

Corporate Insolvency & Directors' Liability Risks



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Part 1

Executive Summary

The global financial crisis has contributed to the collapse of a number of high profile companies as a result of the credit crunch and slowing economy.

Insolvent trading is a serious offence which can have severe consequences in Australia for executive and non-executive directors including personal pecuniary penalties, compensations payable, disqualification and possible imprisonment in the case of a criminal offence.

There are a number of defences available to directors against allegations of insolvent trading. A proactive approach to risk management can also help directors manage their liability risks.

Introduction

We have read much in recent months about the current global financial crisis and the number of high profile companies that have been financially distressed as a result of the credit crunch and the slowing economy. In Australia, the collapse of Opes Prime, ABC Learning and Storm Financial and the recent liquidation of Kleenmaid and Babcock & Brown are just a few examples that come immediately to mind.

As we head towards the end of 2009, it is likely that we will see more companies struggle financially as they seek to refinance debt in a more economically challenging environment. Directors are legitimately concerned. If companies do not have the cash to pay for debts as and when they fall due, directors are placed in a difficult position. On the one hand, they want to preserve stakeholder confidence in the company whilst trying to keep the company afloat but, on the other hand, in their attempt to turn around the company's financial position, they run the risk of incurring personal liability for insolvent trading.

In the course of 2008, there has been a dramatic increase in the number of businesses entering external administration. In Australia for example the number rose from 372 in January 2008 to 813 by December 2008 as companies felt the effects of the global financial crisis. Directors of companies that are currently feeling financially distressed are likely to follow conservative advice and take early action in appointing administrators in order to protect themselves against any potential personal liability for insolvent trading. This may be the prudent approach from a personal liability standpoint but does it provide the best outcome for the stakeholders of the company? At what point is a director liable for insolvent trading?

In cases of corporate financial distress, what lessons should directors take from a risk management perspective? This Liberty White Paper outlines the issues that directors face when their companies are financially distressed, the management strategies that they should carefully consider when placed in such difficult positions and the insurance issues that they should bear in mind as a matter of personal liability risk management.

At What Point Does A Director Engage In "Insolvent Trading"?

The Australian Securities and Investments Commission (ASIC) has yet to decide whether it will prosecute the directors of Kleenmaid for insolvent trading. The former directors of Babcock & Brown are also facing the prospect of an investigation into their roles in the company's failure. Similarly, whilst the creditors have voted for and the court has sanctioned a \$253 million settlement offered by ANZ and Merrill Lynch in respect of Opes Prime, ASIC has yet to decide whether any action should be taken against the directors of Opes Prime for their part in the demise of that company. At what stage can directors be said to be trading whilst the company was insolvent?

Australian directors have an onerous obligation when it comes to compliance with insolvency laws. A director will be liable for insolvent trading if there are reasonable grounds to suspect that the company may be insolvent or may become insolvent when a certain debt is incurred and the director fails to prevent the company from incurring such debt.

A "suspicion" of insolvency sounds vague but the courts have said that the test for "suspicion" of insolvency is an objective test. It is more than mere speculation. There must be a "positive feeling of actual apprehension" that there is insolvency (*Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266). The court will base its determination on the reasonable knowable financial circumstances of the company at the relevant time – such as:

- withdrawal of support from the company's bankers;
- the lack of other avenues for raising finance;
- unexplained resignations of co-directors;
- increasing numbers of creditors not being paid in accordance with their trading terms;
- the inability to raise additional equity capital;
- continuing trading losses;
- requirement by suppliers to place orders on "cost on delivery" basis; and
- overdue payroll and group taxes.

Clearly, each case must be examined on its own facts and circumstances in determining whether the directors had reasonable grounds to suspect insolvency and should therefore have acted to prevent the debt from being incurred.

Who Is Going To Be Liable?

It is not only executive directors who have been formally appointed as directors who are at risk of being sued for insolvent trading. Chairpersons and deputy chairpersons, alternate directors acting in that capacity as well as shadow directors and non-executive directors are also at risk.

The Water Wheel case involving civil proceedings against certain directors of the company, including John Elliot as a non-executive director, is a good reminder that non-executive directors cannot escape liability for insolvent trading simply because they may not have the day-to-day knowledge of the financial position of the company. Non-executive directors are expected to take steps to put themselves in a position to monitor the company and to form an independent judgment of the company's financial position.

What Defences Are Available To Directors?

Directors who are found liable for insolvent trading may be relieved from liability if they can show that:

- (i) they had reasonable grounds to expect that the company would remain solvent even if the debt was incurred;
- (ii) they had relied on information concerning the company's financial affairs supplied to them by another person competent to provide such information. Such persons could be, for instance, a subordinate, another director or an advisor;
- (iii) they took all reasonable steps practicable to prevent the relevant debt from being incurred after insolvency, or
- (iv) for some good reason – such as ill health – the director did not participate in the management of the company at the time the relevant debt was incurred.

