Book reviews

Directors' Duties During Insolvency (2nd ed) by Allens Arthur Robinson: 2007, Thomson Lawbook Co., ISBN 9780455223490. Pages: 349. Price: $135, softcover.

and

Company Directors' Responsibilities to Creditors by Keay A: 2006, Routledge-Cavendish, ISBN 9781845680084. Pages: 424. Price: £36.95, softcover.

INTRODUCTION

This review considers two recently published texts, *Company Directors' Responsibilities to Creditors* by Andrew Keay, hereafter identified as Keay's text, and *Directors' Duties During Insolvency* by Allens Arthur Robinson, hereafter identified as Allens' text. Where possible comparisons are drawn between the two texts in an attempt to determine if the authors have achieved their stated objectives.

At first glance, Keay's text may be pigeonholed as an academic text, while Allens' may be considered an insolvency practitioner's guide. However, both texts contain elements of interest for academics and insolvency practitioners alike.

TEXT SUMMARY

Keay details the current law with respect to company directors and their duty to creditors, principally in the United Kingdom but offers a comparative analysis of common law jurisdictions such as Ireland, Australia, United States, Canada and New Zealand While acknowledging the various duties owed by directors to creditors under civil law, Keay's text focuses on three responsibilities owed to company's creditors by directors. Namely:

(a) a duty not to engage in fraudulent trading;
(b) a duty not to engage in wrongful trading; and
(c) a duty to consider the interests of creditors in certain circumstances.

Allens' text is broader in its scope and considers four general categories of duties owed by directors (not necessarily to creditors) during insolvency, being:

(a) contractual;
(b) common law duty of care, skill and diligence;
(c) equitable or fiduciary duties;
(d) statutory duties.

Both texts recognise that under current English and Australian common law, while directors do not owe an independent or enforceable duty to creditors,[1] "they are still obliged to consider their interests (which includes not prejudicing them) when discharging their duties to the company as a whole, if the company is in or near insolvency".[2] This particular duty to consider the interests of creditors forms a major part of Keay's text, with eight of 22 chapters dedicated to its discussion, whereas Allens' text is more concerned with a discussion of the director's duty to prevent insolvent trading, dedicating nine of its 23 chapters to this topic.

Keay traces the development of the common law rule that directors owe a duty to their companies to take into account the interests of the creditors when companies are in some form of financial difficulty. He considers the duty to be a fiduciary one giving rise to personal liability on the part of the director. Such a duty is needed to offer creditors the protection that is otherwise lacking due, in part, to the weaknesses he identifies with respect to s 214 of the *Insolvency Act 1986* (UK). The creditors effectively replace the shareholders as the residual owners of the company at the time when the company is in financial difficulty.

[1] *Spies v The Queen* (2000) 201 CLR 603; *Liquidator of West Mercia Safetywear Ltd v Dodd* (1988) 4 BCC 30.

[2] Allens Arthur Robinson, *Directors Duties During Insolvency* (2nd ed, Thomson Lawbook Co., 2007), p 90 referring to *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722.

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Of continuing uncertainty is the particular point in time when this duty arises, along the spectrum between when a company is experiencing financial difficulties to where the company is insolvent. Keay suggests the earliest point is where the company directors "know or reasonably expect that the action upon which they are going to embark would lead to the insolvency of the company". In this regard his suggestion is consistent with the "preponderance of authority that the duty is not a continuing one" (p 220).

Keay poses two unresolved questions:

1. When do directors have to take into account creditors' interests?
2. How are directors to act if they are subject to the responsibility to consider creditors' interests when traditionally common law jurisdictions oblige directors to focus on shareholders needs and there are a variety of creditors with differing interests?

Keay proposes a framework to answer these two questions based on the premise of entity maximisation such that "directors make decisions that will maximise the general wealth of the company and enhance its sustainability" (p 241). To do so, directors should take into account creditors' interests as they form part of the community of interests which is comprised by the company and to which the directors owe fiduciary duties.[3] Adoption of such a framework would, he argues, give certainty and guidance to directors and provide some principles for the courts to evaluate directors' actions.

Problem issues are identified and possible reform measures suggested within the body of both texts. However, Keay's text retains more of an academic flavour by examining the theoretical justifications for the existence of the three responsibilities discussed and the possibility of creditors rejecting the potential benefits arising from these duties. Keay provides a brief theoretical analysis of corporate law to support his view that corporate law should require directors to consider the interests of creditors as well as the imposition of "wrongful trading" liability on directors.

What is unusual however is his placement of this analysis, which appears at the end of the text, rather than at the beginning. Perhaps the motivation for such placement was to have the text considered as a practitioner's guide rather than as an academic reading.

