsection (1) in respect of the incurring of that debt.

556 (3A) In proceedings brought under subsection (1) for the recovery of a debt, the liability of a person under that subsection in respect of the debt may be established on the balance of probabilities.

556 (4) Where subsection (1) renders a person or persons liable to pay a debt incurred by a company, the payment by that person or either or any of those persons of the whole or any part of that debt does not render the company liable to the person concerned in respect of the amount so paid.

556 (5) If:

(a) a company does any act (including the making of a contract or the entering into of a transaction) with intent to defraud creditors of the company or of any other person or for any other fraudulent purpose; and

(b) the company is at the time when it does the act, or becomes at a later time, a company to which this section applies; any person who was knowingly concerned in the doing of the act with that intent or for that purpose is guilty of an offence.

Penalty: $10,000 or imprisonment for 2 years, or both.

556 (6) A certificate issued by the proper officer of a court stating that a person specified in the certificate:

(a) was convicted of an offence under subsection (1) in relation to a debt specified in the certificate incurred by a company so specified; or

(b) was convicted of an offence under subsection (5) in relation to a company specified in the certificate; is, in any proceedings, *prima facie* evidence of the matters stated in the certificate.

556 (7) A document purporting to be a certificate issued under subsection (6) shall, unless the contrary is established, be deemed to be such a certificate and to have been duly issued.

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