Discussion of J. Sheahan, SC, 'Directors' Duties in the Zone of Insolvency'

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I am going to suggest that the common law duty still has an important role to play, but I am also going to offer firm support for John Sheahan's radical and intriguing reconceptualisation of the interests of the company.

As regards the role of the common law, I am surprised to find myself taking this position. Before I came to Australia last September I would scarcely have entertained making such an argument, but a semester's experience teaching the corporations legislation – sorry corporations law – to undergraduates at UQ has brought home some of the problems of a hyperactive legislature. Do they get paid by the word? Why can they not be consistent? Why simplify when all it does is complicate things? Why replace the common law sometimes but leave it in place in other cases?

As John Sheahan has pointed out in his fascinating and rather radical paper, two principal rationales are available for the common law imposition of a duty on company directors to consider the interests of creditors when they consider whether a particular course of action is in the best interests of the company they direct.[1]

The first, and conventional rationale for the duty, is what we may term the 'economic rationale'. This suggests that, as the company's financial position deteriorates and it travels towards insolvency, the directors of a company gain an incentive to take progressively riskier decisions. The downside risk is primarily imposed on creditors, while any upside will accrue to the shareholders (with whose interests the directors' interests are basically assumed to be aligned). While the company is a going concern with an adequate equity buffer to absorb any losses which eventuate from risky transactions, the creditors will be protected against loss.[2] However, once that buffer becomes inadequate to absorb potential losses, the creditors become exposed to the risk of loss and the economic justification for the corporation as a mechanism for risk-taking no longer holds. By progressively replacing the shareholder-centric

[1] Other explanations are of course possible. Sealy argues that the cases imposing a duty to creditors are a 'fudge' because they generally deal with small companies in which the directors and shareholders are the same people, and going after the directors allows the courts implicitly to lift the veil. See L. Sealy, 'Directors' "Wider" Responsibilities – Problems Conceptual, Practical and Procedural' (1987) 13 *Monash U Law Review* 164 at 180. Cooke J in *Permakraft (NZ) Ltd (in liq) v Nicholson* (1985) 1 NZLR 242 at 250 explains the duty as reflecting the privilege of limited liability.

[2] Sealy (supra n1) argues at 181 that the law intervenes where the decision goes beyond a 'legitimate business risk'.

conception of the interests of the corporation in favour of a creditor-centric conception, the law gives creditors protection against the incentive of company directors to take excessively risky decisions at their expense once insolvency becomes a real possibility.

The second, and more radical rationale for including creditors among the interests of the company as it approaches insolvency may be termed the 'instrumental rationale'. In his epic decision in *Bell Group v Westpac Banking (No 9)*,[3] Owen J explains the creditor-regarding duty in terms of its function in preserving the company as a separate commercial entity. If the directors fail to consider the interests of the creditors this 'will have adverse consequences for the company as well as the creditors', consequences which 'include threats to the very existence of the company: to its ability to continue as a going concern.'[4] This is a more radical approach because it goes against the – albeit somewhat flimsy – authority of cases such as *Hutton v West Cork Railway Co*[5] and *Parke v Daily News*[6], which identify the interests of the company with the interests of the shareholders, and insist that actions of the directors must be *capable* of producing returns for the shareholders. To shift to what Margaret Blair terms 'Total Wealth Creation' implies that a company which is servicing its debts and paying its employees decent wages should continue in operation even if it is not producing returns for its shareholders.[7]

There is no doubt that, as John has emphasized, there are problems with the duty to creditors. Identifying the point at which it begins to operate is perhaps the most obvious. More specifically, it will not be clear ex ante to directors precisely when a court will determine ex post that they breached the duty to consider creditors because the company was 'approaching' or 'in the vicinity of' insolvency. The common law duty therefore creates a danger that directors will incur suboptimal levels of risk and that the dynamism of the economy will be undermined (although of course similar allegations could be made against s588 and the inscrutability of the concept of 'insolvency'). In addressing this difficulty we should note the following. The point at which the duty is triggered will depend on underlying assumptions about why the duty is imposed in the first place, and this makes the explanation of the duty important. In this regard, the economic rationale offers greater clarity than the instrumental rationale. Once the shareholders' equity cushion is no longer sufficient to cover fully the downside risk of the new project in question, the directors should be liable for any losses which they cause to creditors

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[3] (2008) 70 ACSR 1

[4] Para 4418 of the judgment.

[5] (1883) 23 Ch D 654

[6] (1962) Ch 927

[7] See for example M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Washington DC: Brookings Institution, 1995)

collectively. It may of course be difficult to evaluate downside risk ex ante. However, if one adopts the instrumental rationale, one would appear to fall back on even vaguer notions such as creating an unreasonable danger to the company's continued survival.

