

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

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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 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

Common law: US “prudent” man/director test: Daniels v Anderson (1995)

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
Note, Insolvent Trading Safe Harbour Options paper (2010)

Delegation defence: s 190(2)

Reliance defence: s 189

Section 1317S a court can excuse from civil penalty liability

Must act honestly 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' 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

