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Abstract
Under Part 4 of the Corporate Law Reform Act 1992, sections 592 and 593 of the Corporations Law are replaced by sections 588G, 588U and 588Y. Both section 592 and its replacement section 588G, impose liability on a director whose company has traded whilst insolvent. The new provisions, like so many which have been introduced, are both complex and lengthy. Where previously there were two sections there are now fourteen replacements. The new section 588G is found in Divisions 3 and 4 of Part 5.7 B and interlocks with other amendments, including those establishing civil penalty provisions contained in Part 9.4 B. This part entitled 'Recovering Property or Compensation for the Benefit of Creditors and Insolvent Companies', includes matters such as 'voidable transactions' and 'the liability of a holding company for insolvent trading by a subsidiary'.

In this article the new insolvent trading provisions are analysed with particular emphasis being placed on the differences between the old section 592 and the new sections. The cases dealing with section 592 will also be considered in order to determine how the new sections will be interpreted and what the legal position will be.

Keywords
corporate law, insolvency, liability of directors, Corporate Law Reform Act 1992, section 592, Harmer Report

LIABILITY OF DIRECTORS FOR CORPORATE INSOLVENCY - THE NEW REFORMS

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Introduction

On 13 February 1992, the then Attorney General the Honorable Michael Duffy MP, released draft legislation entitled the *Corporate Law Reform Bill* 1992 together with an accompanying Explanatory Paper for public comment. The Bill was introduced into Federal Parliament in November 1992 and the *Corporate Law Reform Act* 1992 was assented to on 24 December 1992. The Governor General proclaimed that certain provisions of the Act were to commence on 1 February 1993 whilst all others were to commence on proclamation. The Act implements at last many of the reforms proposed in the Harmer Report.[1] The insolvency reforms in Part 4 of the Act required supporting regulations to be drafted and finally commenced on 23 June 1993.

Under Part 4 of the *Corporate Law Reform Act* 1992, sections 592 and 593 of the Corporations Law are replaced by sections 588G, 588U and 588Y. Both section 592 and its replacement section 588G, impose liability on a director whose company has traded whilst insolvent. The new provisions, like so many which have been introduced, are both complex and lengthy. Where previously there were two sections there are now fourteen replacements. The new section 588G is found in Divisions 3 and 4 of Part 5.7 B and interlocks with other amendments, including those establishing civil penalty provisions contained in Part 9.4 B. This part entitled 'Recovering Property or Compensation for the Benefit of Creditors and Insolvent Companies', includes matters such as 'voidable transactions' and 'the liability of a holding company for insolvent trading by a subsidiary'.

In this article the new insolvent trading provisions are analysed with particular emphasis being placed on the differences between the old section 592 and the new sections. The cases dealing with section 592 will also be considered in order to determine how the new sections will be interpreted and what the legal position will be. Whilst it seems that some critical reforms have been implemented, there are areas of current uncertainty which

1 *Australian Law Reform Commission General Insolvency Inquiry*, Report No 45 (1988) AGPS (ALRC) Report (the Harmer Report).

persist and ultimately, despite detailed statutory regulation, many matters will need to be resolved by the Courts.

General outline of sections 592 and 593

Sections 592(1) and 593(1) dealt with insolvent trading and were derived directly from sections 556(1) and 557(1) of the *Companies Code*. According to the Explanatory Memorandum introducing the *Companies Code*, the intention of the sections was to place greater responsibility on persons who are directors or managers of the company at the time that unreasonable debts are incurred by the company, and to provide that such persons and the company are liable to creditors for payment of any debts incurred.

In line with that aim, the key elements of section 592 were that where:

(i) a company has incurred a debt; and

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

(iii) the company was, at the time the debt was incurred, or becomes at a later time, subject to one of the various types of insolvency administrations, including in particular, liquidation;

then directors of the company or any person who took part in the management of the company at the time the debt was incurred, both contravene the section and are liable for the payment of the debt.

Thus, individuals who were liable included directors, alternate directors, de facto directors, those in accordance with whose directions or instructions the directors were accustomed to act and persons participating in management.

A section 592(1) defendant was provided with two defences set out in subsection (2). They were:

(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.

Section 592 created a criminal offence and also a civil remedy. The criminal offence carried a maximum penalty of $5000 or one year imprisonment or both.[2] If a person was convicted of the section 592(1) offence, the Australian Securities Commission or a creditor could then, pursuant to section 593(1) apply to the Court for a declaration that the convicted person be personally responsible without any limitation on liability for the payment of the whole or part of the debt to the creditor.

It should be noted that the liquidator could not bring proceedings for the recovery of a debt for the benefit of all creditors. Proceedings for the recovery of a debt against a director or a person who took part in the management could only be instituted by the creditor for his own benefit.

Prosecution of the section 592(1) criminal offence could not be initiated by creditors. This could only be commenced by the Australian Securities Commission.

