



Submission

Review of Sanctions in Corporate Law

15 June 2007

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Introduction

1. We refer to the Review of Sanctions in Corporate Law discussion paper (“the discussion paper”) and thank you for the opportunity to comment.

2. The Insolvency Practitioners Association is the leading professional organisation within Australia for specialists practising in corporate and personal insolvency. We estimate that we represent over 80% of actively practising registered liquidators.

3. The IPA’s main interest lies in the areas of the application of a general defence to the insolvent trading provisions (paragraphs 3.13 to 3.15 of the discussion paper, section A of this submission) and the obligation to keep financial records (paragraphs 3.27 to 3.31, section B of this submission). As such we focus our comments on those sections of the paper. However, the IPA also makes general comment on penalties and procedures (section C of this submission).

4. We note that Treasury invites submissions from interested parties that address, but need not be limited by, the issues raised in the paper. The IPA accordingly makes this broad based submission on what we see as the insolvency and reconstruction issues raised. Those issues have been the subject of close discussion within the IPA and a range of views has been expressed. At one end of the spectrum, there is a view that the existing insolvent trading provisions are inadequate (based in part on the fact that there are in fact few insolvent trading claims successfully brought). Further, that the insolvent trading laws have no real impact on a person’s willingness to become a director, indeed, in the case of small business enterprises, the appointees will in fact be directors of their own company. In any event, legitimate asset holding strategies give directors adequate protection. In the case of larger enterprises, a view has been expressed that when people consider whether or not they will accept an appointment as a director, their major concerns relate to the monetary returns they expect, the people they will be working with, the industry the business is in, and their individual skill set. Only then may there be some risk return analysis no different from any investment decision. There are also views that the present restructuring opportunities through Part 5.3A are adequate with little evidence supporting the assertion that some companies unnecessarily go into voluntary administration.

5. At the other end of that spectrum, there are views of IPA members that while the existing Part 5.3A regime is adequate for its purposes, there needs to be an alternative business rescue mechanism which would allow practitioners to assist in restructurings either as a chief restructuring officer or as an adviser to the Board. In any such regime, liability for insolvent trading would need to be more limited. It would not be incompatible with such a regime that there be tighter responsibilities imposed on directors in terms of what we suggest as a financial judgment rule.

6. The IPA submission takes a course that steers between these two views, acknowledging that each have their merits.



Executive Summary

7. The IPA makes submissions on the application of a general defence to the insolvent trading provisions and on the obligation to keep financial records. The IPA also makes general comment on penalties and procedures.

8. The IPA says that reasons put forward in the support of insolvent trading type provisions have merit and that such provisions are required. It is appropriate that *financial irresponsibility* is discouraged and those able to avail themselves of protection under the limited liability concept should be made personally liable when they *abuse* the concept. The law has to achieve a *balance* between the protection of bona-fide creditors, on the one hand, and ensuring that directors (on behalf of their companies) are not totally discouraged from taking *appropriate* business risks, on the other hand.

9. The IPA says that a balance should be made between the negative impact of the present law discouraging people from becoming directors, causing directors to become more risk averse, encouraging premature commencement of formal insolvency regimes; with the need to ensure that directors' protection under the principle of limited liability is not abused, that commercial morality is not undermined, and that directors are deterred from financial irresponsibility.

10. The IPA therefore considers that the insolvent trading provisions be retained but that they should be altered to give some legal protection to those directors trying to effect a restructuring of their company. This change in the law as the IPA proposes can achieve a balance between protection of creditors and directors taking appropriate business risks.

11. The IPA canvasses three broad options that it considers are available to achieve this balance, with a recommendation that option 11.3 be adopted. These are:

11.1 The adoption of "the UK position", where directors will be personally liable only if they "knew, or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation"; and they did not take "every step with a view to minimising the potential loss to the company's creditors". That is, to allow directors to continue to lawfully trade, even past the point of insolvency, with liability only being later imposed if a position is reached when the directors should have realised that the position of the creditors would likely deteriorate from that position onwards and the company would proceed into liquidation.

11.2 The application of the general defence to the insolvent trading regime; that is a defence that will relieve directors of liability for decisions made where they act in a bona fide manner; within the scope of the corporation's business; reasonably and incidentally to the corporation's business; and for the corporation's benefit. The IPA considers that the proposed general defence is not appropriate to achieve the objective of director/creditor balance in the context of insolvency.

11.3 The adoption of a "financial judgment rule", as a variation of the existing business judgment rule, that would, *inter alia*, apply the requirements of the business judgment rule (but remove the requirement for the director to not have a material personal interest in the subject matter of the judgment) and add two requirements, that the directors had regard to the interests of creditors and that the company had maintained proper financial records.



12. The IPA considers that penalties need to be structured in such a way that they encourage compliance by directors with their obligations to maintain financial records and deter non-compliance. Penalties need to be imposed on the directors, rather than the company, and as compensation for the creditors. Penalties should be consistently applied. Custodial sentences in addition to a financial penalty are appropriate.

13. The law concerning maintenance of financial records is a minimum requirement for any trading entity, particularly in monitoring the entity's solvency, and the law concerning that should be maintained. The IPA's proposed financial judgment rule, and its proposed stricter enforcement and higher penalties for existing provisions, go to support the application of that law.

14. The IPA agrees that there is scope in corporate law for administrative sanctions to apply to breaches of low level record keeping and reporting provisions, and that specifying the maximum penalty within a provision in the *Corporations Act* would improve understanding and clarity of the offence provisions.





Section A - Application of a general defence to the insolvent trading provisions

A.1 Insolvent trading in Australia

15. Section 588G of the *Corporations Act* seeks to impose a high standard of conduct on directors requiring them to maintain an awareness and continual assessment of their company's financial position and solvency. Further, it requires a director to be mindful of their duty to prevent any additional debts from being incurred if the company is unable to meet its debts as and when they fall due.¹

16. The duty imposed by s 588G was introduced into the law on the recommendation of the Harmer Committee², whose report spoke of the need for a 'positive duty' owed to the company to be imposed to prevent the company from engaging in insolvent trading, thus focussing on the 'real abuse' of directors 'permitting the company to trade after a point where, on an objectively considered basis, the company is unable to pay its debts'³.

