DIRECTORS' DUTIES IN THE ZONE OF INSOLVENCY

A. INTRODUCTION

The decision of Owen J in *The Bell Group Ltd v Westpac Banking Corporation (No 9)*[1] was remarkable for many reasons. It was the culmination of one of Australia's longest civil trials (404 hearing days; the plaintiffs' opening alone occupied 120 days). The judgment was probably the longest in Australian legal history (2511 pages). For my purposes however it is noteworthy because it involved, as part of the ground of the decision, an application of the proposition that directors of a company which is in the vicinity of insolvency are duty bound to have regard to the interests of the company's creditors.

At least in Anglo-Australian jurisprudence this notion derives from an observation of Mason J (with whom Barwick CJ agreed) in *Walker v Wimborne*.[2] He said:

> …the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them.[3]

The idea that directors need to take account of the interests of the company's creditors challenged the traditionally accepted position that directors owe duties to the company alone, the company for this purpose being conceived of as the members as a corporate body.[4] The traditional position was adequate for companies which were comfortably solvent. But Mason J suggested this was not so for companies which were at serious risk of insolvency.

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[1] [2008] WASC 239.
[2] (1976) 137 CLR 1.
[3] (1976) 137 CLR 1, 7.
[4] *Ngurli v McCann* (1953) 90 CLR 425, 438.

Despite the careful phrasing of Mason J's observations, it is perhaps not surprising that they resulted in a flood of academic[5] and judicial[6] discussion regarding the existence and scope of a director's duty regarding creditors. This may suggest that further discussion is superfluous. That suggestion is given added momentum by the

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[5] What follows is by no means an exhaustive list even of the antipodean literature. There is also a great deal in the United Kingdom and even more in North America (for the latter see *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* 930 A.2d 92 (Del. 2007) at fn 28).

L Sealy, 'Directors' Wider Responsibilities – Problems Conceptual, Practical and Procedural' (1987) 13 *Monash University Law Review* 164; S Worthington, 'Directors' Duties, Creditors' Rights and Shareholder Intervention' (1991) 18 *Melbourne University Law Review* 121; R Baxt, 'Do Directors Owe Duties to Creditors – Some Doubts Raised by the Victorian Court of Appeal' (1997) 15 *Company and Securities Law Journal* 373; J D Heydon, 'Directors' Duties and the Company's Interests' in P D Finn (ed), *Equity and Commercial Relationships* (Law Book Co, Sydney, 1987) 120; D Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323; L M Powers, 'Legal Rights and Commercial Realities: The Position of the Unpaid Seller When Insolvency Intervenes' (1995) 13 *Company and Securities Law Journal* 178; H Anderson, 'Directors' Personal Liability to Creditors: Theory versus Tradition', 8(2) *Deakin Law Review* 209; J Duns (ed), 'The High Court on Duty to Creditors' (2001) 9(1) *Insolvency Law Journal* 40; J McConvill, 'Directors' Duties to Creditors in Australia after Spies v The Queen' (2002) 20(1) *Company and Securities Law Journal* 4; A Keay, 'The Director's Duty to take into Account the Interests of Company Creditors – when is it triggered?' (2001) 25 *Melbourne University Law Review* 315; M Berkhan, 'Directors Duties to "the Company" and to Creditors: Spies v the Queen', 6(2) *Deakin Law Review* 360; R Baxt, 'Just to Whom do Directors owe their duties? Will this Conundrum Ever be Satisfactorily Resolved?' (2002) 30(6) *Australian Business Law Journal* 205; A Hargovan, 'Directors' Duties to Creditors in Australia after Spies v The Queen - is the development of an independent fiduciary duty dead or alive?' (2003) 21 *Company and Securities Law Journal* 390; J McConvill, 'Geneva Finance and the "duty" of directors to creditors: Imperfect obligation and other imperfections' (2003) 11 *Insolvency Law Journal* 7; A Hargovan, 'Geneva Finance and the "duty" of directors to creditors: Imperfect obligation and critique' (2004) 12(4) *Insolvency Law Journal* 134; G Stapledon and J Webster (eds), 'Directors' duties and corporate governance' (2005) 23(3) *Company and Securities Law Journal* 205; R Grantham, 'The Judicial Extension of Directors' Duties to Creditors' (1991) *Journal of Business Law* 1.

[6] Australia: *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Geneva Finance Ltd (Receiver and Manager Appointed) v Resource & Industry Ltd* [2002] WASC 121, (2002) 169 FLR 152; *Grove v Flavel* (1986) 43 SASR 410; *Jeffree v NCSC* [1990] WAR 183); *Spies v R* [2000] HCA 43, (2000) 201 CLR 603; *Re New World Alliance Pty Ltd; Sycotex Pty Ltd v Baseler (No. 2)* (1994) 51 FCR 425; *ANZ Executors & Trustee Company Limited v Qintex Australia Limited (Receivers and Managers Appointed)* [1991] 2 Qd R 360; *Lewis (as liq of Doran Constructions Pty Ltd (in liq)) v Doran* (2005) 54 ACSR 410; *Linton v Telnet Pty Ltd* [1999] NSWCA 33, (1999) 30 ACSR 465; *Pascoe Ltd v Lucas* (1999) 33 ACSR 357; *Kalls Enterprises Pty Ltd (in liq) v Baloglow* [2007] NSWCA 191, (2007) 25 ACLC 1094; *Ring v Sutton* (1980) 5 ACLR 546; *Galladin Pty Ltd v Aimnorth Pty Ltd (in liq)* (1993) 11 ACSR 23; *The Bell Group Ltd v Wespac Banking Corporation (No 9)* [2008] WASC 239.

England: *Winkworth v Edward Barron Development Co Ltd* [1986] 1 WLR 1512; *Brady v Brady* (1988) 3 BCC 535; *Liquidator of West Mercia Safetywear v Dodd* (1988) 4 BCC 30; *Facia Footwear Ltd. (in administration) v Hinchcliffe* [1998] 1 BCLC 218; *Re Pantone 485 Ltd* [2002] 1 BCLC 266; *Gwyer v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153, [2002] EWHC 2748; *Re MDA Investment Management Ltd* [2004] 1 BCLC 217, [2004] BPIR 75, [2003] EWHC 227; *Yukong Lines Ltd. of Korea v Rendsburg Investments Corporation* [1998] BCC 870.

New Zealand: *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Hilton International Ltd (in liq) v Hilton* [1989] NZLR 442; *Sojourner v Robb* [2006] 3 NZLR 808.

fact that for Australia at least some of the questions addressed in the literature have been resolved by the decision of the High Court in *R v Spies*.[7]

However the issue does not seem to be going away. The notion of a duty to creditors has been the subject of important decisions by the Supreme Courts of Canada[8] and Delaware[9] in the last couple of years, and of legislative reform in England.[10] The decision in *Bell,* and the inevitable appeal, will ensure that it remains topical in Australia, in particular in the current economic environment.

More importantly, it is arguable that the proposition that directors have a duty to consider the interest of creditors lacks a sound conceptual basis and serves no clear purpose. Indeed it is possible to go further and suggest that it may be a harmful distraction from sound thinking about corporate governance both generally and in particular for companies in financial distress.

In the next section I propose briefly to sketch the development of the doctrine in the cases, leading to what has become the conventional view on the subject. Then I will discuss some obscurities surrounding the conventional view, before outlining the manner in which the issue might better be approached.