TEXTUAL FRAMEWORK

The layout of both texts reflects the above summary. Keay's text consists of:

Part A: Introduction

Part B: Fraudulent trading

Part C: Wrongful trading

Part D: A duty to consider the interests of creditors

Part E: Theoretical analysis of the duty to consider creditors.

Allens' text is divided similarly:

Part A: Definition and elements

Part B: The duty to prevent insolvent trading

Part C: Other general duties

Part D: Other specific duties

Part E: Liabilities and practicalities

Part A of each text is concerned with defining various terms such as debt, directors, creditors, and insolvency. Keay's text adopts a broad definition for both directors and creditors. "Creditors" includes those claims arising from the creation of a debt, albeit contingent, future or prospective; whether consensual (secured or unsecured), or involuntary in nature. "Directors" encompasses formally appointed (de jure), defacto or shadow directors.

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[3] Keay relies on *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* 1991 WL 277613; 1991 Del Ch LEXIS 215; (1992) 17 Del J Corp L 1099 (Delaware Chancery Court) at fn 55 as endorsing the entity maximisation approach.

Allens' text gives a general overview of the statutory definitions of solvency and of insolvency.[4] Solvency is defined as follows: "a person is deemed solvent if, and only if, it is able to pay all its debts as and when they become due and payable".[5] It therefore imposes a cash flow test rather than a simple excess of assets over liabilities. In contrast, when determining if a company has entered insolvent liquidation, s 214(6) of the *Insolvency Act 1986* (UK) requires a balance sheet test rather than a cash flow test be employed.[6]

Part B of Keays' text deals with fraudulent trading provisions. These chapters are more specifically directed to the United Kingdom as Australia does not have a directly equivalent provision. Rather, Australia's insolvent trading provisions are more akin to the United Kingdom's provisions against wrongful trading (found in Part C of Keay's text) and it is this issue that is considered below.

Keay draws comparisons between the United Kingdom's wrongful trading provision found in s 214 of the *Insolvency Act 1986* (UK) and s 588G of the *Corporations Act 2001* (Cth) referring to Barrett J in the New South Wales Supreme Court in *Woodgate v Davis* (2002) 55 NSWLR 222 at [36]; 42 ACSR 286 stating that:

> Section 588G and related provisions serve an important social purpose. They are intended to engender in directors of companies experiencing financial stress a proper sense of attentiveness and responsible conduct directed towards the avoidance of any increase in the company's debt burden. The provisions are based on a concern for the welfare of creditors exposed to the operation of the principle of limited liability at a time when the prospect of that principle resulting in loss to creditors has become real.

Keay considers that s 588G of the *Corporations Act 2001* (Cth) and s 214 of the *Insolvency Act 1986* (UK) are "designed to address the situation where directors can see that their company is in difficulty and they do nothing to protect creditors' interests" (p 76). In this regard he is in agreement with the Australian Law Reform Commission as denoted in the Harmer Report.[7] To that end the United Kingdom's wrongful trading provision and Australia's insolvent trading provision are "an attempt to stop directors from abusing the privilege of limited liability by making them liable if they do so and therefore discouraging directors from pursuing risk-prone investments in a make or break scenario when their company is experiencing financial distress".[8]

Like Allens' text (with respect to s 588G), Keay's book discusses s 214 in particular detail, outlining who may be a claimant (only a liquidator), what conduct contravenes s 214 (the section itself does not set out the kind of conduct considered wrongful trading), when to bring proceedings (considering the strength of evidence, the culpability as well as financial strength of directors, and the view of the largest creditors), as well as the particular elements required to satisfy s 214.

Similarly, in regard to s 588G the key elements discussed are whether there were reasonable grounds to suspect insolvency and whether the director was *actually aware* of the existence of such reasonable grounds or a reasonable person in a similar situation would have been so aware.[9]

Of greater interest is Keay's outlining of recommended director's behaviour when potentially faced with no reasonable prospect of avoiding insolvent liquidation. He recommends: "Directors must keep on top of the financial position of their company, and, in accordance with what the law now requires of directors they must be able to understand company accounts. If they are not able to do so then they must employ someone who can advise them appropriately" (p 94). Similarly, Allens' text provides assistance in the form of checklists (which appear throughout the text), which echo Keay's sentiments but are more specific regarding actual guidelines or steps to be taken regarding directors' ability to understand accounting records and employment of appropriately skilled people to provide

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[4] See *Corporations Act 2001* (Cth), s 95A.

[5] *Corporations Act 2001* (Cth), s 95A(1). *Corporations Act 2001* (Cth), s 95A(2): "A person who is not solvent is insolvent."

[6] Keay A, *Company Directors' Responsibilities to Creditors* (Routledge-Cavendish, 2007) 86.