Practical difficulties involved with section 592

The operation of section 592 gave rise to a number of practical difficulties and ambiguities. One of the most troublesome areas of judicial interpretation in relation to section 592 was to determine the meaning of the expression 'incurs a debt.'

Section 592(1) set out three requirements before a creditor's cause of action was complete. The first was contained in paragraph (1)(a) which required proof that the 'company has incurred a debt'. The question often arose as to the point in time at which the relevant debt may be said to have been incurred. The identification of that time was critical, as it determined the point at which the assessment was to be made as to the company's ability to meet its debts. In some cases this has been regarded as the time at which the contractual obligation was undertaken. The authority relied on for this proposition is *Russell Halpern Nominees Pty Ltd v Martin.*[3] In that case, the directors of a company in liquidation were called upon under section 556 of the then *Companies Code* to meet the company's liability to pay rent under a lease. The point in issue was whether the incurring of the debt occurred at the time the lease was entered into, or instead, upon each and every rent day during the continuance of the lease. Burt CJ, with whom Smith J concurred (Olney J dissenting) held that the relevant act was the entering into of the lease, that is, the undertaking of the obligation to pay rent rather than the day upon which it became payable.

2 See s 1311 of the Corporations Law.
3 (1986) 4 ACLC 393.

One commentator asserts that the reasoning applied by the majority is difficult to accept 'if the aim of section 592 is to ensure that company controllers promptly initiate winding-up proceedings as soon as it becomes apparent that their company is insolvent.'[4]

The issue was raised again in the Supreme Court of Victoria in *Hussein v Good*.[5] In *Hussein* the company purchased a quantity of goods from a creditor with payment to be made on delivery of the goods. Delivery was duly made but there was only part payment. Subsequently the company was liquidated and the creditor received only 3% of the outstanding debt. Again the issue arose as to the relevant date to determine whether there were reasonable grounds to expect that the company could or could not pay all its debts. Southwell J held that the date of delivery of the goods was the relevant date rather than the earlier date upon which the contract was entered into. The decision in the *Russell Halpern* Case was distinguished on grounds which appear illogical to a number of commentators.[6]

Since these two decisions were decided there have been a number of decisions dealing with the meaning of the expression 'incurs a debt'.[7] Recently the phrase was extended to incurring a contingent liability and, in particular, to the situation where a company grants a guarantee. In *Hawkins & Ors v Bank of China*[8] the giving of a guarantee by a company to a bank regarding the liabilities to the bank of two other companies in the same group, where the liability under the guarantee was contingent at the time it was given and was in the nature of an obligation to pay a liquidated sum, was held to be the incurring of a debt for the purpose of section 566 of the then *Companies (NSW) Code*.

The significance of these decisions is that they relate to a critical aspect of the operation of section 592, yet they are difficult to reconcile. As is the case with section 592, the central concept of the new section 588G(1) is the incurring of a debt whilst insolvent and as such the problems identified by the existing case law and several commentators[9] will still apply to the new section. The question of timing is a question of fact with the nature of transaction being the determining factor.[10]

4 Herzberg A, 'Insolvent Trading' (1991) 9 C&SLJ 285 at 293.

5 (1990) 8 ACLC 390.

6 See Antrobus, 'Section 556 - When Does a Company Incur a Debt?' (1980) C&SLJ 324 and above n 4 at 295.

7 See for example *Jelin Pty Ltd v Johnson & Anor* (1987) 5 ACLC 463; *Castrisios v Mc Manus* (1991) 9 ACLC 287; *Rema Industries & Services Pty Ltd v Coad & Ors* (1992) 10 ACLC 530; *Hawkins v Bank of China* (1992) 10 ACLC 588.

8 Ibid.

9 Above n 6 and Antrobus, 'Section 556 (Corporations Law, s 592): Is a Debt 'a Debt'?' (1991) 9 C&SLJ 349; Brown A, 'Does Section 592 apply to Guarantee? The risks increase after the Hawkins case.' (1993) 11 C&SLJ 34.

10 In *Rema Industries and Services Pty Ltd v Coad & Ors* (1992) 10 ACLC 530 Lockhart J observed that the time when a debt is incurred will vary from case to case, depending principally upon the terms of the agreement between the parties, express or implied.

The defences under section 592.

The main area of judicial difficulty in recent times has been in the operation of the defences. There was a degree of judicial divergence as to how the defences provided by section 592(2) and its predecessor section, should be interpreted and applied. There were two defences available under section 592(2) and proof of either one was sufficient to absolve a director or manager from personal liability.

The defence under paragraph (a) took into account a director's lack of responsibility for the incurring of a debt, while paragaph (b) focused on the opinion the director might reasonably have formed about the solvency of the company.[11]

The defence in paragraph (a) caused the most controversy. The traditional view of the defence was upheld in the New South Wales Court of Appeal decision in *Metal Manufacturers Ltd v Lewis*[12] which dealt with section 556(2)(a) of the *Companies Code*, the equivalent of section 592(2)(a) of the Corporations Law.

