

Corporate Insolvency & Directors' Liability Risks Part 1



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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.

In this first part of Liberty's White Papers Series on Corporate Insolvency & Directors' Liability Risks, we look at the concept of insolvent trading, the issues that directors face when their companies are financially distressed and the management strategies that they should consider.

In Part 2, we examine the insurance issues that directors should bear in mind as a matter of personal liability risk management in various jurisdictions including Asia, UK and US.

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.

The Liberty White Paper Series

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