In deciding whether any one of the above defences are available to a director, the court will look to the action, if any, taken by the director, its timing and its outcome or consequences. For example, when the Reynolds Group, who were winemakers, went into liquidation in 2003 with a shortfall of about \$130 million owing to secured and unsecured creditors, the liquidator sued the chairman and deputy chairman of the group for insolvent trading. In his defence, the chairman had argued that he was entitled to relief from liability because he had acted honestly and had relied on advice from others. The court held, however, that he was not excused from liability because he should have been aware that the company was insolvent. He had been kept closely informed by other executives in the group about the increasing difficulties the group

was having in managing creditors. The court said that he should have asked the "hard questions" but he had procrastinated instead. He was therefore liable for breach of directors' duties and for insolvent trading.

What Are The Consequences Of Insolvent Trading?

The sanctions for insolvent trading can be wide-ranging and stringent. Civil penalties of an amount up to \$200,000 could be imposed by and payable to ASIC.

In addition, the court may also order that the defendant director be banned from taking part in management of companies for up to 5 years.

Where a director allows a company to trade, knowing or reckless as to the fact that the company was insolvent, or was dishonest with a view to gaining an advantage, or intended to deceive or defraud someone, then that director is guilty of a criminal offence. The maximum penalty payable for a criminal offence is a fine of \$200,000 or imprisonment for up to 5 years, or both.

In addition to civil penalty proceedings, a director can also be ordered to pay compensation to the company. A compensation claim might also be brought against directors by the liquidator, a creditor or ASIC itself. The amount of compensation that the court may order a defendant director to pay is unlimited and varies from case to case. Perhaps the most well known example in this regard is the case in which the Chairman of the National Safety Council (Victoria) was ordered to pay \$96.7 million for a breach of directors' duties when he signed a statement to the effect that the company was solvent when, in fact, it was not.

Risk Management Strategies For Directors

From the above discussion, it is clear that insolvent trading is a serious offence with serious consequences for directors. Not only does it result in reputational loss, it could also mean personal pecuniary penalties, compensations payable, disqualification and possible imprisonment in the case of a criminal offence.

As far as liability risk management is concerned, apart from seeking proper legal and accounting advice, directors should manage their liability risks by ensuring that they:

- take a diligent and intelligent interest in the financial information either available to them or which they should request from the other executives or employees and agents of the company;
- ensure that there is no conflict, or potential conflict, of interests if they are also directors of a related company;

- ask questions – even the hard questions - about the company’s financial position;
- look out for factors which should trigger a “suspicion” of insolvency and take steps to prevent a debt from being incurred where there are suspicions of insolvency;
- inquire further into matters revealed in financial statements and advice and raise concerns at an urgent board meeting as soon as they arise;
- ensure that their dissent is properly noted in the minutes of the board meeting if the board decides to dismiss their concerns or “suspicions” of possible insolvency;
- where necessary, seek external advice and give proper consideration to the appointment of an administrator; and
- to not procrastinate nor avoid confronting realities. A period of 3 months during which directors seek advice and consolidate their financial information is not considered to be an unreasonable period but beyond that, directors are at risk of procrastination.

Part 2

Executive Summary

It is crucial that directors understand their company indemnification agreements and their D&O Liability Insurance Policy (D&O policy). A company indemnification agreement is usually ineffective when a company is insolvent and the best way a director can manage personal liability risks is with a D&O policy.

While Australian directors have a more onerous obligation not to engage in insolvent trading than many foreign counterparts, it is important to understand the different positions taken by the United Kingdom, United States, Hong Kong and Singapore.

Directors & Officers Liability Insurance

From a liability risk management perspective, it is crucial that directors and officers review their company indemnification agreements and their D&O policy. Of course, a corporate indemnity is going to provide little comfort to directors and officers if the company is insolvent. In such instances, an effective D&O policy is the best way for directors and officers to manage their personal liability risks.

Directors should review their D&O policy to ascertain the precise ambit of their coverage. For example, does the policy provide coverage for costs incurred in attending at inquiries or investigations? As a result of the collapse of Storm Financial, ASIC provided \$450,000 for a public examination into this failed advisory firm. The founders of Storm Financial together with others associated with the failed company have been ordered to give evidence in relation to the company. Clearly, there would be costs associated with the preparation for and attendance at such a public examination and directors would want to know the extent of coverage that is provided, if any, for such costs under their D&O policy.