In *Metal Manufacturers* the majority of the New South Wales Court of Appeal upheld the defence to enable a non-executive director who took no part in the management of her company's business to avoid liability. The decision has been strenuously criticised and, in particular, was the subject of harsh words in the Cooney Report.[13]

It is a sign of the changing times and a developing sensitivity on the part of the judiciary, that the Courts thereafter have found the opportunity to distinguish that decision. The Victorian Courts have led the way in this regard. The recent decisions of the Supreme Court of Victoria in *Statewide Tobacco Services Ltd v Morley*[14] and *Commonwealth Bank of Australia v Friedrich* (the *National Safety Council* case)[15] have been followed by the decision of the Federal Court in *Rema Industries and Services Pty Ltd v Coad & Ors; Re Taspac Thermoforming Pty Ltd*[16] and now the dismissal of the appeal in the *Morley* case by the Full Court of the Supreme Court of Victoria in *Morley v Statewide Tobacco Services Ltd*[17] and the decision of the Full Court of the Supreme Court of South Australia in *Group Four Industries Pty Ltd v Brosnan and Anor.*[18] These cases have all adopted a

11 See *Statewide Tobacco Services Ltd* v *Morley* (1990) 8 ACLC 827.
12 (1988) 6 ACLC 725.
13 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties - Report on the Social and Fiduciary Duties and Obligations of Company Directors*, Nov 1989, AGPS (Cooney Report) par 3.44.
14 Above n 11.
15 (1991) 9 ACLC 946.
16 Above n 7.
17 (1992) 10 ACLC 1233.
18 (1992) 10 ACLC 1437, reversing the earlier decision of Duggan J.

more stringent approach to the application of section 592 and if this approach continues, it appears likely to bring the standards required of directors into line with the expectations of business, the government and the community generally.[19]

The above decisions illustrate the continuing interpretational difficulties that existed with section 592. Correctly, the new defences in section 588H dispense with the controversial defence in section 592(2)(a), that was successfully relied upon in *Metal Manufacturers Ltd v Lewis*.[20]

The Australian Law Reform Commission's recommendations: The Harmer Report[21]

The operation of section 556 of the *Companies Code* (the precursor to section 592) was criticised in the Harmer Report released by the Australian Law Reform Commission in 1988. The ALRC's criticisms may be summarised as follows:

(i) First, the section allows individual creditors to independently sue directors for insolvent trading which ultimately causes inequity among unsecured creditors as a class and gives rise to a multiplicity of actions;[22]

(ii) Secondly, the section gives a director a defence where the director can show that the impugned transaction was entered into without his express or implied authority. The Harmer Report argued that this defence has been used by directors in circumstances where, through lack of diligence, the director has failed to take a sufficient role in the management of the company, thereby technically depriving any transaction of his implied authority.[23] That criticism was certainly justified at the time of writing the report, particularly having regard to the *Metal Manufacturers'* decision, but is perhaps less valid today in light of the strong judgement in *Morley's* case and the cases following it;[24]

(iii) Thirdly, the section involved difficulties for the creditor in proving that the company was in fact insolvent at the relevant time. For a creditor to establish the substantive elements of the section he had to provide evidence of the company's financial position at the time when the debt was incurred. This onerous obligation of providing

19 See *Corporate Practices and Conduct* (1991) Information Australia.
20 Above n 12.
21 Above n 1.
22 *Corporate Law Reform Bill* 1992 Explanatory Memorandum par 1081.
23 Ibid.
24 See also the cases following *Morley's* case, above n 7, 11, 15, 17, 18.

evidence was often impossible for the creditor to satisfy particularly in light of the fact that the evidence needed is rarely contained in documents readily available to the public and in some cases where company records have not been properly kept this information was not available at all.

(iv) Fourthly, the ALRC suggested that the criminal sanctions be removed from the section.[25] Section 592 combined civil and criminal sanctions and operated so that criminal prosecution was a prerequisite for a civil action by the liquidator on behalf of unsecured creditors.[26] The ALRC thought that the aim of insolvent trading provisions should be to obtain a return for creditors rather than to punish directors.[27]

In the Explanatory Memorandum which accompanied the *Corporate Law Reform Bill* 1992 it was stated that the new provisions are designed to address the ALRC's criticisms in a number of ways, namely:

(a) criminal and civil sanctions will be separate, with criminal liability being retained for cases where actual dishonesty or fraud are involved;

(b) directors will be under a positive duty to ensure that the company does not incur debt while insolvent. Breach of this duty will render the director liable to civil action and will also constitute a breach of duty to which a civil penalty will apply;

(c) the liquidator will have a primary right to sue a director for the benefit of all unsecured creditors, with other unsecured creditors being permitted a separate right of action only where the liquidator fails to take action;

(d) the duty is expressed in such a way that the director will not be able to use lack of involvement in the company's affairs as a basis for asserting that a particular transaction was entered into without his or her implied authority. The duty is expressed so as to render a director liable if he or she knew, or a reasonable director of a company in that company's circumstances should have known, that there were reasonable grounds to suggest the company's insolvency;

(e) a series of rebuttable presumptions . . . will assist the liquidator in establishing that the company was insolvent at a particular time.[28]

25 Harmer Report above n 1 par 323.
26 Above n 22 par 1081.
27 Harmer Report above n 1 par 323.
28 Above n 22 par 1224.

The structure of section 588G

Section 588G is the pivotal provision in the new scheme. Sub-section (1) states:

> This section applies if:
>
> (a) the person is a director of the 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 Part.