17. The focus of s 588G is therefore on requiring directors to act proactively to prevent debts being incurred immediately upon the insolvency of the company arising.

18. The four main elements of s 588G are:

- i. the person was a director at the time when the company incurs a debt(s)⁴;
- ii. the company was insolvent at the time or became insolvent by incurring that debt, or by incurring debts including that debt; and
- iii. at the time there were reasonable grounds for suspecting that the company is insolvent or would so become insolvent; and
- iv. by failing to prevent the incurring of the debt, the director contravenes section 588G(2) where at the time the director was aware that there are such grounds for suspecting the company's insolvency, or a reasonable person in a like position in the company would have been so aware.

19. If the elements in s 588G are proved, a director can be absolved from liability under any one of the four statutory defences contained in section 588H. These are:

- i. there were reasonable grounds to expect the company was solvent;
- ii. there were reasonable grounds to rely on the information provided by another person;
- iii. at the time the debts were incurred, the director can establish illness or other good reason;
- iv. the director took all reasonable steps to prevent the incurring of the debt(s).

20. Further, section 1317S allows a court to provide relief from liability to a director in circumstances where the director has acted honestly or ought fairly to be excused from the contravention.

¹ 'Coburn's Insolvent Trading', LBC 2nd ed 2003, Coburn N, p 3

² The Law Reform Commission, General Insolvency Inquiry, Report No 45 ('Harmer Report'), 1988

³ Harmer Report [280].

⁴ This can include paying a dividend or issuing shares: s 588G(1A).



A.2 Proposal for the introduction of a general defence

21. The discussion paper proposes the introduction of a general defence to the insolvent trading provisions. The provision would relieve directors of liability for decisions made where they act:

- in a bona fide manner;
- within the scope of the corporation's business;
- reasonably and incidentally to the corporation's business; and
- for the corporation's benefit.

22. Various issues are raised in the discussion paper, asking, in the context of insolvent trading, whether the introduction of a general defence would improve the balance between discouraging undesirable conduct and promoting responsible risk taking; whether the general defence should apply to the 'core' duties in section 588G, and sections 180-183; whether an extension of the general defence to the insolvent trading provisions would encourage insolvent trading and thereby be to the detriment of creditors, and whether there would then be a need to clarify the interaction of the general defence with the existing defences.

23. The IPA notes that submissions were previously sought on the merits of a general protection for directors and other officers in the Government's consultation paper, *Corporate and Financial Services Regulations Review* (the CFSR review).⁵ In relation to insolvency, the paper notes that some submissions opposed any extension of the protection beyond the existing business judgment rule in section 180, particularly in relation to the duty not to trade while insolvent.

24. We note that the discussion paper says that some submissions to the CFSR review raised a concern that the general defence may in fact facilitate insolvent trading, countered by other submissions

“suggesting that the general defence would be difficult to establish because a director would be expected to know when their company has reached or is nearing insolvency, or at least when they should seek expert assistance in relation to its financial standing. A director who continued to incur debts in the face of insolvency could not be said to be acting in a ‘bona fide manner’ or ‘reasonably and incidentally to the corporation’s business’”.

25. The IPA addresses this issue in its submissions below. We consider there is a case for saying, as the discussion paper comments, that

“many directors who take risks when their company is close to financial insolvency do so in the genuine belief that by taking the appropriate investment or other decision, the company may be able to trade out of its financial difficulties [reference omitted] and should therefore have the benefit of additional legal protections”.

26. While the IPA does not disagree with a contrary view that the early transfer of control of a company to an external administrator may in many instances best protect the interests of creditors in these circumstances, the IPA also considers there should be some latitude and flexibility allowed to directors. An application of the current law can result in a premature decision to place a company into a formal insolvency administration which may not in fact be in the company's, or the creditors', interests.

⁵ Corporations and Financial Services Regulation Review, Australian Government, April 2006.



The value destruction to a company and its stakeholders of appointing a voluntary administrator which, even if technically insolvent, might otherwise have been able to implement an informal restructure can be very significant, and may in some instances, actually decrease the prospects of the company's rehabilitation.⁶

27. Having said this, the IPA is not aware of any statistical or economic analysis of companies which might have been regarded as having entered into the voluntary administration process prematurely, or of estimates of the value destruction caused to companies which might, but for the insolvent trading provisions, have been able to pursue (or most likely continue to pursue) informal restructuring routes.⁷

28. These issues are addressed generally in the remainder of this submission.

A.3 Is there a need in Australia for insolvent trading provisions?

29. Before considering whether the insolvent trading provisions in Australia require amendment or the introduction of a general defence, the IPA believes that it is appropriate to consider whether insolvent trading provisions are required at all.

30. There is extensive literature that queries whether the insolvent trading provisions are necessary or effective from an economic perspective.⁸ The IPA makes no submission from those economic perspectives beyond drawing Treasury's attention to them. We do make the point that there is a general assumption that insolvent trading laws are effective and needed and while the IPA does not challenge that assumption, it notes that there is little in the way of collected data to test that assumption. There are statistics on the number of successful insolvent trading actions, both civil and criminal, and successful contested decisions are reported. We do know from our members that many claims are made, and settled, to the benefit of the creditors of the companies concerned, but we do not know the true extent of such claims. Nor can we really assess the extent to which the prospect of an insolvent trading claim may positively influence director behaviour in the conduct of their company's failing business. We can surmise that a director whose company has the prospect of entering a deed of company arrangement may offer more moneys to creditors through his or her own funds if that means, as it invariably does, that no claim for insolvent trading will be brought.⁹

31. It is also noted that while the threat of insolvent trading charges may well be real for many directors, there are often other legal consequences at play, in particular the directors penalty notice regime under the *Income Tax Assessment Act 1936*. Receipt of a penalty notice will often be of more immediate and pressing a concern for a director, prompting insolvency action, than the more uncertain concern of incurring

⁶ One particular issue arises when there are cross default provisions in companies in corporate groups; that is, the premature appointment of a voluntary administration in one company may trigger insolvency events for an entire corporate group. These problems can be compounded when it is a multinational group.

⁷ Some general analysis, although now dated, is contained in *Business Failure and Change: An Australian Perspective*, Productivity Commission, December 2000 – www.pc.gov.au.

