Superfluous or Superlative: The Role of Reckless/Insolvent Trading prohibitions in New Zealand, Australian and South African Directors’ Duties Regimes

Julie Cassidy
Department of Commercial Law
University of Auckland
Introduction

Sections 135 and 380(4) Companies Act 1993 (NZ) and
Section 588G Corporations Act 2001 (Cth)
Sections 22(1) and 77(3)(b) Companies Act 2008
directors' duty not to engage in reckless trading (in the case of New
Zealand and South Africa) and insolvent trading (in the case of New
Zealand and Australia)
Section 137 Companies Act 1993 (NZ)
Section 180 Corporations Act 2001 (Cth) and
Section 76(3)(c) Companies Act 2008
statutory directors' duty of care
Introduction

Directors' duty not to engage in reckless trading (in the case of New Zealand and South Africa) and insolvent trading (in the case of New Zealand and Australia) has not a common law equivalent.

In each jurisdiction statutory directors' duty of care stands side by side with the complimentary common law duty of care. At times this is explicit (ss 185 and 193 Australia), otherwise implicit (New Zealand and s 77(2) South Africa).

Are the reckless / insolvent trading provisions an unnecessary duplication in light of the statutory duties of care? Is it necessary to provide a remedy for a breach of both when either one of the two would suffice?
Introduction

A significant overlap in the operation of the provisions
In both Australia and New Zealand both duties have been interpreted as
imposing an objective test with the standard of the “reasonable director”
at their core
South Africa the issue is still controversial however leading view is that
the common law duty of care is subjective, while both statutory duties
are objective in nature
Introduction

Serious breaches of these two directors’ duties, namely s 131 (the duty of act in good faith and in the best interests of the company) and s 135 (reckless trading) can now have criminal, not just civil consequences. The Companies Act 1993 contains two new offences contained in ss 138A and 380. Still no criminal consequences for the duty of care.
Introduction

In Australia a dishonest breach of s 588G can attract criminal liability under s 588G(3)
While a dishonest the breach of s 180(1) only civil consequences flow

The business judgment rule defence contained in ss 180(2) (Australia) and s 76(4)(a) (South Africa) only provides a safe haven for directors under the duty of care and thus does not extend to breaches of the reckless/ insolvent trading provisions
Section 588H has quite specific defences that only apply to breaches of the insolvent trading provisions
Introduction

This begs the question whether the provisions are an unnecessary duplication?
While there is a significant overlap in each jurisdiction, the reckless / insolvent trading provisions play an important additional role.
In the context of the reckless / insolvent trading provisions the director’s must shift their focus from the shareholders’ to the creditors’ interests.
While the duty continues to be owed to the company, reflecting this concern with safeguarding creditors’ interests, at times statutory relief is also extended to creditors.
Arguably this focus on creditors’ interests in times of doubtful solvency plays an important part in ensuring directors adequately monitor corporate solvency.
Australia: Duty of Care

Section 180(1) and common law duty of care
Both have been interpreted as imposing an objective test: Daniels v Anderson (1995); ASIC v Rich [2009]
Section 180(1) imposes a duty to exercise the “degree of care and diligence that a reasonable person would exercise”
Interpreted as a reasonable director test: ASIC v Rich [2009]
Section 180(1)(a) and (b) factors provide some flexibility
ie composition of board and size of the company
but ultimately an objective test
Australia: Duty of Care

Objective reasonable director test under negligence: Daniels v Anderson (1995)
Detailed requirements of a reasonable director: Daniels v Anderson (1995)
Cannot plead personal idiosyncrasies
**Australia: Insolvent trading**

Section 588G(1) applies where a person is a director and company incurs debt. Company is insolvent and reasonable ground to suspect insolvent. Section 588G(2) imposes a duty to prevent the company incurring the debt. Triggered where director is aware or a “reasonable person” would be aware. An objective reasonable director test: Metropolitan Fire Systems (1997). “Like position” and “company’s circumstances” provide some flexibility but ultimately objective test. Subjective dishonesty only relevant for criminal liability: s 588G(3). Cannot plead ignorance: Metropolitan Fire Systems (1997); DCT v Clark (2003).
Australia: Insolvent trading

Even defences interpreted as requiring director to have met objective duty of care

Section 588H(2): reasonable grounds to expect company solvent
Only if monitoring company’s finances: Metropolitan Fire Systems (1997)

Section 588H(3): delegation of solvency
Section 588H(4): did not take part in management for a good reason
Cannot plead passive director: DCT v Clark (2003)
Cannot plead ignorance: Metropolitan Fire Systems (1997)

Section 588H(5): took all reasonable steps to prevent the company incurring the debt
Australia: Prerequisites

Technically prerequisites differ
Section 180(1) failure to exercise standard of a “reasonable person”
Section 588G(1) must “incur” a “debt” when “insolvent” and “reasonable grounds for suspecting”
Section 588G(2) “aware” or “reasonable person” would be
Factually a breach of s 588G would be a breach of s 180(1)
Focus is on insolvency and directors’ failure to monitor solvency

Note, interplay with the duty to act in good faith and company’s best interests in equity and s 181(1)(a)
In insolvency interests of shareholders displaced by creditors’ interests: Spies (2000)
Australia: Defences

The defences for these duties differ
The business judgment rule defence contained in s 180(2) only provides a safe haven for directors under the duty of care
It does not extend to breaches of the insolvent trading provisions

Delegation defence: s 190(2)
Reliance defence: s 189

Section 1317S a court can excuse from civil penalty liability
Must act honesty and ought fairly be excused
Applies to both s 180(1) and 588G
Australia: Defences