B THE CONVENTIONAL VIEW

Decisions following *Walker v Wimborne* were ambivalent in their interpretation of what Mason J had said.

Some appeared to adopt a view, going beyond the actual language of Mason J, that directors owe duties to creditors independently of any duty owed to the company.[11]

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[7] (2000) 201 CLR 603.
[8] *Peoples Department Stores Inc. (Trustee of) v. Wise* 2004 SCC 68, [2004] 3 S.C.R. 461; *BCE Inc. v. 1976 Debentureholders* 2008 SCC 69, 301 D.L.R. (4th) 80.
[9] *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007); *Trenwick America Litigation Trust v Billet*, 2007 Del. LEXIS 357 (Del. Aug. 14, 2007), affirming *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168 (Del. Ch. 2006).
[10] *Companies Act* 2006 (Eng) s 172(3).
[11] A Hargovan, 'Directors' duties to creditors in Australia after Spies v The Queen – is the development of an independent fiduciary duty dead or alive?' (2003) 21 *Companies & Securities Law Journal* 390 at 394.

Sir Robin Cooke, then a member of the New Zealand Court of Appeal, was early in outlining a broad interpretation of the principle. In *Nicholson v Permakraft (NZ) Ltd*,[12] decided in March 1985, he appeared to countenance a duty owed by directors *to* creditors, calling in aid the common law duty of care. Having begun by saying that the duties of directors are owed to the company he said:

> On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent, or near insolvent, or of doubtful insolvency, or if a contemplated payment or other course of action would jeopardise its solvency.
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> To translate this into a legal obligation accords with the now pervasive concepts of duty to a neighbour and the linking of power of obligation.[13] …In a situation of marginal commercial solvency such creditors may fairly be seen as beneficially interested in the company or contingently so.

According to Cooke J the recognition of a duty to creditors was justified by the concept that limited liability was a privilege. And though it did not arise for decision in that case, he expressly left open the prospect of direct creditor enforcement of the duty.

This was taken further just over a year later (December 1986) in the speech of Lord Templeman (with whom Lord Templeman, Lord Griffiths, Lord MacKay of Clashfern and Lord Ackner agreed) in *Winkworth v Edward Barron Development Co Ltd*.[14] He began the relevant discussion with the redundant but memorable observation that "Equity is not a computer" and went on to say that:

> … a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred, and the company is not obliged to avoid all ventures which involve an element of risk but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. …. A duty is owed by directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that

[12] [1985] 1 NZLR 242.
[13] Ibid 249-50.
[14] [1987] 1 All ER 114.

> its property is not dissipated or exploited for the benefit of directors themselves to the prejudice of creditors.[15]

This is powerful language. Even so, in neither *Permakraft* nor *Winkworth* did these propositions result in a director being held liable for breach of such a duty.

A second strand of case law adopted what has been described as 'the traditional view',[16] a view ultimately endorsed by the High Court in *R v Spies* ("*Spies*").[17] It found expression in *Kinsela v Russell Kinsela Pty Ltd*.[18] This appears to have been a relatively straightforward claim of misfeasance brought by the company in liquidation. At a time when the company was clearly insolvent it leased its premises to two of the directors at below market rental with an option to buy on very favourable terms. This was done with a view to preserving the company's business in the hands of the directors. The breach of duty by the directors was undeniable. The only point of interest arose from the directors' answer to the claim, which was that the lease agreements had been entered into with shareholder approval. The court found that the shareholder approval or ratification was immaterial. The judgment of Street CJ has become one of the classics in this area. He gave a seductive explanation of why the company in general meeting had no power to authorise or ratify such a transaction:

> …where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.[19]

It was not until 24 years after *Walker v Wimborne* that the High Court was given an opportunity to shed more light on the topic. *R v Spies* was a case dealing with prosecutions under section 176A of the *Crimes Act* (NSW) and s 229(4) of the

[15] [1987] 1 All ER 114, 118.
[16] Hargovan, above n 12 at 393, 394.
[17] (2000) 201 CLR 603.
[18] (1986) 4 NSWLR 722.
[19] Ibid 730.

Companies Code. Its factual and forensic contexts are a little complicated. But for present purposes it is noteworthy because of the majority's [20] rejection of an 'independent duty to, and enforceable by, the creditors by reason of their position as directors': this was not what Mason J had intended in *Walker* and was 'contrary to principle and later authority'. [21] They pointed out that to give some unsecured creditors remedies in an insolvency which were denied to others would undermine the basic principle of *pari passu* participation by creditors.[22]

The court cited with approval some observations of Gummow J in *Sycotex Pty Ltd v Baseler,* observations which are fundamental to a consideration of the issues that arise here. Gummow J had said:

> … the duty to take into account the interests of creditors is merely a restriction on the rights of shareholders to ratify breaches of the duty owed to the company. … Where the company is insolvent or nearing insolvency, the creditors are to be seen as having a direct interest in the company and that interest cannot be overridden by the shareholders. This restriction does not, in the absence of any conferral of such a right by statute, confer upon creditors any general right against former directors of the company to recover losses suffered by those creditors. … [T]he result is that there is a duty of imperfect obligation owed to creditors, one which the creditors cannot enforce save to the extent that the company acts on its own motion or through a liquidator.[23]

The doubts of some commentators notwithstanding,[24] *Spies* at least made clear that the 'duty' so far as creditors are concerned is an aspect of the directors' duty to the company and is not a duty owed to creditors or enforceable by them. The same position was reached by the Supreme Court of Canada in 2004[25] and appears to be favoured in England.[26]

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[20] Gaudron, McHugh, Gummow and HayneJJ. Callinan J concurred in the result.
[21] (2000) 201 CLR 603, 636-37
[22] Ibid, quoting from J D Heydon, 'Directors' Duties and the Company's Interests' in P D Finn (ed), *Equity and Commercial Relationships* (Law Book Co, Sydney, 1987) 120 at 126.
[23] (1994) 13 ACSR 766, 785.
[24] See, for example J McConville, 'Directors' Duties to Creditors in Australia after Spies v The Queen' (2002) 20 *Company and Securities Law Journal* 4 at 16-17.
[25] *Peoples Department Stores Inc. (Trustee of) v. Wise* 2004 SCC 68, [2004] 3 S.C.R. 461.
[26] *Yukong Line Ltd of Korea v Rendsburg Investments Corporation of Liberia and Others (No 2)* [1998] 1 WLR 294 at 312.

Taking this at face value, however, a number of issues and difficulties remain. But I will suggest in due course that one aspect of resolving these difficulties involves taking seriously the observation of Gummow J that the so-called duty regarding creditors is "merely a restriction on the rights of shareholders to ratify breaches of the duty owed to the company".

C DIFFICULTIES AND UNCERTAINTIES

What is the content of the "duty"?

If directors owe at least a duty of imperfect obligation to creditors, the substance and extent of the duty remain uncertain.

First, what does it mean to speak of a duty to "have regard to" the interests of creditors?