⁸ See *Company Directors' Liability for Insolvent Trading*, ed Ramsay I, CCH 2000, Part II; 'Insolvency Law and Policy', Duns J, OUP, 2002, pp 109-111. See also 'Business Failure and Change: An Australian Perspective', Productivity Commission, December 2000 at p 85; and 'Company Directors' Responsibilities to Creditors', Routledge-Cavendish, 2007 by Keay, A, Part E.

⁹ See however the comment in 'Should directors be pursued for insolvent trading' (2005) 4 *Insolv LJ* 163, Anderson C and Morrison D, at 171 and fn 64, as to the claimed impact of the decision in *ASIC v Plymin (No 1)* (2003) 46 ACSR 126 (the 'Waterwheel' decision) on directors' minds.



debts whilst insolvent and being later found personally liable for them.¹⁰ An important aspect of deterrence is the immediacy and likelihood of a sanction being imposed. Insolvent trading can be for many directors a more distant threat in terms of deterring corporate misconduct.¹¹

32. Nevertheless, while the IPA says that it is hard to assess the effectiveness of the insolvent trading laws on corporate conduct at the time of a company's financial difficulties, the IPA also says that insolvent trading is a useful and real claim that can be brought against directors once the company is in liquidation. That presupposes that directors should be held accountable for the damage to the company, and its creditors, that insolvent trading can cause. The IPA considers that such accountability is required in appropriate cases. The benefit that flows is in the nature of the impact of general deterrence on company directors, and of the financial recompense to unsecured creditors¹² directly from those who have been found to have contributed to their losses.

33. Accepting that insolvent trading provisions are at least necessary from an economic perspective, numerous commentators have put forward objections to insolvent trading type provisions. Keay¹³ summarises these objections as including that:

- they discourage people from becoming directors;
- they cause directors to become more risk adverse;
- the courts lack experience and ability in this area;
- creditors should take responsibility for protecting themselves;
- they encourage premature commencement of formal insolvency regimes;
- directors are unfairly penalized; and
- there is an increase in transaction costs.

34. The IPA consider that of these, the real concerns are the value destruction from a premature appointment, and the deterrence for skilled people to take up positions as directors to assist companies which may be in financial difficulties.

35. Equally, there are commentators that support insolvent trading type provisions and Keay also summarises these reasons as follows:

- it is unreasonable to expect creditors to contract by way of including protective measures;
- there is a disparity of bargaining power;
- such provisions foster a sense of commercial morality;
- they ensure distributional fairness so that directors do not directly or indirectly transfer wealth from creditors to shareholders;
- such provisions act as a deterrent to directors from following risky courses of action or passively acquiescing to risky actions proposed by other directors; and

¹⁰ 'Making company directors liable: a comparative analysis of wrongful trading in the United Kingdom and Insolvent Trading in Australia', (2005) 14 Int Insolv Rev 27, Keay R & Murray M, at 39-40.

¹¹ The extent to which the Australian Taxation Office uses what is an invaluable insolvency remedy, under Part VI, Division 9 of the *Income Tax Assessment Act 1936*, available to no other creditor, including regulators, is a separate issue. The IPA does say that it is in all creditors' interests if a company in default of its tax liabilities is given what is in effect a statutory ultimatum by the ATO to attend to its financial and tax obligations.

¹² *Corporations Act* s 588Y(1)

¹³ 'Wrongful trading and the liability of company directors: A theoretical perspective' (2005) 25 Legal Studies 431.



- such provisions can achieve a balance between protection of bona-fide creditors and directors taking appropriate business risks.

36. The courts have long recognised that insolvency presents special problems for creditors. The judgment of Street CJ in *Kinsela v Russell Kinsela Pty Ltd*¹⁴ articulates this:

"In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise... But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending liquidation, return to solvency or the imposition of some alternative administration."

37. Similar comments were more recently made in *Downey v Crawford*¹⁵ where Weinberg J observed that "when a company is insolvent, directors must have regard to the interests of creditors as well".

38. The decision in *Kinsela* provides explanation and justification for creditor protection upon corporate insolvency. Shareholder's funds have been dissipated and it is now the creditors' funds which are at risk. However, as insolvency approaches, this problem is exacerbated. This is because shareholders now have an even more powerful incentive to engage in risk investments given that most of their funds have been dissipated yet there is the possibility of a "bonanza payoff that will prevent insolvency."¹⁶

39. It should be noted however that while the law says that directors owe a duty to the company to consider the interests of its creditors in the circumstances of the company's insolvency, that duty is not owed directly to, nor is it enforceable at the instance of, creditors.¹⁷ Nevertheless, the IPA says that the insolvency of a company, or impending insolvency, does require the directors to have regard to broader interests than when the company is trading successfully. It is for this reason that the IPA says that any general defence, such as is proposed, if it were to be considered at all, should

¹⁴ (1986) 4 NSWLR 722 at 730.

¹⁵ (2004) 51 ACSR 182. That was in fact a case where a claim was made that directors had breached their duty to the company by appointing administrators, which itself depended on whether the directors genuinely believed that the company was insolvent or likely to become so, and whether that belief was reasonable in the circumstances. "That in turn [depended] largely upon whether they took adequate steps to satisfy themselves that the statutory requirements were met before resolving to appoint [the] ... administrator", at 218 [196].

¹⁶ 'Insolvent Trading – An Empirical Study', James P, Ramsey I and Polat S (2004) 12 *Insolv LJ* 210 at 219 fn 35 quoting R Grantham, "The Judicial Extension of Director's duties to creditors" [1991] *Journal of Business Law* 1, 3 itself quoting Coffee (1986) 85 *Michigan Law Review* 1, 61.

¹⁷ *Spies v R* (2000) 201 CLR 603. Insolvency does create more complexity for directors. In 'What directors need to consider before calling in an administrator – and it's not just insolvency' (2006) 24 *C&SLJ* 7, D'Angelo N concludes that, in considering the conflict between the directors duties to act in the best interests of the company and their potential personal liability for insolvent trading, "even where directors have formed the opinion that the company is insolvent or likely to become so at some future time, and even where the directors are at risk of personal liability for insolvent trading, they can not disregard their normal duties to the company." In other words, those directors need to make an assessment whether or not the company would be better off in a voluntary administration or not, even though the company is insolvent. This creates a very difficult conflict of duties, which the IPA considers could be resolved by the proposed amendments.



not be in a form that purported to cover both solvent and insolvent situations. We consider that additional elements would need to be added to such a defence in the case where the company was insolvent or approaching insolvency. Those elements would need to seek to preserve the protection available to creditors available under the current law.

