

AUSTRALIAN GOVERNMENT: THE TREASURY

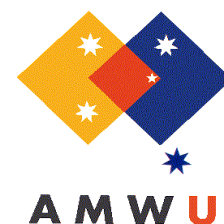
Insolvent trading: A safe harbour for reorganisation attempts outside of external administration

Proposals Paper January 2010

**Comments by the
Automotive, Food, Metals, Engineering, Printing and Kindred
Industries Union known as the Australian Manufacturing Workers'
Union (AMWU)**

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Introduction

The AMWU thanks the Treasury and The Honourable Chris Bowne MP, Minister for Human Services, Financial Services, Superannuation and Corporate Law (the Minister), for this opportunity to respond to this paper.

The AMWU represents approximately 120,000 members working across major sectors of the Australian economy. AMWU members are primarily based in the manufacturing division in the sub-divisions of metal manufacturing, printing and graphic arts, food and vehicle building, repair and service. The AMWU also has significant membership in the mining, building and construction, aircraft and airline operations, laboratory, technical, supervisory and public sector employment. Our members work in unskilled, semi skilled, trade and professional occupations within these industries and source their workplace entitlements and responsibilities from a variety of industrial instruments including award, over award certified agreements and common law arrangements.

This discussion paper is in response to concerns held by industry participants and stakeholder groups that the laws, 'directed at preventing businesses from trading while insolvent may negatively impact on genuine work-out attempts; in particular, where restrictions on the availability of credit impede the ability of businesses to temporarily maintain solvency while work-outs are attempted.'

The AMWU notes that the main purpose of the discussion paper is to canvas opinion in relation to three possible options for reform, which are outlined in the paper, concerning business rescue outside of external administration.

Proposed Options

The three possible suggested options for reform are:

Option 1: Status quo

There would be no change to the current law. Directors need to ensure that their company is solvent whilst attempting to reorganise outside of external administration.

Option 2: Modified business judgement rule

A director's duty not to trade whilst insolvent would be considered to be satisfied if, in addition to the requirements in the business judgement rule in section 180 of the Corporations Act 2001 (the Act):



- the financial accounts and records of the company presented a true and fair picture of the company's financial circumstances;
- the director was informed by restructuring advice from an appropriately experienced and qualified professional with access to those accounts and records, as to the feasibility of and means for ensuring that the company remained solvent or that it was returned to a state of solvency within a reasonable period of time;
- it was the director's business judgement that the interests of the company's body of creditors as a whole, as well as of members, were best served by pursuing restructuring; and
- the restructuring was diligently pursued by the director.

Option 3: Moratorium

Directors would be able to openly and expressly invoke a moratorium from the duty not to trade whilst insolvent for the purpose of attempting a reorganisation of the company outside of external administration. The moratorium would apply for a limited period and would be subject to termination by creditors.

Conclusion of the AMWU

The status quo should be maintained.¹

If this is not the option that the Government adopts then consideration should be given to placing some practical constraints upon the other options prior to implementation.

Reasons for Conclusion

The discussion paper helpfully gives a brief outline of what Australia's current insolvency regime is, the liability of directors under that regime and their means for relief from liability as well as exploring the effects of insolvent trading. The insolvency of a company is then explored, together with the possible responses and then the proposed options for dealing with the reorganisation of a company outside of external administration and the advantages and disadvantages involved.

The stated purpose of this paper² is 'to seek the views of stakeholders on issues that arise for

¹ In a submission to the Treasury Proposals Paper November 2009, *Action against fraudulent phoenix activity*, the AMWU argued that there should be certain amendments to the Corporations Act 2001 as a means of curbing phoenix behaviour and reiterate this contention in this paper.

² Para 1.9.

companies and directors from the operation of the insolvent trading laws, in the context of attempts at business rescue outside of external administration.’ Taken as a whole however it is clear that the Government is primarily seeking views in relation to the argument that the current laws, in the current global economic climate, around insolvency and directorial liability hinder entrepreneurialism and calculated risk taking among directors. Central to this is the concept of the business judgment rule and the notion of safe harbours.

Calls for reform to Australia’s corporate law in respect of safe harbours and the business judgment rule are nothing new; over 20 years ago it was a subject of consideration of Parliamentary Committees.³ The most recent manifestation, which is referred to in the discussion paper at paragraph 1.3 and following, was in 2007 where the ‘previous government sought views on the introduction of a “general defence” in the Corporations Act to alleviate concerns that some corporate law sanctions were adversely affecting directors’ willingness to engage in responsible risk taking.’