The duty is imposed by sub-section (2) which provides as follows:

> By failing to prevent the company from incurring the debt, the person contravenes this section if:
>
> (a) the person is aware at that time there are reasonable 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.

Sub-section (2) establishes a positive duty on the part of a director to prevent insolvent trading by the company. It applies only to a director of the company and in this respect it may be distinguished from its predecessors section 566 of the *Companies Code* and section 592 of the Corporations Law. Both of these sections had an extended application to persons who took part in the management of the company, without necessarily being directors. The exclusion of liability for managers was based upon the view that the duty to prevent insolvent trading focuses on preventing the company from engaging in a course of insolvent trading rather than the incurring of the particular debt and that therefore it is appropriate to look to those who are entrusted with the overall management of the company rather than all those who may have authority to take any part in its management. The Harmer Report stated that it is the directors who have the ultimate power to prevent debts being incurred and that only they should owe the duty to prevent insolvent trading by the company.[29] The Report noted that the

29 Ibid at 1089.

definition of director is wide enough to encompass those who act in a de facto capacity as directors, who should accordingly have the same duty as a validly appointed director.[30]

Under sub-section (1) the company must have been insolvent at the time that the debt was incurred, or must have become insolvent by incurring that debt, or by incurring at that time debts including that debt. Insolvency is defined pursuant to a new section, section 95A(1) which provides that:

> A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable.

Section 95A(2) provides that 'a person who is not solvent is insolvent'. It is unclear whether existing judicial pronouncements in relation to sections 556 and 592 on the meaning of 'inability to pay debts as and when they fall due' will help clarify the new definition.

One of the major difficulties in the past in relation to sections 592 and 556 has been to establish that a company was, at the relevant time, not able to pay its debts as and when they fell due, or, to use the new language, in a state of insolvency. The new provisions of the Corporations Law assist the party trying to establish the existence of circumstances of insolvency by providing two rebuttable presumptions. The presumptions are contained in section 588E and apply to 'recovery proceedings' which include proceedings for the contravention of section 588G. Broadly speaking the presumptions are:

(i) a presumption of continuing insolvency if it can be proved that a company was insolvent at any time during the twelve months prior to the relation-back day which is the date of commencement of a winding up;[31] and

(ii) where the company has failed to keep or retain adequate accounting records pursuant to s 289 there is a presumption that the company was insolvent during that period.[32]

These presumptions were included in accordance with recommendations contained in the Harmer Report. In relation to the presumption contained in section 588E(3) the Harmer Report stated that 'a liquidator, being a stranger to the past business operations of a company, is often confronted with considerable difficulty in affirmatively establishing a company was insolvent at a time prior to the winding up, even though there may be every indication that this was the case. In many cases the liquidator will have to cope with either inadequate or meaningless company accounting records or no

30 Ibid.
31 Section 588E(3).
32 Ibid at 588E(4).

accounting records at all'.[33] The presumption has the effect that, once the liquidator proves insolvency at one point in time, insolvency after that point is presumed, during the twelve month period. Circumstances of insolvency beyond the twelve month period may still be proved but in such cases the onus will be on the liquidator to establish them without the assistance of the presumption of continuing insolvency.[34]

In relation to the presumption contained in section 588E(4), the Harmer Report stated that the presumption was necessary

> to counter the regrettable, but quite usual, state of affairs where the lack or absence of adequate books of account make it difficult or impossible to reconstruct the financial position of a company at or about a particular time.[35]

The presumptions may be rebutted by proof to the contrary: section 588E(9) and insolvency may also be proven directly. The presumptions are highly beneficial as they should help overcome one of the major problem areas in section 592, that is the difficulty in proving insolvency *on the day* of the disputed payment.

Under section 592 for a director to be liable there needed to be reasonable grounds to *expect* that the company would not be able to pay its debts. Under section 588G(1)(c) it is sufficient if there are reasonable grounds to *suspect* insolvency. It is argued by the Harmer Report that the new section imposes a higher requirement on directors to act where they become aware of grounds of suspicion, rather than grounds of expectation. The purpose of this higher requirement being to force directors to be more rigorous in monitoring the company's financial situation. It would appear that the new section does achieve the more onerous effect desired by the Harmer Report. Its true effect will, however, be dependent on the operation of the defences which are referred to below.