40. It is the IPA's general position that the reasons put forward in the support of insolvent trading type provisions have merit and that such provisions are required. It is appropriate that *financial irresponsibility* is discouraged and those able to avail themselves of protection under the limited liability concept should be made personally liable when they *abuse* the concept. The law has to achieve a *balance* between the protection of bona-fide creditors, on the one hand, and ensuring that directors (on behalf of their companies) are not totally discouraged from taking *appropriate* business risks, on the other hand.¹⁸ Indeed, the IPA considers directors should be encouraged to act in a way that provides the best outcome for the stakeholders of a financially troubled company, and that certainly will not always involve the commencement of a formal insolvency process.¹⁹

A.4 The effect on informal restructuring

41. A risk identified with insolvent trading provisions is that they can have the effect of making directors unduly risk adverse and prevent them taking proactive measures, by way of informal restructuring, in order to try to save the company. This is said to have two consequences. First, it may be that provisions such as section 588G have the effect that directors will too quickly put companies into voluntary administration or liquidation for fear of personal liability, even in circumstances where it may be possible for a company to trade out of its financial difficulties by way of an informal restructuring of the company. Second, it is said that provisions such as section 588G may deter qualified people from becoming or remaining company directors and the provisions may be having this effect precisely in relation to those companies in financial difficulty which require the best possible expert assistance from their directors.²⁰

42. Bearing in mind our comment that there is a lack of hard data, anecdotal evidence from our members suggests that the above two consequences are applicable and that there is a need in Australia to review the insolvent trading regime in this light.

A.4.1 Acting too quickly

43. The duty imposed under s 588G allows little latitude to a director; once a company is insolvent and accepting that there are apparent or reasonable grounds for so suspecting, the director has little option but to put the company into a formal insolvency arrangement. The only latitude is that the test of insolvency, based on cash flow, and often qualified by creditor concessions and availability of access to third party funds, itself allows some flexibility in determining whether the company is in fact insolvent. However that uncertainty in itself may cause a conservative and concerned director to prematurely regard the company as insolvent, and act precipitously.

¹⁸ S Schwarcz in "Rethinking a Corporation's Obligations to Creditors" (1996) 17 Cardozo Law Review 647, 673

¹⁹ 'What directors need to consider before calling in an administrator – and it's not just insolvency' (2006) 24 C&SLJ 7, D'Angelo N.

²⁰ 'Insolvent Trading – An Empirical Study', James P, Ramsey I and Polat S (2004) 12 Insolv LJ 205.



44. The IPA submits that while the Part 5.3A process is generally a useful regime to deal with a company's insolvency, the appointment of a voluntary administrator (let alone a liquidator) to a company that has a viable core business will generally destroy value for all stakeholders. The administration process involves the attention to detailed proscribed procedures under the Act and Regulations, including formal meetings of creditors and written reports, and often involves applications to the court for procedural assistance. Apart from the time and cost of this process, there are the effects of the stigma of the company's insolvency on its customers and suppliers and its general commercial prospects; the costs to the company involved in replacing management by insolvency practitioners; and the ability of the company's suppliers to terminate contracts.

45. This is not to say that voluntary administrations and other formal insolvency engagements do not have their place in Australia's insolvency system. The IPA supports the retention of the regime under Part 5.3A and the recent legislative refinements proposed to it. However, what is lacking is a system which encourages directors to take appropriate and practical steps to restructure the affairs of their company that has a core business and reasonable prospects, outside of the formal insolvency regime, without undue risk of personal liability.

46. For a company that may be insolvent but has a core business, that is, one that is worth preserving and ultimately enhancing and there appears to be a reasonable plan going forward to turn the business around, then the IPA considers that the law should allow directors, in appropriate circumstances, to try to salvage the company. That process in itself will often require professional insolvency advice. The IPA does not consider that 'reasonable' directors in such cases should be obliged to resign or appoint voluntary administrators prematurely because of the risk of being held liable for insolvent trading. Indeed the present law means that the process of engaging in an informal restructuring can heighten the risk of being prosecuted or sued for insolvent trading in the event that the informal restructuring attempts are unsuccessful. By the directors engaging in a process with stakeholders in attempting an informal restructure (which would usually be some kind of 'standstill', or extension of terms by key financiers or creditors) they may be providing further evidence that the company was insolvent at that time. That in itself is a discouragement for directors to even consider an informal restructure.

47. We consider that s 588G coupled with s 436A (which allows Part 5.3A to be invoked in the case of the 'likely' insolvency of the company) can sometimes provide an unhealthy incentive for directors to choose the formal insolvency option rather than to consider an informal restructuring.²¹ Instead, the law should allow, in appropriate circumstances, reasonable directors to remain and implement a turnaround plan with the prospect of preserving and enhancing business value for all stakeholders, without undue personal risk.

48. The concept of informal restructurings is one familiar to the IPA's members. It will often involve the trade creditors (who are central to the company's on-going business) being paid in full with only the major creditors and financiers being involved in determining how to provide sufficient accommodation to allow the company to continue in some restructured state. In some cases, successful negotiations for further

²¹ The IPA notes that the 2004 Joint Committee on Corporations and Financial Services recommended lowering the threshold 'insolvency test' to allow a debtor who merely 'may become insolvent' to enter voluntary administration.



financial accommodation and/or extension of trading terms by agreement will mean that the company will cease to be insolvent.

A.4.2 Deterring qualified directors

49. The IPA makes a reasonable assumption that strict insolvent trading laws do provide some disincentive for persons to become or remain directors, if only because the business community must be aware of the potential for personal liability in such circumstances.²² Both ASIC, and the courts, speak severely of the obligations of directors and the potential for liability. In *Tourprint v Bott*²³, the Court opened its judgment with the comment that:

“This case is a cautionary tale for company directors, especially in the small business sector. The defendant, Geoffrey Bott, joined the board of directors of the plaintiff company less than a year before it went into voluntary administration. He received no remuneration as a director. For at least a substantial part of that period, the company was hopelessly insolvent. For the reasons I shall give, the consequence for the defendant is that he is liable to the company’s liquidator under the insolvent trading provisions of the Corporations Law in a sum in excess of \$500,000, plus interest.”