Much like the current discussion paper, the 2007 paper *Review of Sanctions in Corporate Law* (the 2007 Paper) canvassed whether there should be some form of general protection for directors, relieving them of liability in certain circumstances. The mooted relief requirements were that a director had acted in a bona fide manner; within the scope of the corporation’s business; reasonably and incidentally to the corporation’s business; and for the corporation’s benefit.’ The current discussion paper, unlike the 2007 paper, does not have the element of acting in a bona fide manner, as a requisite before being able to invoke a general protection for directors. The AMWU considers this, from a legal standpoint, to be a positive thing as such a requirement would do nothing to add to the required duties of good faith under s 181 of the Act and may in fact have caused some conflict or difficulty when judicially assessed with those fundamental duties when considering instances of insolvent trading and liability.

Although it is stated in the discussion paper at paragraph 1.13 that the, ‘Government has not reached a position on the options or any of the issues raised in this paper, but will consider them in light of the submissions received,’ the Minister acknowledged⁴ that he had a preference for a modified business judgment rule for insolvent trading ‘so that directors would be relieved of the duty not to trade whilst insolvent’ subject to certain conditions.

³ Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors’ Duties*, November 1989, and Companies and Securities Law Reform Committee, *Company Directors and Officers: Indemnification, Relief and Insurance*, Report No 10, May 1990.

⁴ In an interview with the Sydney Morning Herald on 19 January 2010, see <www.smh.com.au/business/chapter-11-mooted-for-business-rescues-20100119-mj8l.html>.

This appears to accord with much of the impetus behind the rationale of the 2007 Paper, where Treasury referred to one of the reasons for extending the general defence to prevent insolvent trading that needs

to be considered in light of the possible unwillingness of directors to make business decisions as their company approaches insolvency. One viewpoint is that many directors who take risks when their company is close to financial insolvency do so in the genuine belief that by taking the appropriate investment or other decision, the company may be able to trade out of its financial difficulties and should therefore have the benefit of additional legal protections.

This viewpoint paraphrased and referred to an argument advanced by Robert Baxt, a partner at the law firm Freehills, in an article he wrote titled *Insolvent trading — a possible new approach* 16 May 2006.⁵

Other frequent advocates for the broadening of the business judgment rule are the Business Council of Australia and the Australian Institute of Company Directors (AICD). The latter recently issued a press release in relation to this discussion paper in which they advocate a further broadening of the business judgment rule beyond that proposed in relation to insolvency.⁶ The AICD website is replete with articles calling for the extension of the business judgment rule, though they contain little analysis of the existing business judgment rule and its efficacy.

A statutory business judgment rule was introduced into the Act with the CLERP Act. Section 180(2) provides that a director (or other officer) of a corporation who makes a business judgment will be taken to meet the requirements of the duty of care and diligence in s180(1), and their equivalent duties at common law and in equity, in respect of that judgment in certain circumstances. Section 180(3) defines the business judgment rule as any decision to take or not take action in respect of a matter relevant to the business operations of the corporation. In order to obtain the benefit of the business judgment rule, a director must:

- make the judgment in good faith for a proper purpose;
- not have a material personal interest in the subject matter of the judgment;
- be informed about the subject matter of the judgment to the extent they

⁵ Available by subscription on the CCH website, see <www.cch.com.au/au/ContactUs/Print.aspx?ID=8898>

⁶ Available from the AICD website, see <www.companydirectors.com.au/Media/Media+Releases/2010/AICD+welcomes+insolvency+law+reforms.htm>

reasonably believe to be appropriate; and

- rationally believe that the judgment is in the best interests of the corporation.

As can be seen from a reading of s 180 it is quite clear that the business judgment rule as it presently exists provides a safe harbour for directors against claims that they have not exercised the appropriate care and diligence in their decision-making. And it is equally clear that provided they are appropriately informed and rationally believe that their actions are in the interests of the company they are able to take risks without fear of any action being taken against them. Any risk aversion a director might have more likely stems from the mutual interests they have in common with the company of which they are a director (shares, bonuses etc) rather than a fear of legal action levelled against them personally for what might turn out to be a bad commercial decision.