The liability provision in section 588G(1)(c) makes a director liable where there are *reasonable* grounds for suspecting that the company is insolvent. The standard of reasonableness is set out in paragraphs 588G(2)(a) and (b). There must be proof that the director is aware at the time that the debt was incurred that there are reasonable grounds for suspecting that the company is insolvent or that a reasonable person in the position of director of a company *in that company's circumstances* should have been aware of the company's insolvency. This wording interlocks with the general standard of care and diligence set out in the amended section 232. The standard of care in section 232 is expressed clearly as an objective standard, having regard to the size, nature and complexity of the company in question. The Explanatory Paper specifically stated that the test in section 588G(2)(b) was qualified in order

33 Harmer Report above n 1 par 290.

34 Above n 4 at 307.

35 Harmer Report above n 1 par 297.

to make it consistent with the general test of care and diligence in the amended section 232.[36] This test gives the court a huge discretion and may be criticised for being overly wide in that it allows the objective test to be modified by subjective criteria. However it should enable the court to determine what is reasonable in all the circumstances and to take into account the vastly different nature of each individual company.

The final element of section 588G is proof that the director failed to prevent the company from incurring the particular debt in question. This element links in with the defence which is set out in section 588H(5).

The defences

A director in breach of the duty to prevent the company from engaging in insolvent trading is absolved from liability if that director can establish any of the four defences set out in section 588H. In addition, section 1317JA provides the Court with a discretionary power to relieve a director from liability under section 588G, in whole or in part.[37]

The first defence is set out in s 588H(2) which provides a defence where the director,

> at the time when the debt was incurred 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.

This defence requires an *expectation* of solvency which the director must prove to rely on the defence. It should be noted that in contrast, the statement of duty set out in section 588G(1) only requires a *suspicion* of insolvency. The net result will be a contest between the Australian Securities Commission, or the liquidator in seeking to establish reasonable grounds for *suspicion* of insolvency and the director seeking to establish reasonable grounds for *expectancy* of solvency. The subtlety of reasoning will be a matter for the Courts.

As stated in the Explanatory Memorandum the defence in section 588H(2) draws on a defence which was previously available under section 592(2)(b), where the absence of an expectation that the company would not be able to pay its debts is a defence.[38] The new defence does not comprehensively

36 *Corporate Law Reform Bill* 1992 Public Exposure Draft and Explanatory Paper par 1229.

37 Pursuant to s 1317JA(2) the Court may relieve a person from liability for contravention of s 588G where it appears that the person has acted honestly and having regard to all the circumstances of the case ought fairly to be excused. This provision is based upon the previous s 1318 and was necessary because in *Commonwealth Bank v Friedrich* it was held that s 535(1) of the *Companies Code*, the equivalent of s 1318, did not apply to contraventions of s 592.

38 Above n 22 par 1091.

define the director's duties and inevitably it will be the Courts who will be required to make a determination on the basis of what they consider to be reasonable conduct for directors. The defence provides the Court with a wide judicial discretion and as such the divergent opinions which have been prevalent in relation to the old section 592 defences could re-emerge. The Explanatory Memorandum indicates that the legislation is trying to achieve a strict approach to director's liability as evidenced in the Supreme Court of Victoria decisions in *Morley*'s and *Friedrich's* case. The new defences are intended to assist a director who has 'acted diligently and has positively participated in management, but who has nevertheless been unable to prevent the incurring of the crucial debt.'[39]

The second defence is set out in section 588H(3). This section provides a director with a defence where he is able to establish that at the time when the debt was incurred he:

(i) had reasonable grounds to believe and did believe:

(a) that a competent and reliable person ('the other person') was responsible for providing to him adequate information about whether the company was solvent; and

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

(ii) expected, on the basis of information provided to him by that 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.

The Harmer Report explained that this defence was necessary in the case of larger companies where directors are forced to delegate the management of parts of the company's business. In such circumstances a director should be excused for relying on information supplied by a subordinate.[40] The defence also reflects the criteria which are set out in section 232, against which the conduct of a director is to be judged for the purpose of determining whether he has acted with due care and diligence.