50. There are similar comments in other cases.²⁴

51. As well, ASIC’s website and media releases continually emphasise the dangers of liability for insolvent trading, for example “04/200 Insolvent trader sentenced to jail”, and “02/462 Tasmanian directors charged with 265 counts of insolvent trading”. ASIC has set up and actively promoted its National Insolvent Trading Program with one aim being to “make directors of potentially insolvent companies aware of their responsibilities and the implications of continued trading if they know they’re insolvent”.

52. The IPA accepts that the business community is generally well aware of the dangers of trading whilst insolvent and IPA’s members are cognisant of the need to draw that to the attention of directors, and creditors, in their work.

A.5 Three options – the UK position, the general defence, or a refined business judgment rule

53. The IPA supports the insolvent trading laws in general. But the IPA considers that the law should achieve a better balance than now applies between the rights of the company to have the space and time to restructure without formal intervention, and the protection of creditors.

54. We will now consider the options that the IPA considers are available to achieve this balance.

²² Useful analysis of the extent of directors’ *knowledge* is contained in ‘Company directors’ knowledge of the insolvent trading provisions’ 91998) 6 Insolv LJ 186, Mescher B. See also ‘Insolvent trading: the final word?’, The Baxt Report, May 2004, Baxt R.

²³ (1999) 17 ACLC 1543

²⁴ See also *Woodgate v Davis* (2002) 20 ACLC 1,314 at 1,321



55. The IPA wishes to draw Treasury's attention to equivalent provisions in the UK from which guidance may be obtained²⁵ and which may be considered as an option. It then examines the existing Australian provisions, including the application of the general defence, and a refinement of the existing business judgment rule.

A.5.1 UK provisions

56. Section 214 of the *Insolvency Act* 1986 (UK) provides for the offence of 'wrongful trading'. There are elements of that provision that may be useful to consider in the Australian context. Under that section, a director is liable if he or she knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation.

57. The principle of wrongful trading was introduced in the *Insolvency Act* to complement the offence of fraudulent trading (that is, where the company's business has been carried on with intent to defraud creditors or for any fraudulent purpose) or rather to address the limitations of that offence. Fraudulent trading will normally be established where the directors of a company, knowing that it has no prospect of ever paying its debts, incur further debts.

58. Unlike fraudulent trading, wrongful trading needs no finding of 'intent to defraud' hence wrongful trading is a less serious, and more common offence than fraudulent trading, and is the claim usually brought by liquidators.

59. Section 214 provides that wrongful trading occurs when the directors of a company have continued to trade a company past the point when they:

- "knew, or ought to have concluded that there was no reasonable prospect of avoiding insolvent liquidation"; and
- they did not take "every step with a view to minimising the potential loss to the company's creditors".

60. The action can be taken only by the company's liquidator who may apply to the court for an order that any persons who were knowingly parties to the carrying on of the business are to be made liable to make such contributions to the company's assets as the court thinks proper.

61. In order to establish liability, the liquidator needs to demonstrate, on the balance of probabilities, that the directors continued trading the company beyond a point in time when they knew, or ought to have ascertained, that insolvent liquidation was inevitable. Insolvent liquidation is defined in balance sheet, not cash flow, terms.

62. As Keay notes²⁶, the words "wrongful trading" appear only in the notes to the section. He says that "the trading that offends against s 214 is, perhaps, better referred to as 'irresponsible' or 'illicit'." However, he also notes that the provision has

²⁵ See generally, 'Making company directors liable: a comparative analysis of wrongful trading in the United Kingdom and Insolvent Trading in Australia', (2005) 14 Int Insolv Rev 27, Keay R & Murray M. The IPA has not considered information in other jurisdictions but as to New Zealand, see 'Company Directors' Liability for Insolvent Trading', ed Ramsay I, CCH 2000, Part IV. Regimes range from that in the US, where in effect there is no insolvent trading liability without bad faith being proved, to, at the other extreme, the regime in Germany, where there are even more strict insolvent trading liabilities imposed on directors: see generally, 'Directors in the Twilight Zone II' INSOL International, 2005.

²⁶ 'Company Directors' Responsibilities to Creditors', Routledge-Cavendish, 2007 by Keay, A, at p 73 and 147.



been interpreted benevolently by UK courts, suggesting that there needs to be some element of failure of commercial morality for the director to be liable, beyond irresponsibility.

63. The UK law allows some distinction between skilled and unskilled directors. The facts that a director ought to have known are those which a reasonably diligent person having both the skill and experience possessed by a reasonable director, together with the skill and experience *actually possessed* by that individual: s 214(4) *Insolvency Act* 1986. That is, there is a two-fold test for knowledge. There is a general level of skill required for all directors under the first part of the test. Under the second, a higher standard of knowledge is required by those with specialist skills, such as in law or accounting. This principle has been applied in a case where an executive husband had to pay £210,000 to the liquidator compared with his non-executive wife's £50,000.²⁷

64. In contrast to Australia, it is not unlawful in the UK to continue trade a company while it is insolvent. Indeed in some situations, if the directors genuinely believe that the position will be turned around and the position of creditors will improve, it is the correct thing to do. The directors' actions will only constitute wrongful trading when a point is reached when the directors should have realised that the position of the creditors would likely continue to deteriorate and the company would proceed into liquidation.

65. It is at that point that the law requires a director to take immediate action in relation to the company's position, which would invariably be to seek immediate professional advice from an insolvency practitioner.

66. There is therefore a *blue sky* defence, that if the directors in good faith believed that the company was about to 'turn the corner', and things would soon improve, then they would not normally be held liable for continuing to trade. Liability would only attach when the company had no realistic prospect of avoiding insolvent liquidation.