This is language more commonly found in the context of administrative law. There are undeniable parallels between that body of law and the equitable rules governing the exercise of fiduciary powers.[27] However duties described in this fashion tend to be focussed on *process* rather than *outcomes*. That is, so long as regard is had to all relevant considerations (here including the interests of creditors) the decision is unimpeachable unless it is substantively bad on other grounds. In this context that might be so if the decision were so negligent as not to be saved by the business judgment rule[28] or it was made for an improper purpose.[29] If this is what is intended the duty to have regard to creditors' interests might not achieve much in practical terms.[30]

[27] See P D Finn, *Fiduciary Obligations* (Law Book Co, Sydney, 1977) at [26].
[28] *Corporations Act* s 180(2).
[29] *Corporations Act* s 181(1).
[30] See P L Davies, 'Enlightened Shareholder Value and the New Responsibilities of Directors' (The Inaugural W E Hearn Lecture, University of Melbourne Law School, 4 October 2005).

Alternatively, does the duty to have regard to the interests of creditors when interests of shareholders and creditors conflict require some sort of balancing exercise?[31] Or do the interests of creditors when a company is "nearing insolvency" always trump the interests of shareholders?

It may be useful to put these questions into a practical frame. At the risk of over-simplifying, the likely conflicts between creditors and shareholders can be reduced to the decisions to pay dividends or to make business decisions that are unusually risky. (I leave out of account decisions that would be impeachable in any event on other grounds, for example, fraudulent conveyances; or misfeasance or improper purpose cases like *Kinsella*). If a company is solvent but nearing insolvency, shareholders may wish to extract what they can from the company as dividends rather than risk it in further trading. Creditors on the other hand might prefer it if funds were preserved to maximise the prospects of full payment. Alternatively, in such a company shareholders may be happy to have very risky but potentially profitable ventures undertaken as they are exposed to all the upside and the creditors to most of the downside. For the same reasons creditors would have a different perspective. As Iacobucci has pointed out, both dividend payments and unusually risky business decisions can amount in economic terms to techniques to shift value to shareholders at the expense of creditors.[32]

However in neither case can it be said that the creditors' perspective should always dominate. This is clear in the case of risky business decisions. The job of directors is always to weigh the risks and benefits of any business decision. A very risky investment may be the best one if the prospective returns are high enough. Conversely, an investment with the prospect of high returns may be uneconomic if it is too risky. None of these equations is necessarily altered by the wealth of the company. The nature of the company's business may also be relevant – a speculative minerals exploration company will legitimately approach risk differently from a business with more predictable cash flows.[33] In addition, creditors who deal with a

[31] See the discussion in A Keay, *Directors' Duties* (Jordan Publishing Ltd, Bristol, 2008) at [13.42]-[13.47].
[32] EM Iacobucci, "Directors' Duties in Insolvency: Clarifying What is at Stake", (2003) Can Bus LJ 398, 401.
[33] See *Kinsella*, 10 ACLR at 404.

company while it is undertaking a risky venture can allow for that in the terms on which they deal with the company (insisting on guarantees, payment in advance, security or higher rates of interest).

In the case of dividends, ordinary commercial pressures will usually persuade directors to preserve capital if the company is in a parlous state, so that a duty to consider the interests of creditors is unlikely to add much. But even in such cases some payment of dividends may be appropriate if necessary to maintain the company's ability to raise equity.

In *Bell* Owen J accepted that the interests of creditors were not paramount. Their significance he said would "wax and wane" with the circumstances:

> [4439] …[I]t would be going too far to state, as a general and all-embracing principle, that when a company is in straitened financial circumstances, the directors must act in the interests of creditors, or they must treat the creditors' interests as paramount, to the exclusion of other interests. To do so would come perilously close to substituting for the duty to act in the interests of the company, a duty to act in the interests of creditors.

A balancing exercise?

All this suggests that the duty requires some kind of balancing exercise. There are several problems with this however.

First, as Professor Keay has pointed out:

> [B]alancing is a fairly nebulous idea unless there is a goal that has been set for the balancing exercise. To what end is the balancing to be directed? To be effective any balancing must be done in the context of achieving an aim.[34]

So far the courts have not identified the objective to which directors of a company in the zone of insolvency must direct themselves.

[34] Keay, above n 35 at [13.46].

Secondly, and this is related to the first point, what does such a duty involve in a context where different creditors have different interests? Obviously the interests of secured creditors may be quite different from those of unsecured creditors. But it is not even as simple as allowing for that difference. Different groups of unsecured creditors have differing interests. For example, when a company is in distress *continuing* trade creditors and particularly employees (who have the benefit of priority) often prefer the business to continue, whereas other creditors (unsecured financiers, one off trade creditors) have a narrower perspective – they simply want their debt repaid. Other creditors with special interests are suppliers of goods with retention of title, debtors with rights of set-off, and bond-holders with rights to convert to equity, and subordinated creditors. These examples could be multiplied.[35] Indeed, not all shareholders will have the same interest. Preference shareholders have a different perspective to ordinary shareholders, one more akin to creditors as, typically, they do not share in the upside of risky investments.[36] To make matters worse, modern corporate finance has created a vast array of hybrid interests exhibiting both equity and debt-like characteristics.

Thirdly, as Professor Sealy has pointed out, allowing for a balancing of competing interests tends to deprive either constituency of control over the outcome. Where duties are owed to different persons, "with potentially opposed interests, the duty bifurcates and fragments so that it amounts ultimately to no more than a vague obligation to be fair; and (however much we delude ourselves) this kind of 'fairness', especially in a commercial context, is not a justiciable issue."[37]

Having regard to these concerns, it is interesting that in *Bell* Owen J seems to have rejected any notion of balancing in favour of a test framed in absolute terms by reference to the interests of *the company*. He said:

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[35] See A Keay, 'Formulating a Framework for Directors' Approach to Creditors: An Entity Maximisation Approach' (2005) *Cambridge Law Journal* 616.
[36] Keay, ibid, text at n 59.
[37] L Sealy, 'Director's Wider Responsibilities – Problems Conceptual Practical and Procedural' (1987) 13 *Monash University Law Review* 164 at 175. See also Davies, above n 34. The point was originally made by AA Berle in his famous debate with Professor Dodd – see 'For whom Corporate Managers are Trustees: A Note' (1932) 45 *Harv L Rev* 1365.

> [4436] [Mason J in *Walker v Wimborne*] … did not say that the interests of creditors supplanted those of shareholders. Regardless of the financial situation of a company (short of a winding up and dissolution), the shareholders retain their interest. The relative degrees to which their interests (and the interests of third parties) intersect with those of the company may wax and wane. **But it must always come back, ultimately, to the interests of the company.**
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> [4440] …It may be, therefore, that in particular circumstances the only reasonable conclusion to draw, once the interests of creditors have been taken into account, is that a contemplated transaction will be **so prejudicial to creditors that it could not be in the interests of the company as a whole**. But that will be because of the particular circumstances and not because a general principle has mandated that the treatment of the creditors' interests is paramount. [Emphasis added.]

The emphasised words are important. I will return to them in due course.

Which Creditors?

If directors are to owe even a "duty of imperfect obligation" to creditors, it is imperative that they know to whom such a duty is owed. In a winding up, liquidators may only pay dividends from the insolvent estate to creditors whose debt or claim has been admitted by the liquidator at the date of distribution, and the classes of claimants and the priorities are well-defined.[38] Before insolvency, which creditors' interests are the directors to consider?

Here again neither the courts nor principle give clear guidance.

The speech of Lord Templeman in *Winkworth* extended the duty to "creditors, present and future."[39] In *Permakraft*, Cooke J offered a more nuanced analysis. He would have extended the duty to current and *likely continuing* trade creditors;[40] the position of current creditors other than trade creditors was not addressed. However, he said:

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[38] *Corporations Act* ss 553-564.
[39] See above at n 16.
[40] [1985] 1 NZLR 242 at 249.