The third defence is set out in section 588H(4). This defence is established if the director can prove that at the time when the debt was incurred 'because of illness or for some other valid reason, he or she did not take part at that time in the management of the company.' As Herzberg correctly points out 'such a defence is superfluous if section 588H(2) were to be interpreted the same way as section 592(2)(b)'.[41] Factors such as illness and the absence of a person are relevant for determing whether the director

39 Above n 22 par 1086.

40 Harmer Report above n 1 par 307.

41 Herzberg A, 'Corporate Governance - Which Way Ahead?', Unpublished paper pre-sented at the National Corporate Law Teacher's Conference 1993 held in Brisbane at p 7.

had 'reasonable grounds to expect' that the company was solvent pursuant to section 588H(2). In addition the defence may allow 'sleeping' directors to limit their liability.[42]

The fourth defence set out in section 588H(5), enables a director to avoid liability where the director took all reasonable steps to prevent the company from incurring the debt. The crucial element of this defence is what constitutes 'all reasonable steps'. The Explanatory Paper which accompanied the Public Exposure Draft of the *Corporate Law Reform Bill* 1992, states that the reference to 'reasonable' in this provision would require 'the Court to have regard to factors such as the size and complexity of the company concerned, the size of the debt which was incurred and the nature of the grounds which gave rise to the suspicion of insolvency.'[43] The Explanatory Paper states that 'to take advantage of sub-section 588H(5) a Court might require unequivocal action on the part of those directors seeking to rely on the defence to exercise what powers and functions they possess'[44] to prevent the incurring of the debt. However it is also stated that 'the provision is not intended to hamstring the company by requiring that every transaction no matter how small be scrutinised because of an academic possibility of the company's trading whilst insolvent.'[45] In determing whether a defence under section 588H(5) has been proved, section 588H(6) directs the court to have regard to matters such as any action the director took with a view to appointing an administrator of the company, when that action was taken and the results of that action. It would appear then that positive, active intervention by a director will be required to obtain the protection of the defence and that if the director cannot prevent the debt being incurred he would need to seek to have the company wound up or resign.

As mentioned earlier in this article the new defences entirely dispose of the controversial defence found in section 592(2)(a) which provided that the director would escape liability if the debt was incurred without authority or consent.[46]

The new legislation does not provide a clear and precise definition of the defences. This remains a problem to be resolved by the Courts and as such the judicial uncertainty that plagued the section 592 defences may still persist. Although the cumulative effect of the recent decisions in the Full Courts of Victoria and South Australia, in *Morley's* case and the *Brosnan* case,[47] may have clarified the judicial approach, particularly in relation to the fact that a director can no longer escape liability on the grounds of ignorance

42 Ibid at 8
43 Above n 36 par 1240.
44 Ibid.
45 Ibid.
46 See above n 22 par 1086.
47 Above n 17 at 18.

of the company's affairs. It would appear however that no amount of legislation can comprehensively define directors' duties and it is inevitable that the courts will be left with a discretion. As such the new defences will give both the courts and commentators, ample opportunity to display divergent views.

Liability of the director

A director who breaches section 588G will be liable to pay compensation in accordance with Division 4 of Part 5.7B. He may also be subjected to a civil penalty order pursuant to s 1317EA, and where the director contravenes section 588G with the necessary mental element set out in section 1317FA(1), his contravention may also constitute a criminal offence.

Civil penalty provision

Section 588G(3) states that section 588G is a civil penalty provision as defined by section 1317 DA. Civil penalty provisions are regulated under Part 9.4B, which provides for criminal and civil consequences of contravention.

Pursuant to section 1317EB, an application for a civil penalty order can be made only by the Australian Securities Commission, its delegate, or some other person authorised by the Minister to make the application. Section 1317EA(3) allows the court to make an order prohibiting the director, for such period as is specified in the order, from managing a corporation; and/or an order that the director pay to the Commonwealth a pecuniary penalty of an amount not exceeding $200,000.

Criminal penalties

Section 1317FA(1) sets out the circumstances when contravention of a civil penalty provision will constitute a criminal offence. A person who contravenes section 588G will be guilty of a criminal offence if that person contravenes that section:

> (a) knowingly, intentionally or recklessly; and
> (b) either:
>
> (i) dishonestly and intending to gain, whether directly or indirectly, an advantage for that or any other person; or
>
> (ii) intending to deceive or defraud someone.[48]

Conviction of the criminal offence is punishable by a fine of $200,000 or

48 Section 1317FA(1).

imprisonment for 5 years or both. For directors the positive news is that a breach of section 588G, without the elements of criminality referred to above, will not constitute a criminal offence and will not attract a jail penalty. The negative side however is that a breach, though allegedly of a civil nature, will in fact attract a penalty of $200,000 and the onus of proof will be the civil onus and not the criminal onus. It will be a lot easier to establish the elements of section 588G on the balance of probabilities, rather than beyond a reasonable doubt. As mentioned earlier, it should be noted that the previous penalty under section 592 of the Corporations Law was $5000.

Compensation

The liability of a director to pay compensation is set out in Division 4 of Part 5.7B and can be summarised as follows:

Section 588J(1) enables the court, on an application for a civil penalty order, to make an order that the director pay to his company compensation, equal to the amount of loss or damage suffered by an unsecured creditor due to the company's insolvency.

Section 588J(2) allows a company's liquidator to intervène to be heard on the question of compensation in such an application. The Explanatory Paper expresses the view that this will enable the liquidator to achieve savings as he will not have to bring an action in his own right.[49]

Section 588K provides a similar scheme for compensation orders where a Court finds a director guilty of a criminal offence due to a contravention of section 588G when the elements of criminality are present. An order for compensation can be made whether or not the Court imposes a civil penalty or a criminal penalty on the director.