67. In the UK, the court determines the contribution that it can require the director to pay. Traditionally this has been compensatory, rather than punitive. The starting point for assessing the appropriate amount is the difference between the net assets of the company at the date that the directors should not have traded beyond, and the net assets at the date of liquidation. The court however has wide discretion, and may award just a percentage of this.²⁸

68. There have been a number of articles in which the UK provision has been criticised and described as not living up to its initial expectations.²⁹ In comparing the UK and Australian provisions, Keay and Murray³⁰ acknowledge that while it is not possible to gauge the effect of threats of wrongful trading actions on directors, from a consideration of the case law it appears that the provision has been a 'paper tiger ... a view reflected in the business community'. The comment is made that besides the fact that s 214 actions appear to be few and far between, there is said to be no evidence

²⁷ *Re Brian D Pierson (Contractors) Ltd* (1999) BCC 26 and see 'Company Directors' Responsibilities to Creditors', Routledge-Cavendish, 2007 by Keay, A at 88-93.

²⁸ See *Re Brian D Pierson (Contractors) Limited* [1999] BCC 903 where the court awarded 70% of the fall in net assets on the basis of the judge's "guesstimate" that the 70% fall was due to the actions of the directors, with 30% being attributed to extraneous causes. See *Company Directors' Responsibilities to Creditors*, Routledge-Cavendish, 2007 by Keay, A, at p 100-101.

²⁹ See 'Company Directors' Responsibilities to Creditors', Routledge-Cavendish, 2007 by Keay, A.

³⁰ See 'Making company directors liable: a comparative analysis of wrongful trading in the United Kingdom and Insolvent Trading in Australia', (2005) 14 *Int Insolv Rev* 27, Keay R & Murray M, at 52-53. 'Company Directors' Responsibilities to Creditors', Routledge-Cavendish, 2007 by Keay, A also favourably compares the Australian provisions.



that directors' conduct has become more responsible as a consequence of the section. The authors suggest that there are difficulties with the section as to when it can be said there is no reasonable prospect of the company avoiding insolvent liquidation, and what constitutes 'every step' taken to minimise losses to creditors. The authors then go on to say that the provision would have been better focused on the 'insolvency' of the company, as the test as to when the provision applies. This is the test in Australia, which, while the authors acknowledge it is imprecise, is not, in their view, as imprecise as the test in s 214.

69. Despite concerns about the way that s 214 works in the UK, the IPA considers that an option in Australia would be, in trying to give directors some greater latitude to restructure their company outside the formal processes available under Part 5.3A, to introduce some elements of the UK law into the Australian insolvent trading provisions. This may be to remove the defining point of 'insolvency' in determining liability, or extend that time forward, or to provide a better defence to the existing provision.

70. The IPA considers that the positive side of this would be to free up directors to pursue a more enterprising restructuring without the concern that they might be held liable for insolvent trading; that is, that directors be permitted to trade, and incur debts, despite the company's insolvency, if there are some reasonable prospects that this will in fact restore the company's position.

71. Whatever refinements to the existing provisions are made, the IPA supports an evident purpose of both s 214 in the UK, and s 588G in Australia, that is, to regulate and control corporate conduct. In respect of s 214, Keay³¹ says that

“the wrongful trading provision was introduced in order to require directors to take some action to arrest their companies' slide into insolvency; directors were to be forced to engage in more rigorous monitoring of their companies' health. The section was designed ... to address the situation where directors can see that their company is in difficulty and they do nothing to protect creditors' interests”.

72. A similar philosophy supports section 588G. The section in its terms imposes a positive duty on the director to 'prevent insolvent trading', that is, to be proactive, when the company is insolvent, or may become insolvent by incurring a debt. It tries to ensure that directors will “engage in more rigorous monitoring of their companies' health” in order to anticipate and then know when insolvency occurs. The difference in Australia is that at that point the directors should immediately cease trading; in the UK, further steps can be pursued. Indeed the Australian law then goes further, by way of inviting the directors to seek the protection for their company and themselves under Part 5.3A. Any action by the director is, inter alia, to be assessed in terms of any decision by the director to appoint an administrator: s 588H(6). Indeed, an administrator may be appointed at an earlier time, when the company is only 'likely' to become insolvent and when the director could not possibly be held liable for insolvent trading.

³¹ 'Company Directors' Responsibilities to Creditors', Routledge-Cavendish, 2007 by Keay, A at p 76.



A.6.2 A defence for insolvent trading

73. The discussion paper introduces the concept of a general defence and the application of this defence to the insolvent trading regime.

74. The *Corporations Act* already includes a business judgment rule in section 180(2) which, at this time, operates in relation to the statutory duty of care and diligence in section 180 of the *Corporations Act* and equivalent duties at common law. That rule does not apply to insolvent trading. The requirements for the business judgment rule to apply to a particular business judgment include:

- making the judgment in good faith for a proper purpose;
- not having a material personal interest in the subject matter of the judgment;
- informing themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and
- rationally believing that the judgment is in the best interests of the corporation.

75. The *Corporations Act* goes on to state that the director's belief that the judgment is in the best interests of the corporation is rational one unless the belief is one that no reasonable person in their position would hold.

76. In this section of our submission we consider the benefits of introducing a further defence to insolvent trading. We specifically consider the merits of the general defence versus the business judgment rule and then reach a conclusion as to what we believe is an appropriate balance between the protection of creditors and allowing directors to take appropriate business risks.

A.6.2.1 General defence

77. It is the IPA's position that the proposed general defence is not appropriate to achieve the objective of director/creditor balance.

78. The phraseology used in the general defence is weaker than that used in the business judgment rule. The general defence has a greater focus on the rights of the company and it does not seek to include a requirement for the director to take informed advice. Even apart from circumstances of insolvency, it is not clear to us how the general defence and the business judgment rule could co-exist. We understand the business judgment rule to have been originally introduced to provide the sort of defence for directors that is the subject of Treasury's discussion paper, even though confined to the duties in section 180 in Chapter 2D.³² The IPA has not itself given any analysis to the effectiveness of that rule in relation to claims under section 180 but we are not aware that it has been found to be ineffective in its terms or application.³³

79. In the context of insolvency, the IPA considers that the general defence would be inappropriate.

³² And equivalent duties in law and equity. See 'Company Directors: Principles of Law and Corporate Governance', LexisNexis 2005, Austin, Ford & Ramsay, at 6.11.