> to make out a duty to future *new* creditors would be much more difficult. Those minded to commence trading with and give credit to a limited liability company do so on the footing that its subscribed capital has not been returned to the shareholders, but otherwise they must normally take the company as it is when they elect to do business with it. Short of fraud they must be the guardians of their own interests.[41]

In *Jeffree* the duty was extended to prospective creditors.[42] And in New Zealand the duty has been extended to contingent creditors.[43]

In the United States it has been suggested that the duty should be owed only to creditors with low levels of volition, cognition, and exit – namely tort creditors, certain terminated employees, taxing authorities, and certain trade creditors.[44]

None of this provides the kind of guidance company directors need in making practical business decisions.

From the perspective of principle two observations may be made. The *first* is that if there is such a duty then at least in some circumstances it may be necessary to have regard to potential future creditors, if only because the decision in question may be one that is more likely to affect future creditors than present ones. Take for example a decision to engage in a project whereby current debts will be paid out of cash flow but new debts incurred. It is the new creditors who ought to be of concern. However Cooke J's analysis would distinguish in such a case between new and continuing trade creditors. It is not easy to see why – both are at risk from the continued trading and continuing trade creditors may be even better placed than new creditors both to appreciate the degree of risk and to negotiate terms which reflect or account of it. Nevertheless it may be accepted that a need to consider any future creditors imposes a difficult burden on directors.

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[41] Ibid, at 250.
[42] (1989) 15 ACLR 217 at 227.
[43] *Sojourner v Robb* [2006] 3 NZLR 808.
[44] J C Lipson, 'Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' 50 *UCLA Law Review* (2003) 1189 at 1245-49. See also D W Mckenzie-Skene, 'Directors' Duty to Creditors of a Financially Distressed Company: A Perspective From Across The Pond' (2007) 1 *Journal of Business & Technology Law* 499.

The *second* observation is that there may be a strong case for having regard to the interests of future tort claimants where their cause of action will arise from past conduct of the company, even if the cause of action has not yet accrued. This was essentially the problem which was highlighted by James Hardie Industries Ltd's attempt to distance itself from liabilities to asbestos victims. JHIL established the Medical Research and Compensation Foundation ("MRCF") in February 2001 for the purpose of acquiring subsidiaries which had formerly been in the asbestos industry ("Amaca" and "Amaba") and to manage and fund all asbestos related claims. The total value of the assets acquired by the MRCF was $293 million. The Jackson QC Special Commission of Inquiry estimated that as at 2003, the value of the asbestos related liabilities was at least $1.5 billion. The directors of the MRCF were then faced with the difficulty of determining the future of a company destined for insolvency but which was presently able to pay its debts as they fell due.

In contemplating which course of action to take, the directors faced the question whether they were obliged to take into account the interests of parties who were not yet creditors but might in the future, as tort claimants, become creditors. The problem was that persons who had been exposed to asbestos but who had not manifested any symptoms of asbestos-related illness were unlikely to fall within the definition of creditor for the purpose of either administration or liquidation. The position of potential future claimants who had not yet been exposed to asbestos was *a fortiori.* When the directors sought judicial advice this aspect of the matter was not really clarified. Young CJ in Eq said (at [153]):

> There are various options open to the plaintiffs including appointing a provisional liquidator, but none of those options are going to make the position of future claimants any stronger and indeed, some will remove their prospects of ever obtaining any money at all. Accordingly, good business sense suggests that it would be wise to carry on as before. However, the directors of Amaba and Amaca cannot obtain insurance and there is at least a risk that a court might extend the principle in *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722 ; 10 ACLR 395 and

> hold that a company in a precarious financial position might not only owe duties to the shareholders and creditors but also to the interests of likely future creditors. [45]

Again, it may be accepted that if regard to such remote interests may be necessary then the duty imposed on directors is a burdensome one.

How is the duty enforced?

I noted earlier the similarity between the apparent content of the duty we are considering (that is, to have regard to a relevant matter, namely, the interests of creditors) and principles of administrative law. The usual remedy in the public law context is to remit the decision so it can be made again. Is that what is contemplated here?

Professor Sealy discussed this question by reference to s 309 of the *Companies Act* 1985 (UK) which imposed on directors a duty to have regard to the interests of employees. He said:

> In the case of employees, what could a court be asked to do for them, supposing that it is established that insufficient regard has been had to their interests? At best, it might be possible to think of some woolly form of declaratory or injunctive relief which obliged the directors to reconsider their decision.[46]

His ultimate assessment was quite blunt:

> The emphasis of the U.K.'s section 309 is thus exposed. It is either one of the most incompetent or one of the most cynical pieces of drafting on record.[47]

Of course compensation might be available in some cases. But that will raise some interesting questions. If the duty is one owed to and enforceable by the company, its

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[45] *Edwards v Attorney General (NSW)* (2004) 208 ALR 605 at [153].
[46] Sealy, above n 41 at 177.
[47] Ibid.

loss may bear no relationship to the prejudice suffered by the creditors. In some cases the company will have suffered no loss at all.[48]

More important however is the disruption that the availability of such a remedy may cause to the scheme of insolvent administration of companies. In *Spies* reference was made to the fact that "to give some unsecured creditors remedies in an insolvency which are denied to others would undermine the basic principle of *pari passu* participation by creditors".[49] This was said in the context of rejecting the notion of a duty owed to and enforceable by creditors. However recognition of a duty to have regard to the interests of creditors would naturally tend to inform the statutory duty of care created by s 180(1) of the Act and perhaps the purposes encompassed by s 181(1)(b).[50] By virtue of s 1324 these duties are directly enforceable by creditors if they are persons whose interests have been, are or would be affected by conduct in contravention of the duties imposed by those sections. The duties may be enforced by injunction. But s 1324 (10) provides for a remedy in damages:

> Where the Court has power under this section to grant an injunction restraining a person from engaging in particular conduct, or requiring a person to do a particular act or thing, the Court may, either in addition to or in substitution for the grant of the injunction, order that person to pay damages to any other person.

As Professor Baxt has pointed out, this provision makes directors' statutory duties enforceable by outsiders. By this means the vices of direct creditor enforcement are reintroduced, as it were, by the back door.

When does the duty arise?

This topic can be and has been discussed at great length.[51]

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[48] *Jeffree v NCSC* was probably in that category as the assets were sold at valuation: (1989) 15 ACLR 217 at 221.

[49] (2000) 201 CLR 603 at [94]. See also Keay, above n 35 at [13.65].

[50] See the discussion of *Angas Law Services Pty Ltd (in liq) v Carabelas* [2005] HCA 23; (2005) 226 CLR 507 in *Bell* [2008] WASC 239 at [4429]-[4433].

[51] A Keay, 'The Director's Duty to take into Account the Interests of Company Creditors - when is it triggered?' (2001) 25 *Melbourne University Law Review* 315. He returned to the topic in Keay, above n 35 at [13.25]ff. See also Mckenzie-Skene, above n 48 at 507ff; *Bell* [2008] WASC 239 at [4441]-[4450] and Davies, above n 34.