Section 588M provides that where a director has contravened section 588G, the debt is unsecured and the creditor to whom the debt is owed suffers loss or damage as a result, the liquidator of the company may recover from the director as a debt due to the company, an amount equal to the amount of loss or damage. Under section 592 liquidators were not permitted to initiate recovery proceedings against directors who contravened section 592. This situation was one of the main defects in the existing legislation and section 588M should overcome this deficiency by allowing liquidators to commence recovery proceeedings regardless of whether the Australian Securities Commission has commenced an action.

Section 588M(3) allows a creditor who has suffered loss or damage to recover from the director, as a debt due to the creditor, an amount equal to

49 Above n 36 par 1245.

the amount of the loss or damage in certain circumstances. These circumstances are first, where the consent of the liquidator has been given or secondly where the creditor has given notice of his intention to institute proceedings to the liquidator, and the liquidator has failed to institute his own proceedings. Sections 588R-588U set out the procedure to be followed by creditors who are initiating compensation actions.

In summary, the Court may order payment of compensation to the company in the following circumstances:

(i) on the hearing of proceedings with respect to a contravention, either civil or criminal (ss 588J and 588K); and

(ii) when the liquidator institutes independent proceedings on behalf of the company (s 588 M); and

(iii) when a creditor institutes proceedings on his own behalf, either with the consent of the liquidator or in the absence of action on the liquidator's part after due notice by the creditor to the liquidator (s 588M).

The compensation recoverable for contravention of section 588G is the amount of loss or damage suffered by all unsecured creditors whose debts were incurred due to the company's insolvency.[50] The new sections should be contrasted with the previous position under section 592. Under section 592 the director was liable to pay the amount of the debt in question and as such the compensation recoverable was easily quantified. In contrast the new provisions leave the extent of compensation open ended, as the amount recoverable is 'the amount of loss or damage suffered'. This open endedness has the potential to cause a great deal of uncertainty and as such could lead to intense litigation on this point.

It should be noted also that amounts recovered from directors are payable to the company and are available to all unsecured creditors including those creditors whose debts were incurred before the company became insolvent. The sharing by all the unsecured creditors of the sums recovered was a proposal put forward by the Australian Law Reform Commission.[51] In contrast under section 592(1) directors were only liable to compensate the particular creditor who initiated the action.

Conclusion

The new insolvent trading provisions of the *Corporate Law Reform Act* 1992 provide a significant reform of section 592. Correctly, the stigma of a criminal offence and the risk of imprisonment from the duty to avoid

50 See ss 588J, 588K and 588M.

51 Harmer Report above n 1 par 280.

insolvent trading have been excluded unless the mental element specified in section 1317EA is present.[52] Instead directors are dissuaded from insolvent trading by the possibility of incurring a fine of up to $200,000, and suspension of one's right to act as a director.

It is a worthwhile amendment that the liquidator of the company is given the primary right to bring an action against directors for the benefit of all unsecured creditors. Individual unsecured creditors are permitted a separate right of action only where the liquidator has consented or has failed to take action himself.[53] This change is welcomed as it should prevent a multiplicity of actions by creditors, and as noted above the money received by the liquidator will be applied in favor of all the unsecured creditors.

The duty to prevent insolvent trading in the new section is expressed in such a way that the director will not be able to use his lack of involvement in the company's affairs as a basis for asserting that the particular transaction was entered into without his implied authority. This change is in line with the judicial trend seen in the recent cases concerning section 592.[54] It also leaves no doubt that the sort of reasoning that was applied by the majority in *Metal Manufacturers* will no longer operate and this is a positive result. The only question now to be resolved, is to what extent directors should positively inquire into the financial affairs of their company.

One of the major problems for directors of companies passing through a difficult period, will be to identify the point at which they can no longer trade safely due to the risk they subject themselves to, with regard to personal liability. In recent years there has been a significant growth in 'informal workouts' where lenders have sought to refinance or assist in the restructure of corporate borrowers who are in financial difficulties. This practice raises potential problems for directors who by allowing the company to incur further debt may expose themselves to a greater risk of personal liability.

The presumptions of continuing insolvency would seem to have a significant impact in this regard. The situation could occur where the presumptions could be applied in circumstances where insolvency has existed at one point in time but may thereafter have been rectified. In such a case an ongoing presumption of insolvency would appear to be unduly harsh and penalise directors who are trying to work their company out of financial trouble. The presumptions of insolvency will undoubtedly assist creditors, whilst at the same time they will worry directors.

Another area of concern for directors is that the Australian Securities

52 It should be noted that at par 322 of the Harmer Report above n 1 the Australian Law Reform Commission argued strongly for the total decriminalisation of s 592.