Section 588H quite specific defences that only apply to breaches of the insolvent trading provisions
Section 588H(2): reasonable grounds to expect company solvent
Only if monitoring company’s finances: Metropolitan Fire Systems (1997)
Section 588H(3): delegation of solvency
Section 588H(4): did not take part in management for a good reason
Section 588H(5): took all reasonable steps to prevent the company incurring the debt
Australia: Consequences

Both ss 180(1) and 588G are civil penalty provisions
Penalty of up to $200,000
Disqualification particularly under s 206C

A dishonest breach of s 588G can attract criminal liability: s 588G(3)
A dishonest the breach of s 180(1) has only civil consequences

Compensation payable to the company: ss 1317H and 1317J
Company initiates or joins ASIC civil penalty action
Creditors have no standing
Compensation payable to the company: s 588J, 588K and 588M
While normally liquidator initiates or joins ASIC civil penalty action
Limited right of creditors to bring an action s 588M(2)
New Zealand: Duty of Care

Section 137 and common law duty of care
Both have been interpreted as imposing an objective test: Mason v Lewis [2009]; Dairy Containers Ltd [1995]
Section 137 imposes a duty to exercise the “care, diligence and skill” of a “reasonable director”
A reasonable director test
Section 137(a) - (c) factors provide some flexibility: Vercauteren v B-Guided Media Ltd [2011]
ie nature of the company and position of the director
but ultimately objective test
Duty to guide and monitor the company: Mason v Lewis [2009]; Dairy Containers Ltd [1995]
New Zealand: Reckless trading

Section 135 applies where a person is a director and the company’s business is conducted in a manner likely to create a substantial risk of serious loss to the company’s creditor’s. It has been interpreted as a duty to prevent the company incurring the debt: Mason v Lewis [2006]. Essence is seen as reasonable care: FXHT Fund [2010]. Objective test: Mason v Lewis [2009]. Interpreted as an objective “ordinary prudent director” test: Thompson v Innes (1985). Because of overlap often an action is brought under both s 135 and 137: Ocean Boulevard Properties v Everest (2000); FXHT Fund [2010]; Jordan v O’Sullivan.
New Zealand: Prerequisites

Technically prerequisites differ
Section 137 failure to exercise the standard of a “reasonable director”
Section 135 must be a “substantial risk” of “serious loss to the company’s creditors”
Note, technically no reference to insolvency
Absence insolvency how can there be a risk of loss?
Action normally brought under s 301 when company is in liquidation
**New Zealand: Prerequisites**

While factually a breach of s 135 would be a breach of s 137, focus is on “serious loss” to creditors and insolvency.

Note interplay between s 135 and duty to act in good faith and company’s best interests in equity and s 131(1). In insolvency interests of shareholders displaced by creditors interests: Nicholson v Permacraft (NZ) Ltd (in liq) [1984]
New Zealand: Defences

There are no specific defences to these duties
General defences:
Delegation defence: s 130
Reliance defence: s 138
New Zealand: Consequences

Until recently there were no specific statutory consequences for breaches of these duties
This remains true for civil breaches of ss 131 and 135
Remedies are in equity/common law

While strictly duty is owed to the company: Mason v Lewis (2009)
Action normally brought under s 301 when company is in liquidation
Allows the court to order repayment of money/property or pay compensation
Proceedings can be initiated by liquidator, shareholder or creditor
Can include an order of payment to the creditor: s 301(1)(c)

Disqualification primarily under s 385
**New Zealand: Consequences**

Serious breaches of these two directors’ duties now have criminal consequences. Criminal liability will follow for a breach of the duty of act in good faith when the director acts in “bad faith”, “believing the conduct is not in the best interests of the company” and “knowing, or being reckless” as to whether the conduct will cause a “serious loss to the company” or “benefit or advantage” a person: s 138A(1). Criminal liability for reckless trading will arise when the director “knows” that as a consequence of the conduct “a serious loss will be suffered by 1 or more of the company's creditors”: s 380(4).
New Zealand: Consequences
The director will in turn face the penalties set out in s 373(4) Companies Act 1993
Five years imprisonment or a fine of up to $200,000. As a breach of these duties will now constitute an offence, the automatic ban from management for five years under s 382 Companies Act 1993 will apply
South Africa: Duty of Care

Section 76(3)(c) and common law duty of care
Common law have been interpreted as imposing a subjective test: Fisheries Development Corp of SA Ltd v Jorgensen “Gross negligence”
Section 76 imposes a reasonable director test
Section 76 factors provide some flexibility
ie composition of board and size of the company
but ultimately an objective test
South Africa: Insolvent trading

Section 77(3)(b) applies where a director “acquiesced in the carrying on of the business despite knowing that it is conducted in a manner prohibited by section 22(1)”

Section 77(3)(b) imposes a duty to prevent the company engaging in reckless trading in breach of s 22

Triggered where director is aware or a “reasonable person” would be aware (see definition in s 1)

Always intended s 22 to be a remedy for creditors but unclear if prior to liquidation it provides a remedy only to the company

Section 424 only applies insolvent and in liquidation
Conclusion

While there is a significant overlap in each jurisdiction, the reckless / insolvent trading provisions nevertheless play an important additional role.

In the context of the reckless / insolvent trading provisions the director’s must shift their focus from the shareholders’ to the creditors’ interests.

Arguably this focus on creditors’ interests in times of doubtful solvency plays an important part in ensuring directors adequately monitor corporate solvency.