Furthermore, considerations should also be given to the fact that most policies typically include an “insured v insured” exclusion with certain “write-backs” to provide cover for proceedings brought by shareholders in a derivative action, a receiver, administrator or liquidator and ASIC. Directors should peruse their D&O policy carefully to ascertain the full extent of coverage. For instance, what are the possible applicable exclusions?

In particular, directors should be on the look-out for D&O policies which contain a specific “insolvency exclusion” which seeks to exclude all claims and losses arising out of the insolvency of the company. This exclusion is almost always attached as an endorsement at the back of the policy wording. When one considers that the vast majority of claims brought against directors and officers arise out of insolvency of the company, such an endorsement could act as a punitive restriction of cover.

The other point to bear in mind is that, by virtue of the Corporations Act 2001 (Cth), D&O policies must not cover a director or officer for liability incurred as a result of wilful breach of duty. A D&O policy will not, for example, cover a director or officer for liability for insolvent trading where such a contravention is a criminal offence. This is because a criminal offence is committed as a result of a wilful breach of duty, or

wilful deceit. Most D&O policies will therefore only cover liability of directors and officers which is incurred under a civil penalty provision, such as an imposition of a fine or the requirement to pay compensation to the company. A criminal offence is difficult to prove so, in reality, most insolvent trading actions will seek civil penalty remedies and would thus be covered under the direct cover component of a D&O policy, subject to applicable exclusions.

Finally, directors must not overlook their duty of disclosure at the time of renewal or commencement of the D&O policy. The failure of a director or officer to disclose the insolvency of the company, the possible insolvency of the company or other circumstances which may give rise to a claim (such as the possibility of insolvent trading proceedings being commenced against them) at the time of taking out the D&O policy may lead to the insurer avoiding the insurance contract altogether or refusing to provide indemnity to the relevant directors, the company, or both. The recent case of *CGU Insurance Limited v Arimco Mining Pty Limited* highlights the importance of proper disclosure of financial matters at the proposal stage and up until the inception of the policy.

In that case, CGU was able to deny indemnity altogether on the basis of a breach of the duty of disclosure by the directors of Arimco. The court found that the directors had failed to disclose to CGU the adverse changes to its financial position at the time of the contract. This case is a reminder to directors, and insureds generally, that their duty of disclosure is one that applies up to the inception of the policy. If there are any changes to information stated in any proposal, which may be prepared weeks or even months in advance of a renewal date, these facts must be disclosed to insurers so as to avoid any later denial of indemnity by insurers on the basis of non-disclosure.

These are issues that directors should consider and discuss carefully with their insurance advisors.

Going Forward?

An empirical study prepared in 2004, by law firm Clayton Utz and the Centre for Corporate Law and Securities Regulation at The University of Melbourne, showed that, since the insolvent trading provisions were introduced into Australian companies legislation in 1961, there have been a remarkably low number of insolvent trading actions being brought against directors. As at 2004, there were a total of just 103 insolvent trading cases brought in Australia. The study

also showed that there was a significant increase in the number of insolvent trading cases (63) brought in the 1990s but the number had dropped since the end of the 1990s to 2004.

Given the increased availability of litigation funding for liquidators in the last few years, however, and a perceived public interest in liquidators pursuing insolvent trading claims against directors, it would not be too surprising to see an increase in the number of insolvent trading actions being brought against directors in future. Directors are therefore advised to manage carefully their potential insolvent trading liability risks.

What's The Liability Risks Position Of Directors Overseas?

Australian directors have a more onerous obligation not to engage in insolvent trading than their foreign counterparts. In the United Kingdom (UK), Canada, United States (US) and China, for instance, there is no liability on directors for insolvent trading. In the UK, directors are legally allowed to continue to trade even if the company is insolvent provided that they believe that the company's financial position could be turned around. Of course, there reaches a point when they should have realised that the position of creditors would be likely to deteriorate and there was no reasonable prospect of the company avoiding liquidation. If the directors continue to trade past this point, then their actions may constitute "wrongful trading" for which they would be liable.

The advantage of the UK position is that directors in the UK are allowed some scope of what is commonly known as "pre-pack to administration". Under this process, valuable assets of the company are preserved and can be sold on the basis of an on-going concern prior to formal appointment of administrators and without any reputational loss. Whilst some critics of this regime have said that it does not sufficiently protect the interests of creditors, others have applauded it on the basis that it preserves and maximises the financially troubled company's pool of assets.

Even in Germany, where the Insolvency Code also imposes onerous obligations on directors, amendments were made to the Code towards the end of 2008 in response to the global financial crisis. Before the amendments, directors of German companies were obliged to file for insolvency if the company was either "insolvent" or "over-indebted", subject to a three-week "cure" period. If the directors did not file for insolvency during this time limit, they could be liable for criminal prosecution for the delay and also for damages to the company's creditors.