Various verbal formulae can be found in the cases. *First*, the duty is generally said to arise when the company is insolvent. That might be thought clear but it is uncertain whether a balance sheet test or cash flow test is to be applied.[52] In Australia the Act applies the cash flow test, but we are concerned here with equity – it might adopt the same approach but then again it might not, or might not do so in all cases. In some jurisdictions both tests are employed in different contexts.[53]

To extend the scope of the duty, what might be called "muddying" expressions have been employed, such as "doubtful solvency"[54] or "should have been concerned for" solvency.[55] Locational metaphors have also been used – the duty arises when the company is "near"[56] or "in the vicinity of"[57] insolvency. Some prefer more elastic descriptors – a "dangerous financial position"[58] or "financially unstable".[59] Professor Grantham has suggested a functional test – "given the distribution of risk does it continue to be appropriate to regard the interests of the shareholders as exclusively reflecting the corporate interest."[60]

It would not be right to be unduly critical of the terminological variety here. The underlying concept is clear enough – the interests of creditors should be regarded when their interests are at stake, which will be, in general terms, when decisions are to be made which have a significant risk of diminishing the capacity of the company to pay all creditors in full. This is in substance the position reached by the New South Wales Court of Appeal in *Kalls Enterprises Pty Ltd (in liq) v Baloglow*[61] and by Owen J in *Bell.*[62] In *Kalls* the court said:

> It is sufficient for present purposes that, in accord with the reason for regard to the interests of creditors, the company need not be insolvent at the time and the directors

[52] Keay, ibid (2001), at 322ff.
[53] Ibid, at 323-24.
[54] *Permakraft* [1985] 1 NZLR 242, 249.
[55] *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465, 478.
[56] *Sycotex Pty Ltd v Baseler* (1994) 51 FCR 425, 444 per Gummow J.
[57] *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp* (1991) Del. Ch. LEXIS 215.
[58] *Facia Footwear Ltd v Hinchcliffe* [1998] 1 BCLC 218.
[59] *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465, 471, 474.
[60] R Grantham, 'The Judicial Extension of Directors' Duties to Creditors' (1991) *Journal of Business Law* 1 at p 15.
[61] [2007] NSWCA 191; (2007) 63 ACSR 557 at [162].
[62] [2008] WASC 239 at [4441]-[4450].

> must consider their interests if there is a real and not remote risk that they will be prejudiced by the dealing in question.[63]

Assuming there to be a duty to consider creditors' interests this statement is probably as clear and cogent a definition of the trigger for the duty as one can hope for. Nevertheless it can fairly be said that the imprecision of the concept is not a positive feature of this so-called duty. Owen J, however, was not apologetic:

> [T]he law does not shy away from concepts simply because they are difficult. And nor do business people.
>
> …
>
> [T]he intense debate that raged throughout this case about whether the Bell group companies were or were not insolvent at the relevant time (a debate that is mirrored in countless other court decisions) shows how difficult those assessments can be.
>
> …
>
> But there is a wealth of difference between an assessment that is difficult and one that can be resolved only by thaumaturgy. When confronted by difficult decisions I often bring to mind the comment of Samuel Johnson: 'Difficult do you call it, Sir? I wish it were impossible'.[64]

D WHAT DOES THE DUTY ACHIEVE?

A possible answer is "not much, if anything at all".

First, at least in Australia, the provisions of Part 5.7B of the *Corporations Act* are likely to leave little need for reliance on a duty to consider creditors' interests. Of course, these provisions operate only where a company is in liquidation, as opposed to "nearing insolvency". But if the company in question has not become insolvent it is hard to imagine a complaint being made that creditors' interests were wrongly ignored – *ex hypothesi* the creditors whose interests were ignored can be paid. The statutory remedies provided in relation to uncommercial transactions, unfair loans, preferences, director-related transactions, and insolvent trading provide a wide scope for relief.

[63] 63 ACSR 557 at [162]
[64] *Bell* [2008] WASC 239 at [4448]-[4450].

Importantly, the remedies are carefully framed to balance company (creditor) and other interests, as shown by the inclusion of defences (ss 588FG, 588H, 588X, 1317S and 1318). They invite the question why there should be a need for, or scope for, resort to undeveloped and uncertain equitable doctrine in cases where companies have become insolvent. There are also of course the statutory directors' duties to keep in mind, should there be a need.

Secondly, as is emphasised by some judges and many commentators, creditors have the ability to protect themselves in advance against decisions by companies which are adverse to their interests, by imposing terms of supply which cater for the risks of default.

These arguments were neatly summarised by the Delaware Supreme Court[65] quoting with approval an earlier decision of the Court of Chancery:

> In *Production Resources*, the Court of Chancery remarked that recognition of fiduciary duties to creditors in the "zone of insolvency" context may involve
>
>> … using the law of fiduciary duty to fill gaps that do not exist. Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections. The implied covenant of good faith and fair dealing also protects creditors. So does the law of fraudulent conveyance. With these protections, when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant. Having complied with all legal obligations owed to the firm's creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value.[66]

[65] *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* 930 A.2d 92 (Del. 2007), text at n 29.
[66] *Production Resources Group L.L. v. NCT Group, Inc*., 863 A.2d at 790.

Finally, it is not clear from the cases decided by reference to a duty to have regard to creditors that the results have warranted the effort. Indeed it is not easy to find cases where the outcome was affected by the suggested duty, leaving aside the role that Gummow J would give it – namely, as a limit on the shareholders' power to approve or ratify breaches of duty by directors.

Focussing on the Australian decisions: *Walker v Winborne* involved misfeasance and misuse of power (diverting company property to the use of other group companies without regard to the separate interest of the company); as noted above, *Kinsela* was a simple misfeasance case; *Ring v Sutton* was a misfeasance case in which a director caused loans to be made to himself on uncommercial terms – as in *Kinsella* the interests of creditors were probably only relevant to ratification or approval;[67] *Qintex* was a transaction by a subsidiary which imposed burdens but no benefits – like *Kinsella* the real issue was the effect of unanimous shareholder assent; and *Sycotex* was a successful insolvent trading claim under s 592 of the *Corporations Law* (a provision which permitted direct claims by creditors), but a claim by the creditor relying on breach of a duty to have regard to the interests of creditors was rejected as misconceived.

A couple of decisions perhaps warrant closer attention. *Jeffree v NCSC*[68] was a decision of the Full Court of the Supreme Court of Western Australia in which both *Permakraft* and *Winkworth* were relied on. The managing director of a small family company was found to have made improper use of his position[69] by causing the sale of the company's business, at full value, to another company controlled by him. The sale was prompted by the prospect of the company becoming insolvent if certain legal proceeding were unsuccessful. Assuming this decision to be correct it is best understood as turning on the director's subjective purpose in entering into the transaction (namely, preserving the business and so a job for himself) as being

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[67] (1980) 5 ACLR 546. I say "probably" because the reasons are a little obscure. Professor Sealy regards it as likely to have been wrongly decided: Sealy, above n 41 at 172.
[68] (1989) 7 ACLC 556; (1989) 15 ACLR 217.
[69] Contrary to s 229(4) of the *Companies (WA) Code*.

collateral to the interests of the company, rather than on a failure by the director to act in the interests of the company.[70]

In *Kalls Enterprises Pty Ltd (in liq) v Baloglow*[71] a claim based on the *Walker v Wimborne* duty succeeded. Kalls was a director of two companies, "KE" and "AA". KE held funds on trust for AA. Kalls used part of those funds to repay a personal debt of his and another's to a third party. The transaction was not a loan, was not documented or secured and recoverability was uncertain. Both companies later became insolvent. In those circumstances there was, not surprisingly, a breach of Kalls' fiduciary duties as a director of both KE and AA irrespective of the question of regard to creditors.[72] The transaction was also held to be uncommercial and voidable under s 588FF. An additional finding of breach of duty in failing to have regard to the interests of the creditors of AA[73] was, in truth, superfluous.