³³ 'Company Directors: Principles of Law and Corporate Governance', LexisNexis 2005, Austin, Ford & Ramsay, at 6.6.



A.6.2.2 Financial judgment rule

80. It is the IPA's position that with some amendments, the business judgment rule could be effective in achieving the objective of director/creditor balance to which we have referred and which forms the basis of our submission.

81. In our opinion, it is not appropriate for one rule to apply in both solvent and insolvent situations because insolvency, or pending insolvency, brings to bear a different range of considerations. In particular, insolvency of a company requires directors to have regard to broader interests. As such, the IPA considers that a variation of the existing business judgment rule is necessary.

82. The following changes are required to the business judgment rule to render it suitable for application to the insolvent trading regime. In the context of insolvency, we refer to this rule as the "financial judgment rule". The existing business judgment rule should be varied by:

- removing the requirement for the director to not have a material personal interest in the subject matter of the judgment;
- introducing a concept of a duty owed to creditors; and
- making it dependent on the maintenance by the company of proper financial records.

83. We consider each of these amendments in more detail.

Remove the requirement for the director to not have material personal interest in the subject matter of the judgment

84. We agree with the opinion of Mr David Topp³⁴ that there is a fundamental conflict between the requirements of the business judgment rule and a director's own personal interests once a company is insolvent or near insolvent. Mr Topp writes:

"A director's obligation to ensure that a corporation does not trade whilst insolvent is one that meets with very severe sanctions, namely personal liability for that corporation's debts incurred while trading insolvently.

Logically therefore, the question begs: if a director of a corporation enduring actual or impending insolvency makes a business judgment of any sort, are they making that decision in the best interests of the corporation or in the best interests of themselves? And how can they make out the "do not have a material personal interest in the subject matter of the judgment" requirements when it is their personal solvency of itself that stands at risk of a section 588M prosecution, depending on the outcome of their business judgment?"

³⁴ "Government should take a closer look at corporate insolvency reforms", Topp, D, Lawyers Weekly, 11 May 2007, p 18.



Introducing a concept of a duty to creditors

85. As previously mentioned in this submission, directors owe a duty to consider the interests of creditors in the circumstances of the company's insolvency, although that duty is not enforceable at the instance of creditors.

86. When a company is insolvent or approaching insolvency, it is critical that when making business decisions, directors have the company's obligations to its creditors in mind. Incorporating this obligation into the financial judgment rule will ensure that this is the case.

87. We do not recommend that the current position, being that the right is not enforceable by creditors, be changed, but rather that there be a positive obligation for directors to look beyond the company to the wider group of stakeholders affected by the company's insolvency when making decisions.

88. The creditors are in effect being used as working capital after the date of suspected insolvency (be it either 'new' creditors, 'existing' creditors to whom the company increases its indebtedness to, or as is more likely, a combination of both). They are the stakeholders who bear the burden and risk (unless fresh cash is injected into the company) of funding continued trading by the company for the benefit of all stakeholders. This continued trading may facilitate a turnaround or instead, if unsuccessful, result in a formal insolvency appointment. If the directors ceased trading at the date of their suspected insolvency, this new debt would not have been incurred. This is the "loss or damage" (s 588M) suffered when there is a breach of s 588G. This issue also arises in the context of the directors' heightened responsibilities to maintain, and use, proper business records under what we propose as a financial judgment rule. It would be expected of directors that they have regard to the cash flow forecasts of the company in terms of its ability to meet both new and ongoing liabilities to creditors. This is explained further in paragraph 94 below.

89. As to cash flow, anecdotal evidence from IPA members suggests that without a cash injection, any restructuring attempt is more a matter of "moving pieces around a chessboard" as debt is moved from one group of creditors to another. Nevertheless there remains the valid turnaround option of securing a financier who is willing to convert short term debt to long term debt, or debt to equity. These are matters to be borne in mind by directors when seeking to rely on the financial judgment rule the IPA has proposed.

Making the availability of the financial judgment rule dependent on the maintenance of proper financial records

90. It is the IPA's opinion that a director would be unable to make a judgment in good faith and for a proper purpose if they do not have appropriate financial records on which to base that decision. As such, if it is proved that a company has failed to keep financial records as required by section 286, then a director should not be able to rely on the financial judgment rule.

91. There is precedent for the incorporation of a financial records requirement in the insolvency context. Section 588E(4) provides a rebuttable presumption of insolvency, in a recovery proceeding, where it is proved that the company has failed to keep financial records as required by section 286(1) or has failed to retain financial records for the period required by section 286(2). This presumption does not apply in relation



to a contravention of section 286(1) that is only minor or technical. Nor does it have effect if it is proved that:

- the contravention was due solely to someone destroying, concealing or removing the financial records of the company: and
- none of those financial records was destroyed, concealed or removed by the person; and
- the person was not in any way, by act or omission, directly or indirectly, knowingly or recklessly, concerned in, or party to, destroying, concealing or removing any of those financial records: s 588E(6).

92. The exceptions included in section 588E(6) would also be appropriate to be included in the financial records condition of the financial judgment rule.

93. There may be a case for this condition to be refined in the case of a company director relying upon it in the circumstances where the company is entering the 'twilight zone' and directors and their advisers are seeking protection from the insolvent trading laws. Directors could be required to demonstrate not only that records have been maintained but also that they have given consideration to the company's financial position and solvency when exercising their business judgement; for example, that they have considered the existing balance sheet, profit and loss and statement of cash flows and the projected financial statements that is anticipated will result from their decisions. However the requirement is framed, the IPA considers it has the added benefit of encouraging responsible business management, particularly in times of financial stress. The IPA considers that maintenance of good business and financial records is necessary if directors are to fully discharge their obligations to the company to monitor and manage its trading performance. Directors are unable to properly assess that performance, and any potential or actual insolvency, without good records.

94. As well, as pointed out in section B of our submission, the IPA's members continue to experience difficulties with obtaining appropriate business records of insolvent companies, invariably because they have not been properly maintained. This can severely hamper the conduct of an insolvency administration and further prejudice the creditors.

95. The IPA considers that the variation proposed has the added benefit of providing a further incentive for the maintenance of financial records.