53 Sections 588R - 588U.

54 Above n 7, 11, 15, 17, 18.

Commission or the liquidator have merely to prove grounds of suspicion of insolvency on the part of the director to establish liability under section 588G. It would appear that where there are grounds for suspicion it will be difficult for a director to successfully establish grounds of expectation to the contrary. The result being that directors may be forced to bring an end to a company's business earlier than necessary in order to avoid personal liability.

It would appear however that the underlying purpose of the insolvent trading provisions is to encourage prompt action by directors either to invoke the voluntary administration scheme or some other form of insolvency administration. The new legislation should definitely achieve this purpose.

The defences under section 592.

The main area of judicial difficulty in recent times has been in the operation of the defences. There was a degree of judicial divergence as to how the defences provided by section 592(2) and its predecessor section, should be interpreted and applied. There were two defences available under section 592(2) and proof of either one was sufficient to absolve a director or manager from personal liability.

The defence under paragraph (a) took into account a director's lack of responsibility for the incurring of a debt, while paragaph (b) focused on the opinion the director might reasonably have formed about the solvency of the company.[11]

The defence in paragraph (a) caused the most controversy. The traditional view of the defence was upheld in the New South Wales Court of Appeal decision in *Metal Manufacturers Ltd v Lewis*[12] which dealt with section 556(2)(a) of the *Companies Code*, the equivalent of section 592(2)(a) of the Corporations Law.

In *Metal Manufacturers* the majority of the New South Wales Court of Appeal upheld the defence to enable a non-executive director who took no part in the management of her company's business to avoid liability. The decision has been strenuously criticised and, in particular, was the subject of harsh words in the Cooney Report.[13]

It is a sign of the changing times and a developing sensitivity on the part of the judiciary, that the Courts thereafter have found the opportunity to distinguish that decision. The Victorian Courts have led the way in this regard. The recent decisions of the Supreme Court of Victoria in *Statewide Tobacco Services Ltd v Morley*[14] and *Commonwealth Bank of Australia v Friedrich* (the *National Safety Council* case)[15] have been followed by the decision of the Federal Court in *Rema Industries and Services Pty Ltd v Coad & Ors; Re Taspac Thermoforming Pty Ltd*[16] and now the dismissal of the appeal in the *Morley* case by the Full Court of the Supreme Court of Victoria in *Morley v Statewide Tobacco Services Ltd*[17] and the decision of the Full Court of the Supreme Court of South Australia in *Group Four Industries Pty Ltd v Brosnan and Anor.*[18] These cases have all adopted a

11 See *Statewide Tobacco Services Ltd* v *Morley* (1990) 8 ACLC 827.

12 (1988) 6 ACLC 725.

13 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties - Report on the Social and Fiduciary Duties and Obligations of Company Directors*, Nov 1989, AGPS (Cooney Report) par 3.44.

14 Above n 11.

15 (1991) 9 ACLC 946.

16 Above n 7.

17 (1992) 10 ACLC 1233.

18 (1992) 10 ACLC 1437, reversing the earlier decision of Duggan J.

more stringent approach to the application of section 592 and if this approach continues, it appears likely to bring the standards required of directors into line with the expectations of business, the government and the community generally.[19]

The above decisions illustrate the continuing interpretational difficulties that existed with section 592. Correctly, the new defences in section 588H dispense with the controversial defence in section 592(2)(a), that was successfully relied upon in *Metal Manufacturers Ltd v Lewis*.[20]

The Australian Law Reform Commission's recommendations: The Harmer Report[21]

The operation of section 556 of the *Companies Code* (the precursor to section 592) was criticised in the Harmer Report released by the Australian Law Reform Commission in 1988. The ALRC's criticisms may be summarised as follows:

(i) First, the section allows individual creditors to independently sue directors for insolvent trading which ultimately causes inequity among unsecured creditors as a class and gives rise to a multiplicity of actions;[22]

(ii) Secondly, the section gives a director a defence where the director can show that the impugned transaction was entered into without his express or implied authority. The Harmer Report argued that this defence has been used by directors in circumstances where, through lack of diligence, the director has failed to take a sufficient role in the management of the company, thereby technically depriving any transaction of his implied authority.[23] That criticism was certainly justified at the time of writing the report, particularly having regard to the *Metal Manufacturers'* decision, but is perhaps less valid today in light of the strong judgement in *Morley's* case and the cases following it;[24]

(iii) Thirdly, the section involved difficulties for the creditor in proving that the company was in fact insolvent at the relevant time. For a creditor to establish the substantive elements of the section he had to provide evidence of the company's financial position at the time when the debt was incurred. This onerous obligation of providing

19 See *Corporate Practices and Conduct* (1991) Information Australia.
20 Above n 12.
21 Above n 1.
22 *Corporate Law Reform Bill* 1992 Explanatory Memorandum par 1081.
23 Ibid.
24 See also the cases following *Morley's* case, above n 7, 11, 15, 17, 18.