Last there is *Bell.* At its heart the case involved an allegation that directors of the plaintiffs had breached their duties by causing them to enter into financing transactions which were not in the companies' interests – in particular because they involved insolvent companies giving security over their assets for the liabilities of other insolvent companies in the group. The claim was not against the directors however, but against the banks which were parties to the transactions. It was said that they were liable under the first limb of *Barnes v Addy*[74] as knowing recipients of money paid in breach of fiduciary duty.

Despite the attention given to the duty to consider creditors in the judgment and in the plaintiffs' formulation of the case, the better view is that the outcome depended not on any such duty but rather on a conventional application of the corporate benefit principle. The point can be seen from a selection of passages from Chapter 29 of the judgment:

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[70] Consistently with this, the case was a prosecution was under s 229(4) of the *Companies Code*, not s 229(2). For the distinction see *Marchesi v Barnes* [1970] VR 434 and the discussion in R P Austin, H A J Ford and I M Ramsay and Ford, *Company Directors: Principles of Law and Corporate Governance* (LexisNexis Butterworths, Sydney, (2005)), at paragraph [7.3].
[71] [2007] NSWCA 191; (2007) 63 ACSR 557 at [162].
[72] (2007) 63 ACSR 557 at [166], [169].
[73] (2007) 63 ACSR 557 at [174].
[74] (1874) LR 9 Ch App 244

4620 The real thrust of the plaintiffs' case in this area is whether the directors confined their attention to the group or whether they genuinely turned their minds to the interests of individual companies.

4621 The law does not require directors of a group of companies to ignore the interests of the wider group. But it does demand that where one or more companies in a group enter into a transaction or transactions, consideration must be given to the interests of that company or those companies. Most commercial transactions involve both benefits and detriments and, in considering the interests of the participants and those affected by the transaction, it will usually be a case of balancing the two.

…

6039 In my view the essence of the breaches, so far as the Australian directors are concerned, lies in three areas. First, they concentrated on the interests of the group and failed to look at the interests of individual companies. Secondly, they effected the first step in a 'plan' to restructure the financial position of the group without any or any sufficient idea about what the 'plan' was, how it would be implemented, how long it would take to do so and how the companies could survive in the meantime. Thirdly, Mitchell and Oates (but not Aspinall) were concerned about the interests of the BCHL group rather than the interests of the Bell group companies of which they were directors….

6040 The Australian directors failed to arm themselves with clear and precise advice as to what was required of them given the financial position in which the companies found themselves. They looked at the problem solely from a group perspective and said something to the effect: 'We all survive or we all go down'. They did not look at the circumstances of each individual company that was to enter into a Transaction. They did not identify what, if any, creditors (external and internal) the individual companies had or might have and what, if any, effect a Transaction would have on the creditors or shareholders of an individual company.

6041 There is another aspect to this problem. The directors knew that the Bell group companies were in a precarious financial position. If they did not know the companies were insolvent, they certainly knew that they were nearly insolvent or of doubtful solvency. Yet they caused companies that did not have a pre-existing indebtedness to the banks to undertake such an obligation. Further, by the terms of the Transactions bringing that situation about, the directors caused those companies

> to place their assets in jeopardy in the interests of borrowers and guarantors that were themselves insolvent, nearly insolvent or of doubtful solvency. This brings into play the notion that the companies would themselves, if not already insolvent, inevitably become so. It constitutes an improper purpose for which powers were exercised.
>
> 6042 The shareholders of a company (even in a group situation where there are interlocking relationships) have relevant interests in their own right. They might also have interests because they have creditors to whom they owe obligations. In the remainder of this section if I refer only to the interests of creditors it should not be taken that I have overlooked **the concomitant interests the interests of shareholders.**
>
> 6043 **Brought down to its most basic terms, the directors failed to ensure that there was a corporate benefit to the individual companies in entering into the respective Transactions.**

The references to creditors in these passages are, on analysis, superfluous. As the emphasised words in pararaph [6042] suggest, the position would have been the same if the plaintiff companies had been solvent, so that no occasion to refer to their creditors arose. The directors simply failed to have any regard to the separate interests of the individual companies. This was in circumstances where, absent a credible plan to bring the main group companies back to solvency, the transactions could not reasonably have been regarded as for the benefit of the plaintiffs. As Owen J said in his conclusion:

> A fundamental problem is that the directors concentrated on the group and failed to look to the interests of individual companies. They caused the companies to undertake obligations when they did not previously have such obligations. … They thereby exposed the companies (and their creditors and shareholders) to a probable prospect of loss and no probable prospect of gain.[75]

That should have been enough to dispose of the directors' duty issue. The omitted words – "*They did so knowing that those borrowers were in an insolvency context.*" – do not affect the analysis.

[75] [2008] WASC 239 at [9746]

All this is consistent with the experience in the United States, which has recently been described as follows:

> Many cases have dicta supporting special director duties to creditors in this situation, or at least a special duty to balance duties to shareholders and creditors. But on closer examination these cases resemble "shaggy dog" stories – long windups about the plight of creditors and encomiums about directors' responsibilities ending in narrower and more traditional holdings that leave the reader wondering about the relevance of the rest of the opinion.[76]

E A MODERN CONCEPT OF DIRECTORS' DUTIES

All this prompts the question whether a simpler approach is possible. I will suggest that it is. I have in mind three proposals – the first two go together and together are, I would suggest, a modest development. The third I offer more tentatively.

The *first* proposal is that a director's duty to act in good faith in the best interests of the corporation does not need to be further refined by reference to notions such as "the company as a whole" or "the shareholders as a whole" or in cases of doubtful solvency, "the creditors". Rather, the expression "the company" in this context should be understood to mean, and consistently to mean, the corporate enterprise conceived of as a legal entity separate from both members and creditors.

The *second* is that, as Gummow J suggested, the company in general meeting is unable to approve or ratify a breach of duty by directors when creditors interests are at stake.[77] Conduct might be a breach because it involves a breach of a duty of diligence not saved by the business judgment rule, or a use of powers to benefit a third party rather than for a corporate purpose, or because it involves a breach of the

[76] L E Ribstein and K A Alces, 'Directors' Duties in Failing Firms' *University of Illinois Law & Economics Research Paper No. LE06-004* [available at Social Science Research Network: http://ssrn.com/abstract=880074].
[77] For other limits on these powers see the judgment of Santow J in *Miller v Miller* (1995) 16 ACSR 73 at 89; and generally, S Worthington, 'Corporate Governance: Remedying and Ratifying Directors' Breaches' (2000) 116 *Law Quarterly Review* 638.

profit rule or the conflict rule or a misuse of corporate information. But in any case, it is unnecessary to bring the interests of creditors into play. It is only necessary to acknowledge that where a breach of duty has caused harm to creditors, it is no defence to say it was approved or ratified by shareholders.

The second proposal should be uncontroversial. But can the first proposal be reconciled with the cases and with principle? Just as importantly, does it *work*?

Foundations

It may be useful to return to the beginning, and to *Walker v Wimborne*. Mason J said:

> …the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences **for the company as well as for them**.[78]

I have emphasised the last few words because they suggest that what Mason J had in mind was consequences that were not *merely* adverse for creditors but *also* adverse for the company. In other words attention to the interests of creditors might become necessary because of the impact a decision may have on the company, the impact being caused by or connected with the impact of the decision on creditors.