The Australian courts do not have a history of punishing company directors for bad decision making. It cannot be ignored that, even before the statutory availability of the business judgment rule, provided the decision and actions were taken in good faith and for a proper purpose, the courts will not interfere in the business of companies. The courts have explicitly stated that it is the role of the directors not judges to assess whether or not a decision or action is in the commercial interests of a company. The High Court over 40 years ago famously observed that, '[d]irectors in whom are vested the right and duty of deciding where the company's interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts.'⁷ A few years later this view was reaffirmed where it was observed that:

[I]t would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision ... if bona fide arrived at. There is no appeal on the merits from management decisions to courts of law nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.⁸

This judicial line of reasoning has not changed in recent years to warrant the legislative changes as proposed in the options put forward. As recently as 2007 the court held that the

⁷ Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL (1968) 121 CLR 483

⁸ Howard Smith Ltd v Ampol Petroleum Ltd [1974] 1 NSWLR 68; (1974) 3 ALR 448; [1974] AC 821 at 832; [1974] 1 All ER 1126, per Lord Wilberforce.

question of whether to enter into a merger proposal involving a deed that provided for a break fee which included money spent by the other company in the merger which was involved in a previous merger that fell through was a matter for directors' commercial judgment, it was not as the plaintiff contended a breach of the directors' duties.⁹

In the same case the court stated further that

There is a well-known line of authority to the general effect that it is the province of directors, not the courts, to identify where the interests of a company lie, and that the courts do not exercise a supervisory function over the business judgments of directors: see, for example, *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* [1968] HCA 37; (1968) 121 CLR 483 at 493; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC) at 832. Unlike a company's power to issue shares with which the cases just cited were concerned, the power to agree to the inclusion of a break fee provision in a complex contract of the TID kind, being sui generis, is even less apt to being circumscribed by any more detailed rules than the general duty expressed in s 181(1).¹⁰

The common law approach by the Australian courts has equivalents in other jurisdictions. For example in the United States there exists a business judgment rule that offers a director protection from civil liability in relation to business decisions and actions provided (1) they do not have an unauthorised interest in a transaction of the company to which the business judgment related; (2) they have appropriately informed themselves about the subject of the judgment; (3) they have acted in good faith or for a proper purpose; or (4) they have acted as a reasonable director with like experience would have acted in respect of the interests of the company.¹¹

As was said as early as 1919 in the US, the courts 'will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds.'¹² Similar sentiments and notions of the business judgment rule are found in United Kingdom¹³, New Zealand and Canada. In none of those jurisdictions has there

⁹ *Idameneo (No 123) Pty Ltd v Symbion Health Limited* [2007] FCA 1832

¹⁰ *Ibid* at para 114.

¹¹ *Aronson v Lewis* (Del 1984) 473 A 2d 805.

¹² *Dodge v. Ford Motor Co.* (1919) 204 Mich. 459.

¹³ See for example *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407 and section 727 of Companies Act 1985, which although to some extent provides similar relief or defence as the statutory business judgment rule in Australia should not be taken to be a codification of the business judgment rule in the UK as that jurisdiction has previously considered whether the business judgment rule should be codified and to date has decided that it is not necessary for it to be written into statute as the courts are quite capable of deciding whether the rule should be applied in the cases that are brought before them.

been any move for special provisions of the rule in relation to insolvency trading despite there being greater exposure to and impact of the GFC.

It should be borne in mind that if there were to be any extension or revised version of the business judgment rule that it will ultimately still be subjected to interpretation and assessment by the courts and that the courts are likely to do this with reference to the relevant case law.

Moving to the proposed moratorium option, the AMWU agrees with the Minister as acknowledged in a recent interview¹⁴, that it is the most radical proposition. It has been characterised as being similar in nature to the US Chapter 11 bankruptcy provisions, but one, the AMWU believes with less formality, fewer safeguards and the potential for much uncertainty.

The moratorium option also raises questions with respect to contracts, those that are currently in existence and those that will be created if a form of moratorium does advance into statute. For example, could a company become contractually bound to enter into a moratorium on the happening of a certain event, or might the actual entering into a moratorium be contractually considered to be an event that itself gives rise to a default under the terms of a contract?

There would of course also be significant concerns surrounding the practical running or regulating of a period of moratorium and the costs and risks that would be involved. And finally, as pointed out in the discussion paper, there remains the fact that additional time limits, their extensions and the actual termination of a moratorium will be subject to the behest of the creditors and not decisions that the directors are able to freely control.

In relation to the viewpoint of overly complex laws and processes the AMWU observes that it is not necessarily laws, rules and regulations that impede entrepreneurialism; it depends on the actual regulations in place. For example, those in relation to the availability of credit lending and raising have not hindered entrepreneurial activity in Australia. In fact Australia's regulations in this respect have been claimed to be part of the reason why Australia has managed to avoid much of the impact of the GFC. As the former Treasurer, Peter Costello claimed on Lateline in February last year¹⁵ in response to a speech by the Deputy Prime

¹⁴ In an interview with the Sydney Morning Herald on 19 January 2010, see < www.smh.com.au/business/chapter-11-mooted-for-business-rescues-20100119-mj8l.html >.

