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DIRECTORS' LIABILITY FOR INSOLVENT TRADING

Highlights

Unsecured creditors have claims of $100 million.

Company trades in insolvent circumstances.

Well known and respected company director held personally liable for debts.

Creditors end up with nothing because all available money goes to the litigation funder, the liquidator and the lawyers!

Economic Uncertainty

With stock markets in turmoil and business confidence reaching new lows, one can expect that some businesses will experience financial pressures.

A Tough Case

For this reason we wanted to talk about the tough outcome of a recent case (Hall v Poolman).

The case related to the financial collapse of the Reynolds Group which went into voluntary administration in August 2003 (and subsequently into liquidation) owing its unsecured creditors about $100 million. The Reynolds Group was involved in wine production, marketing and sales.

The case focused on the liability of Malcolm Irving, the Chairman of the Company and a man whom the judge referred to as having had a "long and highly distinguished career as a director of many substantial companies", including Caltex Australia Ltd and Telstra Corporation.

Insolvent Trading

There is a simple definition in the legislation about "solvency". A company is solvent if, and only if, it is able to pay all of its debts, as and when they become due and payable. Otherwise it is "insolvent". That simple statement is easy to express but difficult to apply in practice. As the Court said, "the test of solvency of a company is … a question of fact and the Court approaches that question as a matter of commercial reality".

A Company liquidator can recover from the directors personally, the loss suffered by a creditor to whom a debt is owed if the Company incurs that debt when it is insolvent, (or becomes insolvent as a result of incurring the debt).

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A Director has a defense against the claim if he can prove that he had reasonable grounds to expect, and did expect, that the Company was solvent.

Even if a director fails in that defense, there is another potential lifeline, where the Court can relieve a director from liability if it thinks that he ought fairly to be excused, having regard to all of the circumstances.

Finding of Insolvency

After an exhaustive analysis of the Reynolds Group's financial position, the Court concluded that it had been insolvent throughout the whole of the period when it continued to incur trade debts, ie from October 2002 until it was placed into administration in August 2003 – about 10 months.

The problem for the directors was complicated by their uncertainty about a major liability to the tax office – which would tip the scales against the Reynolds Group's solvency.

For Mr Irving to be liable, the Court would have to decide that a reasonable person in his position would have been aware that the Company was insolvent. The Court analysed the kind of enquiry that a director would have to make. He must "inform himself or herself as fully as possible of all relevant facts". The director has to ask whether the available assets can be turned into cash to meet the company's debts. He must ask "Is that outcome certain, probable, more likely than not, possible with a bit of luck, possible with a lot of luck, remote, or is there no real way of knowing". The director runs the risk that a Court would come to a different conclusion.

However, if the director simply does not know the answer, then there is no way that he can have a reasonable expectation of solvency and the director cannot reasonably justify the continuation of trading. If that happens the director should "call the administrators". "The directors must face up to the issue of insolvent trading directly and with brutal honesty: they must not shirk from asking themselves the hard questions and from acting resolutely in accordance with the honest answers to those questions".

The Court concluded that Mr Irving did not have reasonable grounds to expect that the Group would be able to pay its debts as they fell due! Accordingly Irving could not rely on the defense that there were reasonable grounds to expect that the company was solvent.

The Defense of Acting Honestly

Nevertheless, the Court has a discretion to relieve a director, either wholly or partly from liability if it finds that the director has acted honestly and having regard to all of the circumstances, the director ought fairly to be excused. This was referred to by the Court as the "discretionary exoneration defense". The Court has a wide discretion to excuse company officers from liability in situations where it would be unjust and oppressive not to do so, recognising that they are business people acting in an environment involving risk in commercial decision-making.

This information in our newsletter is intended to draw your attention to the development of the Legal and Corporate Consulting Industries. Our newsletter do not constitute legal advice.

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It is a difficult decision for a director of a trading company which is suffering from liquidity problems to decide whether, and when, to abandon hope. As the Court noted, there are often pressing interests involved in the decision such as the jobs of employees which would be lost and the investment of shareholders which would evaporate. On the other hand, creditors whose business depends on payment could be ruined if the Company were to continue to trade while insolvent.

Should the Court exercise its discretion to wholly or partially exonerate Irving from liability? The Court identified a point in time (during February 2003) when, having had an unsuccessful meeting with the ATO, Irving ought to have appreciated that there was no reasonable prospect of the Group resolving its dispute with the ATO. Up to the time of that meeting, Mr Irving had acted as other reasonable, commercially experienced directors might have acted. The Court decided to exonerate him from liability for the period up to the date of the ATO meeting, but no further. He would be liable for the debts incurred during the remainder of the period from February until the date of administration in August.

Litigation Funding

A troubling aspect of this case was that from the start it was known that even if the liquidators recovered the full amount of their claims from the directors, after payment of the litigation funder's costs and the costs of the liquidators and their solicitors, unsecured creditors would receive no more than a fraction of a cent.

Mr Irving argued that he should not personally suffer a heavy judgment in circumstances where he was guilty, not of dishonesty, but of error of judgment, when those who have truly suffered, ie the creditors, would get very little or nothing out of the case.

In our November 2007 newsletter, we talked about the benefits of litigation funding, and noted that one of the recognised benefits of using a litigation funder was that it gave access to justice for plaintiffs who would not otherwise be able to afford to litigate. In this case however the judge found that if "access to justice" for creditors was a justification for these proceedings, then justice failed because the creditors would be lucky to get anything at all.

As the judge said "hard cases make bad law". This case showed how a mammoth piece of litigation could be the ruin of a defendant, with negligible access to justice for those who had really suffered loss. At the same time, there were lucrative rewards to be had for those who made a business of investing in litigation!

However, the Court (with obvious regret) concluded that despite the derisory return to creditors, this could not provide relief from liability for Mr Irving.

Mike Lyons

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