As a result of the 2008 amendments, directors in Germany are no longer required to file for insolvency if the company is "over-indebted" provided that there is a "predominant probability" that the business of the company could continue despite the over-indebtedness. This amendment applies, however, only until December 2010.

In Asia, much attention has already been focused in the last decade on insolvency law reforms as a direct response to the 1997 Asian Financial Crisis. For example, in Malaysia, Thailand, Indonesia, and Korea, new corporate rescue laws have supplemented liquidation-based regimes. Hong Kong, however, is an exception. Unlike every other jurisdiction in Asia, Hong Kong does not have a formal corporate rescue regime. Since 2000, the Hong Kong Law Reform Commission had tried to come up with a model that allows the appointment of a qualified professional to take over the management of the company and develop a rescue plan. The procedure was to be streamlined, with minimal court involvement. This draft proposal has stalled because no solution has yet been found as to how to satisfy the requirement of the Hong Kong government that individual workers' full entitlements – or at least a cap of up to HK\$278,500 (approximately US\$36,000) – must be paid first out of company funds, as a priority, when the company is in liquidation.

The Hong Kong Law Reform Commission had also proposed to introduce an insolvent trading law, which would contain elements of the existing UK's wrongful trading provisions and Australia's insolvency trading provisions. The draft legislation was introduced to the Legislative Council in 2000 but, in view of concerns that had been expressed about the broad coverage of the legislation, the draft proposal has not progressed since. Given the fact that Hong Kong is now in the midst of a major review and rewrite of its Companies Ordinance, it remains to be seen whether the previously proposed legislation on insolvent trading laws will be reviewed in the rewriting process.

In Singapore, the insolvency law regime is similar to that of the UK in that directors of a company in liquidation may be liable for “wrongful trading” only if they are knowingly a party to the contracting of a debt when they had no reasonable or probable ground of expectation that the company would be able to pay the debt. However, unlike the UK position, Singapore does not provide a statutory defence to directors for “taking every step he ought to have taken to avoid loss to creditors”.

Directors who are convicted of a breach of the “wrongful trading” offence in Singapore are liable for a fine up to \$2,000 or to imprisonment for a term up to 3 months. To this extent, civil penalties imposed on directors in Singapore are far more lenient than those that can be imposed on Australian directors for insolvent trading. Even in the case of fraudulent trading - where there is an intention to defraud creditors - the criminal penalty on directors is only for an amount up to \$15,000 or to imprisonment of a term not exceeding 7 years.

Meanwhile, in the United States (US), the position is quite different. There is a “Chapter 11 Bankruptcy” procedure that gives protection to companies from their creditors whilst the directors of that company try to reorganise and, hopefully, return the company to profitability. Directors in the US have a right to rely on the Business Judgment Rule as a defence to act immediately to avoid financial catastrophe by implementing turn-around strategies in an attempt to preserve the company’s business. The well publicised restructures of Chrysler and General Motors are examples of the use of this defence. It basically allows some company restructuring in the “twilight zone” without the risk of personal liability provided that the directors can show that they were acting with due diligence, and it was reasonable to think that the company could continue to trade through the financial difficulties.

The Australian Commonwealth government announced in April 2009 that it would audit the issue of company directors’ liability in the second half of 2009. We should note, however, that a review of the adequacy of Australia’s insolvency laws was carried out in 2003 and the outcome was the Corporations Amendment (Insolvency) Act 2007 (Cth). Whilst the intention of the Act was to modernise, streamline and strengthen Australian’s insolvency laws, most of the amendments related to the fine-tuning of the voluntary administration process in addition to improving outcomes for creditors and deterring misconduct by company officers. There was no change to the onerous obligation on directors not to engage in insolvent trading.

In light of the current global economic crisis and the recent adoption by Australia of UNCITRAL Model Law on Cross-Border Insolvency* into the laws of Australia, it will be interesting to see the outcome of the audit proposed by the Commonwealth Government. After all, the adoption of the model law is intended to maintain Australia’s reputation as a place to do business. If Australia’s insolvency laws are, indeed, more onerous in terms of imposing personal liability on directors and, in the process, deter them from implementing turn-around strategies in an attempt to preserve the company’s business, then Australia may end up being out of step with our trading partners such as the UK or the US. Ultimately, this would not help to enhance Australia’s reputation as a place to do business.

***Footnote**

The UNCITRAL Model Law on Cross-Border Insolvency was developed by the United Nations in recognition of the fact that today’s global economy, with the assistance of telecommunications and technology, means that many corporations today are multi-national with assets and creditors in more than one country. A key objective of the Model Law is to achieve uniformity across the globe in the way that cross-border insolvencies are treated. Australia adopted this Model Law in 2008, joining countries such as UK, US, Canada, Japan, Korea, South Africa and New Zealand.

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