Understood in this way, the duty to which Mason J is referring is simply an explanation of what, in certain circumstances, the duty to have regard to the interests of the company may require.

Coming forward to *Bell*, one sees a reflection of this in the passages quoted earlier from paragraphs [4436] and [4440] of the judgment: "*But it must always come back, ultimately, to the interests of the company*"; "*a contemplated transaction [may] be so prejudicial to creditors that it could not be in the interests of the company as a whole*".

[78] (1976) 137 CLR 1, 7.

An objection, however, may be that if it is appropriate to speak of duties in terms of the interests of shareholders (as Mason J did in *Walker*) then it may be salutary to give specific notice to creditors in appropriate cases. There is force in this. But it raises the question whether it is necessary or appropriate still to speak of the interests of the company in terms of the interests of shareholders.

I share with Professor Worthington the suspicion that in relation to issues of corporate governance much difficulty has been caused by a reluctance fully to embrace the significance of separate corporate existence.[79] When it comes to corporate liability there is almost a fixation on the corporation as an artificial entity distinct from its members, who shelter behind its veil. Why then when it comes to defining the object of directors' duties are the shareholders brought into the foreground?

Still, if authority requires it, it must be done. Here it is necessary to deal with what was said by the High Court in *Ngurli Ltd. v McCann.*[80] This is because it is sometimes treated as authority for this proposition: that while the company has an existence separate from its shareholders the directors do not exercise their power according to the interests of the company as a separate commercial entity.[81]

The decision and reasons in *Ngurli* are not a difficulty. The case concerned the exercise by a director of his fiduciary power to issue new shares. The court decided the case by reference to the proposition for which *Mills v Mills*[82] was authority: namely, that the power must be used bona fide for the purpose for which it was conferred – that is to say, to raise capital – and must not be used for the purpose of benefiting some shareholders or their friends at the expense of other shareholders or so that some shareholders or their friends might gain control of the company.

However, in the course of its reasons, the court quoted with approval what had been said by Lord Evershed in *Greenhalgh v Arderne Cinemas Ltd.*[83] That was a case

[79] Worthington, above n 81 at 648.
[80] (1953) 90 CLR 425.
[81] *Kirwan v Cresvale Far East Ltd (in liq)* (2002) 44 ACSR 21 at [124] per Giles JA (diss).
[82] (1938) 60 CLR 150.
[83] [1951] Ch 286.

relating to a special resolution by members to alter the articles of association so as to remove a ban on sales of shares to non-members. The question was whether the resolution was passed in good faith and for the benefit of the company as a whole. His Lordship said:

> [T]he phrase, 'the company as a whole,' does not **(at any rate in such a case as the present)** mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body. That is to say, the case may be taken of an individual hypothetical member and it may be asked whether what is proposed is, in the honest opinion of those who voted in its favour, for that person's benefit. [Emphasis added.]

When *Greenhalgh* is cited in the context of directors' duties the emphasised words are often omitted.[84] Properly understood, the decision says nothing about directors' duties, or least nothing outside the case of decisions to amend a company's constitution in a way which raises issues for the shareholders *inter se*.

Nevertheless it may be that once there was a basis in the companies legislation for treating the body of shareholders as the object of the directors' concerns. For example, s 354(4) of the *Companies Act* 1981 (Cth) provided:

> On and from the date of incorporation specified in the certificate of incorporation, but subject to this Act, **the subscribers to the memorandum,** together with such other persons as from time to time become members of the company, **are an incorporated company** by the name set out in the memorandum.[85]

In a response to Dyson Heydon's masterly analysis of the law in this area,[86] Ian Renard pointed out that this statutory language naturally promotes a conception of the company as, in effect, an aggregation of its members.[87]

However the law has changed materially since 1986. The current Act has no formula equivalent to s 354(4). Instead, pursuant to s 119, incorporation is now the statutory

[84] See, for example, Austin, Ford and Ramsay, *Company Directors*, at 276.
[85] Emphasis added.
[86] Heydon, above n 26 at 120ff.
[87] Ibid at 138

consequence of registration. Moreover, from the outset a company may have only one member and one director. Consistently with this, the current edition of Ford, Austin and Ramsay describe a corporation as

> a legal device by which legal rights, powers, privileges, immunities, duties liabilities and disabilities may be attributed to a fictional entity equated for many purposes to a natural person.[88]

In contrast, the 4th edition had said that "the company" is not "the abstract entity" but "the members as a whole in their capacity as associated persons".[89]

These changes are reinforced by the changes to the definition of the statutory directors' duties. Where the *Uniform Companies Acts* (s 124) and the *Companies Codes* (s 229) expressed directors' duties in an open way (for example, "shall at all times act honestly in the exercise of his powers"), the current formulation specifies the primary duty as referable to the *corporation*:

> A director or other officer of a corporation must exercise their powers and discharge their duties:
>
> (a) in good faith in the best interest of the corporation; and
>
> (b) for a proper purpose.

This statutory identification of the object of the directors' duty of good faith precludes the identification of an equitable duty to exercise power in the interests of any other object. While section 185 preserves the equitable duties,[90] those duties can only operate by reference to the identification elsewhere of the scope and objects of the directors powers and duties. That identification is relevantly in the Act.

A duty to the corporate enterprise

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[88] R P Austin and I M Ramsay, *Ford's Principles of Company Law, 7th ed, at paragraph* 1.050

[89] H A J Ford, *Principles of Company Law* (4th ed, Butterworths, 1986) at paragraph 1507.

[90] 185. Sections 180 to 184: (a) have effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person because of their office or employment in relation to a corporation.

All this paves the way for an acceptance of the view that **the duties of corporate officers may be conceptualised as directed to the *corporate enterprise as a separate entity*, rather than to the body of shareholders or creditors or both –** a view propounded in this country in the 1970s by Dr BH McPherson[91] and in the 1980s by Dyson Heydon QC.[92]

With directors' duties conceived in this way, it is possible to abandon the language of "duties" as regards creditors, and perhaps to abandon with it some of the complexity discussed earlier in this paper. One would have a framework in which directors were required to be diligent and loyal as regards the company considered as a separate enterprise. As Professor Worthington has explained, when directors exercise a discretion it is far simpler to judge the directors' actions as 'loyal' if they are designed to advance the success of the company and disloyal if they are not and this can be assessed directly without adding the gloss that the directors' intention ought to be to benefit the members as a whole. For commercial enterprises this means to increase the value of the company.[93]

What diligence and loyalty require in exercising powers concerning the enterprise will obviously depend on the circumstances of the time, including its financial position. They may involve giving effect to the wishes of neither creditors nor shareholders.

In *Credit Lyonnais Bank Nederland NV v Pathe Communications Corp*[94] Chancellor Allen gives an elegant exemplification of the principle that, as he put it, "at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise".