[7] Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 Vol 1 (1988) at [272].

[8] Australian Law Reform Commission, n 7, p 76.

[9] *Corporations Act 2001* (Cth), s 588G(1), (2).

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such key financial information.[10] In this regard, Allens' text benefits from the experience of its authors, the majority of whom are insolvency practitioners.

Although Keay's analysis of court cases indicates that liability on directors is not readily imposed, he does identify that s 214 orders have been made involving "exclusively small closely held companies" (p 99). He highlights various reasons for this phenomenon, including the difficulty for directors of small companies to divorce themselves from the failure of the company's enterprise and the more readily available financial information to directors of large companies. Unfortunately the Allens' text is lacking a similar analysis in regard to s 588G.

Having discussed the pros and cons of s 214 at length, Keay makes recommendations for reform of the section. While a number of recommendations are not extensive, such as including administrators as well as the Secretary of State for Trade and Industry to commence proceedings under s 214 but rejecting the notion of permitting creditors to do so, others are more radical, including replacing s 214 with provisions very similar to those of ss 588G and 588H of the *Corporations Act 2001* (Cth) and the recommendations of the Cork Committee[11] such that directors would be liable if they traded when the company was insolvent. If such reform were to take place, then it would be appropriate to consider Allens' text where the authors identify two loopholes that exist in regard to the defence available under s 588H(3) and the possible reform thereof.

POSSIBLE ADDITIONS TO THE TEXTS

In relation to Keay's text, the omission of corporate groups, specifically holding company liability where one or more group companies are experiencing financial difficulties is a key area that requires attention. Failure to include any such discussion may be a reflection of there being no provision equivalent to s 588V of the *Corporations Act 2001* (Cth) in the *Insolvency Act 1986*. However, given Keay's recognition that directors have an albeit indirect duty to consider the interests of creditors as a function of their "entity maximisation" goal, then a discussion of whether this duty should extend to the directors of a holding company and the incurrence of a debt by the subsidiary while insolvent or becoming insolvent as a result of the debt is warranted. Similarly, if Keay recommends reform of s 214 of the *Insolvency Act 1986* (UK) along the lines of s 588G of the *Corporations Act 2001* (Cth) it would be appropriate to consider holding company liability along the lines of s 588V of the *Corporations Act 2001* (Cth).

Similarly, there is omission of relevant material from Allens' text. Allens' attempt to include theoretical rationale for the particular laws (the majority statutory provisions) extends only to explanatory memoranda or previously issued reports of reform bodies.[12] The authors make no attempt to link directly with corporate theory with the exception of the separate entity and economic entity discussion regarding holding company liability under s 588V of the *Corporations Act 2001*. In this regard, Allens' text lacks the underlying theme, recurrent in the Keay text, of the indirect duty owed by directors to consider the interests of creditors.

CONCLUSION

Allens' text concentrates on serving the practical needs of insolvency practitioners, directors and creditors by providing a text that supplies the essential background to insolvency and discusses the Australian statutory and common law duties facing directors during insolvency in a convenient, practically orientated, and lucid manner. Thus, it provides a useful checkpoint for directors, legal or accounting professionals or creditors requiring assistance in dealing with corporate insolvencies.

[10] The checklists are based upon guidelines provided to directors and the courts to consider whether directors have acted reasonably in assessing grounds of possible insolvency under *Corporations Act 2001* (Cth), s 588G. See *Corporate Law Reform Bill 1992* (Cth), Public Exposure Draft and Explanatory Paper (1992) at [1229].

[11] United Kingdom, Department of Trade, Insolvency Law Review Committee (Cork Committee), *Insolvency Law and Practice* (1982).

[12] Such as Australian Law Reform Commission, *General Insolvency Inquiry*, Report no 45 Vol 1 (1988) (*Harmer Report*) or Corporations and Markets Advisory Committee, *Corporate Duties Below Board Level* (April 2006).

In comparison, Keay's text while providing a doctrinal perspective of the United Kingdom's statutory wrongful trading and fraudulent trading provisions, also undertakes comparative and theoretical analysis in attempting to determine whether directors should be held responsible for wrongful trading or for failing to consider the interests of creditors. In this regard, Keay's text adds to the theoretical legal scholarship of company law in not only the United Kingdom but in Australia, New Zealand and other common law jurisdictions. However, as noted at the outset of this review the two texts contain elements of interest for academics and insolvency practitioners alike. Hence it is conceded that any criticism based on omitted material may be considered harsh if it is accepted that the emphasis of Keay's text is an academic one and Allens' text is as a practitioners guide respectively. Both would be welcome additions to any corporate insolvency law library.

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