A.6.2.3 Medium to large corporate enterprises

96. The IPA has also considered whether the business judgment rule, or some other variation to the insolvent trading laws, may apply only in relation to medium to large corporate enterprises. This is raised based on the reality that a small company may not have sufficient economic interests to engage in an informal restructuring process when approaching insolvency. Whereas large companies with significant stakeholders are more likely to be able to effect a consensual restructure, as those stakeholders will see that a consensual restructure offers them the best prospect of maximising return without the value destruction inherent in a formal insolvency process. There is also the concern that access to a defence such as the financial judgment rule may be subject to abuse and potentially open a gate to 'phoenix' activity in smaller enterprises. The IPA can consider this refinement further in the discussion process, if Treasury considers it worthwhile.



A.6.2.4 Application of existing provisions of the business judgment rule

97. We consider that, apart from s 180(2)(b), the existing paragraphs of the business judgment rule are applicable to directors of insolvent or near insolvent companies.

98. It is appropriate to retain the need for the director to have made the financial judgment in good faith for a proper purpose: s 180(2)(a).

99. Importantly, we consider the director must “inform themselves about the subject matter of the financial judgment to the extent they reasonably believe to be appropriate”: s 180(2)(c). The IPA is of the view that this would impose an obligation on a director to seek relevant professional advice. Thus in any defence raised on that component of the financial judgment rule, the directors would need to show that they had kept themselves informed of the company’s financial position (and maintenance of financial records would be an essential part of this) and took relevant advice that they reasonably believed was appropriate in the particular circumstances. Necessarily a critical financial situation would require some insolvency focussed advice.

100. Further, we consider that in an insolvency context, the directors should be able to prove that they “rationally believe(d)” that the financial judgment was in the best interests of the company: s 180(2)(d).

A.6.2.5 Further application of the defence

101. We also draw Treasury’s attention to the provisions parallel to s 588G both in their drafting and general purpose. Section 588FGA of the *Corporations Act* imposes personal liability on directors in circumstances where the directors have permitted the company to pay a voidable preference to the Commissioner of Taxation; the directors are required to indemnify the Commissioner in the event that he is required to repay that to the liquidator. The defence provision (s 588FGB) is very similar to, and is modelled on, the defence contained in s 588H³⁵. Similarly, under Part VI Division 9 of the *Income Tax Assessment Act 1936*, directors can be made personally liable after service of a directors penalty notice; again, the defence provisions (s 222AOB) is similar to s 588H. The IPA simply notes these provisions as existing and says that it may need to be considered whether the general defence would extend to these provisions. Any defence under the *Corporations Act* would not, it seems, extend to the tax provision without specific provision. Finally, we note the connection between s 596AB (entering into a transaction that avoids employee entitlements) and s 588G whereby a liability may arise under both provisions when a debt is incurred.

³⁵ *DCT v Clarke* (2003) 57 NSWLR 113



Section B - Obligation to keep financial records

102. The IPA considers that penalties need to be structured in such a way that they encourage compliance by directors with their obligations. Based on the experience of insolvency practitioners with the difficulty of obtaining adequate books and records in liquidations, the penalties currently in place for breaches of section 286 do not provide an adequate deterrent.

103. Penalties for breaches of section 286 can currently be imposed:

- against the company under section 286;
- against a director under section 344; or
- indirectly under section 530A, by not providing books and records to the liquidator.

104. Penalties under section 344 can be both civil (section 344(1)) or criminal in nature (section 344(2)).

105. According to a recent press release by ASIC,³⁶ 144 company officers have been prosecuted in the three months from January to March 2007. Of these prosecutions there were none under section 286 as this is a prosecution of the company, not the directors. There were also no prosecutions under section 344, which we understand may be because there is a need to prove dishonesty under section 344(2).

106. There were 103 prosecutions under section 530A and we understand that these prosecutions often relate to a failure by company directors to provide books and records to the liquidator, even though section 530A covers a range of matters concerning the failure to assist the liquidator. However, disappointingly, the average fine was only \$845. The maximum fine was \$3,200 and the lowest financial penalty \$250, with some directors being given good behaviour bonds only. There also appeared to be a significant difference in penalties depending on the jurisdiction.

107. These statistics indicate that, for whatever reason, directors are not being prosecuted under section 344. It is also clear that the penalties being imposed under section 530A are inadequate deterrents to director non-compliance.

108. The Parliamentary Joint Committee on Corporations and Financial Services considered the issue of penalties for breaches of section 286 in its enquiry into the Corporations Amendment (Insolvency) Bill 2007 (“PJC enquiry”).

109. During evidence to the PJC enquiry, Mr John Melluish, then President of the IPAA, pointed out that a director was better off being prosecuted for failure to keep proper books and records than to provide information to a liquidator and risk exposing themselves to a larger claim. This should not be the case. Directors in this position should risk a penalty, payable to the company, substantial enough to make them take seriously their obligations as a director and think twice about withholding company books and records from a liquidator.

110. The IPA is supportive of recommendations put forward in the report from the PJC enquiry. We recognise, however, that the penalties need to be against the directors, rather than the company, which is how section 286 is currently worded. It

³⁶ 07-99 ASIC prosecutes 144 company officers in response to public complaints, 16 April 2007.



may well be that it is more appropriate that the penalties are imposed by way of other sections.

111. However the penalties are incorporated, it is important that the penalties are paid to the company as compensation for the creditors. At the moment, it is the creditors that ultimately bear the cost of inadequate books and records. In such situations, the external administrator must undertake more work in order to gain an understanding of the company's financial position and investigate the company's failure. It may well be that because of the lack of books and records, valuable assets such as director's loans or actions against the directors go unidentified.

112. The IPA is also concerned about the variation in penalties that are imposed. Whilst we understand that the severity of the offence can differ, there was a variation of 1280% in the penalties imposed under section 530A during the period January to March 2007, with a noticeable distinction between jurisdictions.

113. In the event of ongoing non-compliance, incarceration in addition to a financial penalty is appropriate.





Section C - Penalties and procedures

114. The IPA agrees that there is scope in corporate law for administrative sanctions to apply to breaches of low level record keeping and reporting provisions, such as those set out in Table 2 of the discussion paper.

115. The IPA agrees that specifying the maximum penalty within a provision in the *Corporations Act* would improve understanding and clarity of offence provisions.