Assume a company with a single asset, a judgment debt for $51million, and creditors of $12 million. The judgment is on appeal, and the best assessment of the prospect of

[91] (1977) 51 ALJ 460 at 468. See also GFK Santow and PT Crouch, (1979) 53 ALJ 374.
[92] Heydon, above n 26 at 134-35. For a more recent discussion broadly to the same effect, see Keay, above n 39.
[93] S Worthington, (2001). Reforming directors' duties, London: LSE Research Online. Available at: http://eprints.lse.ac.uk/archive/00000200 Available online: April 2005
[94] 1991 Del. Ch. LEXIS 215.

various outcomes on appeal (success, failure and modification) is that the judgment debt has a value of $15 million. On any view the company is solvent. When it comes to settlement negotiations, if the best offer from the other side is $12 million, the interests of the creditors would suggest acceptance, despite the prejudice to shareholders. Conversely, even if the best offer were $17.5 million, the interests of the shareholders might suggest rejection, as they had an appreciable chance of complete success. On the "corporate enterprise" approach however, the directors' duty is reasonably clear: to reject any offer below $15 million and to accept any offer above it.

As Chancellor Allen goes on to say:

> But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Implicit in the example just given is a proposition about the object or aim of directors' duties conceived of as owed to the corporate enterprise – it is to maximise corporate value. So much was affirmed by the Supreme Court of Canada in *Peoples Department Stores Inc*.[95] There the court said:

> Insofar as the statutory fiduciary duty is concerned, it is clear that the phrase the 'best interests of the corporation' should be read not simply as the 'best interests of the shareholders'. From an economic perspective, the 'best interests of the corporation' means the maximization of the value of the corporation.[96]

Maximising Enterprise Value

[95] *Peoples Department Stores Inc. (Trustee of) v. Wise* 2004 SCC 68, [2004] 3 S.C.R. 461; see also *BCE Inc. v. 1976 Debentureholders* 2008 SCC 69, 301 D.L.R. (4th) 80.
[96] 2004 SCC 68, [2004] 3 S.C.R. 461 at paragraph [42] referring to E M Iacobucci, 'Directors' Duties in Insolvency: Clarifying What Is at Stake' (2003) 39 *Can. Bus. L.J.* 398 at 400-401.

This does not by any means involve sacrificing the interests of creditors. On the contrary it suggests an economic framework in which their interests can be allowed for in a logical and principled way. This brings me to my third, more tentative proposal. It is that at least for larger firms, a useful device for calibrating the exercise of directors' powers is the notion of enterprise value. This a tool of financial analysis which seeks to arrive at an economic measure of the market value of the whole business of a company. In short, it measures what a predator would be prepared to pay – in terms of value given and obligations assumed – for a target. The basic formula for enterprise value is:

EV = Market value of shares + market value of debt – excess cash.

It will be noted that the formula brings both debt and equity into account. This reflects the fact that both equity and debt holders are interested in the firm. The utility of the concept can be seen from an example. Assume a company with 1 million issued shares worth $1 each, 1 million bonds worth $1 and no excess cash (current assets and current liabilities cancel out). In that state of affairs, the company has an EV of $2 million. If business deteriorates, the share price will drop but the bond price may remain fairly stable – so that if the EV reaches $1.5 million, the bonds are still worth $1 but the shares only 50 cents. At some point, the value of the bonds also starts to deteriorate as lenders become concerned about recoverability and credit ratings decline. This will happen well before the shares become valueless. Throughout this process, the goal of the board should be to maximise EV, by restoring value to both bonds and shares.

Implications

Treating directors' duties as directed consistently to the maximisation of the value of the corporate enterprise has certain advantages over what I have called the conventional view.

First, as Professor Worthington noted, some confusion and controversy might be removed if it were held that the fiduciary duty is owed to the company as a separate legal entity: "this has the advantage of according with the existing conceptual framework of company theory and the underlying principles of fiduciary powers. It is also simple."[97]

Secondly, bringing enterprise value into account much reduces the temptation for boards, as the company nears insolvency, to engage in the kinds of actions which are likely to harm creditors. As mentioned above, the paradigm cases are paying dividends and engaging in excessive risk-taking. Such transactions are tempting when the value of equity is low, but only if corporate value is narrowly conceived as equal to shareholder value. If instead corporate value is seen as enterprise value the temptations substantially diminish. Inappropriate dividends reduce the surplus funds available to ensure ultimate solvency and reduce the value of bonds. Excessive risk-taking when there is little residual equity means the bond-holders and other creditors carry substantially all the risk of loss from the venture – again the result is that the company's debt falls in value, and so does its enterprise value.

Thirdly, under this approach there are no shifting allegiances. At all times the board has the same duty and the same goal. As the Supreme Court of Canada explained:

> 46 The directors' fiduciary duty does not change when a corporation is in the nebulous 'vicinity of insolvency'. … In assessing the actions of directors it is evident that any honest and good faith attempt to redress the corporation's financial problems will, if successful, both retain value for shareholders and improve the position of creditors. If unsuccessful, it will not qualify as a breach of the statutory fiduciary duty.
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> 47 … In using their skills for the benefit of the corporation when it is in troubled waters financially, the directors must be careful to attempt to act in its best interests by creating a 'better' corporation, and not to favour the interests of any one group of stakeholders.[98]

[97] S Worthington, 'Directors' Duties, Creditors' Rights and Shareholder Intervention' (1991) 18 *Melbourne University Law Review* 121 at 131.
[98] Ibid at 46, 47.

Fourthly, a focus on enterprise value better reflects the contemporary reality that there is no longer a sharp division between equity and debt. Over the last decade there has been a proliferation of hybrid securities issues encompassing both equity decoupling (unbundling economic, voting, and sometimes other rights customarily associated with shares) and debt decoupling (unbundling the economic rights, contractual control rights, and legal and other rights normally associated with debt, through credit derivatives and securitization).[99] In this environment equity and debt are better seen as a continuum, progressing from ordinary shares through preferred shares, redeemable preference shares, convertible or stapled instruments, perpetual debt, subordinated debt, unsecured debt and secured debt.[100] A focus on enterprise value encourages boards to try to capture and enhance corporate value across the entire continuum.

Finally, if the focus on maximising the value of the corporate enterprise is given a long-term perspective it arguably satisfies many of the concerns which underlie the current debates about stakeholder interests and corporate governance.[101] This is very large topic, however, one that is well beyond the scope of this paper to address. I would only venture this observation. One implication of the events concerning James Hardie is that listed corporations cannot, while maximising value, indefinitely operate outside the bounds of accepted community standards of corporate behaviour – whether these standards are legally mandated or not. The modern commercial environment attributes too much significance to brand value and reputational value for this to be a viable long-term strategy for most companies.

John Sheahan

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[99] H T C Hu and B S Black, 'Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications' (June 15, 2008), University of Texas Law, Law and Econ Research Paper No. 120; *European Financial Management Journal*, Vol. 14, 2008; ECGI - Finance Working Paper Series No. 207/2008; McCombs Research Paper Series [available at Social Science Research Network: http://ssrn.com/abstract=1084075].

[100] http://www.blakedawson.com/Templates/Publications/x_article_content_page.aspx?id=54433.

[101] The literature is enormous. For an introduction, see B Horrigan, 'Fault Lines in the Intersection Between Corporate Governance and Social Responsibility', (2002) 20 *UNSWLJ* 515; P Davies, above n 34; and S Marshall and I Ramsay, 'Stakeholders and Directors' Duties: Law, Theory and Evidence' (May 10, 2009). Available at SSRN: http://ssrn.com/abstract=1402143. For an argument for "enlightened value maximisation" as the proper long run goal of corporate governance, see M Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' (October 2001) in J. Andriof, et al, eds, *Unfolding Stakeholder Thinking* (Greenleaf Publishing, 2002).