¹⁵ ABC TV, originally broadcast on 3February 2009, see < www.abc.net.au/lateline/content/2008/s2481545.htm >

Minister at Davos where she extolled the virtues of the Australian regulatory regime in comparison to those in other countries:

I think the US regulatory system was deficient. The US regulatory system had the Federal Reserve regulating banks, essentially nobody regulating mortgage originators. They didn't have proper insurance regulators. In the US, they have 50 insurance regulators, one for each state. And they had nobody looking at the overall prudential control of the system. Now, we recognised that was an error in 1997. And in 1997, I established a body called the Australian Prudential Regulatory Authority, A.P.R.A. - APRA. And we took prudential regulation away from the Reserve Bank. ...

Now, the Australian banks, which prior to that would have been considered minnows in world terms, are now, because of all of the failures in the US, are now amongst the 20 top banks in the world and they're all double A-rated.

The discussion paper also recognises at paragraph 4.1.4 that the restrictions on companies accessing credit have eased significantly. So, in many respects the GFC as an argument in favour of safe harbour legislation lacks the force it might previously had.

The AMWU notes that the options do not propose any temporary period of operation. If one of the reasons for the proposed options is indeed the GFC then a temporal aspect to the options should be given some consideration. Germany for example is allowing some flexibility in relation to insolvencies, but only for a limited period - until the end of 2013. As a means of dealing with the GFC, the German Government amended section 19 of the German Insolvency Code, which provides for a statutory definition of insolvency. Prior to its amendment in October 2008 (which was originally to last only to 31 December 2010), company directors were under a statutory obligation to file for insolvency within a period of three weeks once book liabilities exceeded book assets. The amendment allows company directors the defence to the charge of trading while insolvent, or over indebted, where they can show there were circumstances which made it reasonably likely that the company would be able to trade out of its insolvency.

The AMWU acknowledges that external administration can often be expensive and time consuming, and that there will be adverse consequences on existing, not to mention potential future contracts, and very possibly a negative effect on a company's value and the market's confidence. However, the ease with which an enterprise can be kept running through troubled times has to be carefully weighed against the duty to protect creditors from

insolvent trading. After all there is more at risk to the economy as a whole if its laws and regulations around insolvency have lost the faith and confidence of the markets. This point is broadly recognised in paragraph 3.9 of the discussion paper.

If the broader policy objective is considered to encompass the general notion that directors should not place the companies of which they are directors into administration and perhaps ultimately into insolvency, proper consideration needs to be given of the operation of the General Employee Entitlements and Redundancy Scheme (GEERS).

GEERS was never supposed to be a long term solution. The longer it continues the more problems it creates. One of the unforeseen consequences is that when companies are placed into administration the administrators make a decision to liquidate as they know they will receive access to GEERS. It is the AMWU's experience that when a company has been placed into administration, the administrators weigh up the benefits of attempting to trade out or liquidate and one of the benefits is activating the GEERS payments thereby acting as an incentive to enter into liquidation as opposed to putting together a Deed of Company Arrangement.

Employers need to take responsibility for the money they owe their workers. It is not acceptable for employers to rely on government to cover their costs or to be able to treat their employees' entitlements as an interest free unsecured loan.

The AMWU is of the view that we need reform of the corporations law to allow proper prosecution of employers (including the directors) who do not put away funds to cover the legal obligations they owe to their employees.¹⁶

The current business judgment rule would protect the bona fide directors, but the unscrupulous rogues should be, and after appropriate modifications to the Ac, would be, held to account.

However, in the shorter term in relation to GEERS the Government should extend the GEERS entitlement beyond the cap of 16 weeks, and to remove the incentive to liquidate should look at relaxing the conditions around when payments may be made out of GEERS. Payments should be able to be made during a company's external administration and not only once an insolvency event has occurred. This practical proposal would have the advantage of providing employees access to much needed finances and would discourage companies

¹⁶ See the AMWU submission to the Treasury Proposals Paper November 2009, *Action against fraudulent phoenix activity*, the AMWU for further details arguing for amendments to the Corporations Act 2001.

entering insolvency to the extent that payments to insolvency practitioners are dependent on a company's insolvency status.

As per our recent submission¹⁷, the most effective solution in securing employee entitlements is to establish a universal scheme funded by a very small levy contribution by employers. Until such time, GEERS has to be amended, as does the corporations law to prosecute rogue directors.

In closing the AMWU would like to observe that it should not be forgotten that the reasoning underlying s 588(G) and related provisions of the Act:

[S]erve 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.¹⁸

Dave Oliver
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¹⁷ AMWU submission into the Inquiry into Australia's Insolvency Laws, 31 July 2003.

¹⁸ per Barrett J in *Woodgate v Davis* [2002] NSWSC 616 (12 July 2002) at para 36.