As regards John's specific arguments in Part D about what the duty achieves, I would like to make the following points. It is certainly true that Part 5.7B contains detailed rules allowing for the winding back of insolvent transactions. However, the common law duty kicks in earlier, in the approach as well as the event of insolvency, thereby potentially increasing the amount which can be recovered from directors for the creditors collectively, assuming the company does become insolvent.[8] Moreover, the common law duty is a standard and is therefore apt to catch decision-making which does not fall within the specific provisions of Part 5.7B but which does prejudice the interests of creditors. Just because the duty has arguably not been determinative of a case to date does not mean that it is not potentially a useful weapon in the judicial armoury. Most importantly, from the perspective of an economic analysis of the creditor-regarding duty, it operates to fill in gaps in creditor contracts. I do not find John's dismissal of this justification for the duty convincing. He argues that 'creditors have the ability to protect themselves in advance against decisions of companies which are adverse to their interests'. He draws support from a dictum of the Delaware Court of Chancery to the effect that this duty might 'fill gaps that do not exist'. Yet the Delaware court's assumption that all creditors can and do bargain for and obtain full contractual protection of their interests owes more to the assumptions of neoclassical economics, with its emphasis that agreements entered into voluntarily necessarily make both parties better off and make full provision for all contingencies, than to the realities of creditor contracting. More nuanced economic approaches emphasise the law's role in filling the gaps in contracts caused by transaction costs and bounded rationality.[9] In particular, trade, tort and small creditors simply do not bargain with companies because the costs of assessing risk and making detailed contractual provision for all possible contingencies cannot be justified. The law therefore steps in with a general standard which imposes a duty on directors to take account of creditor interests where the downside risk to those interests is not fully covered by the shareholders' equity cushion. This can be justified on the basis that creditors would bargain for this if it were not for the transaction costs of doing so. Admittedly, the duty may be redundant as far as large-scale,

[8] In this regard it is instructive to contrast s214 of the UK Insolvency Act 1986, which catches wrongful trading where the directors 'ought to have realized that the company had no reasonable prospect of avoiding insolvent liquidation', with s588G of the Corporations Act 2001, which only applies where the company is insolvent at the time of incurring the debt or becomes so as a result of incurring the debt.

[9] Bounded rationality might also affect bargaining creditors: it is difficult to anticipate all the actions which a company could take which would impair the value of the creditors' rights and therefore to provide for them in a contract.

sophisticated creditors are concerned. Moreover, and more problematically, the duty may not protect the interests of smaller creditors whose bargains suffer from contractual incompleteness because, in contrast to the statutory actions which may be brought by the liquidator, the misfeasance claim will already have accrued to the company and therefore be available to meet the claims of relevant secured creditors in priority to the claims of those unsecured creditors which the duty is – on this account – designed to protect.[10] However, this is not an argument against the imposition of a duty, but against the existing rules on priority over the proceeds of particular misfeasance proceedings. It would be perfectly possible – especially given the hyperactivity of the Australian legislature – to require that some or all of any recovery in misfeasance proceedings for breach of this duty must be reserved to meet the claims of unsecured, non-bargaining creditors.[11]

I am therefore not entirely convinced by John's argument that a duty on directors to consider the interests of creditors 'lacks a sound conceptual basis and serves no clear purpose'. However, his suggestion that 'a simpler approach is possible' and that the duty to creditors should be viewed simply as an aspect of the director's duty to act in the best interests of the company as a separate entity is both radical and intriguing.

It is radical because it involves abandoning the idea of enlightened shareholder value as embodied in cases such as *Hutton* and *Parke*. However, the time is arguably right to abandon those decisions, both because of changes in the organization of production which mean that shareholders are no longer the sole risk-bearers in the corporate enterprise (Margaret Blair argues that employees who have invested in firm-specific human capital also bear risk), and because it would complete corporate law's process of transition from partnership to separate legal entity. The idea that the board of directors was the agent of the shareholders – which it was in deed of settlement companies (which were unincorporated associations or partnerships) – was rightly rejected in *Automatic Self-Cleansing Filter Syndicate v Cunninghame*.[12] However, the scope of the 'interests of the company' was not similarly updated, and *Hutton* was applied uncritically in *Parke*, drawing support from *Greenhalgh v Arderne Cinemas*,[13] which as John rightly points out, concerned conflict 'between the shareholders inter se', and is arguably not relevant to the question of what the law requires in terms of the balance between shareholders and other constituencies. Accordingly, adopting the instrumental approach and strengthening

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[10] For English authorities to this effect see *Re Oasis Merchandising Ltd* (1998) Ch 170 and *Re Yagerphone Ltd* (1935) Ch 392.

[11] See for example s588Y(1) of the Corporations Act 2001 which provides that compensation for breach of the insolvent trading provisions must go first to the unsecured creditors rather than the secured creditors.

[12] (1906) 2 Ch 34

[13] (1951) Ch 286 at 291

the corporate entity would finally complete the process of transition from partnership law to corporate law.

Precisely what should replace the shareholder-centric notion of the 'interests of the company' is more problematic. The UK's Company Law Reform process rejected pluralism (that is allowing a range of interests to be taken into account as ends in themselves) in favour of enshrining enlightened shareholder value in statute. s171 CA 2006 which refers to promoting the success of the business for the benefit of the members as a whole taking account of a non-exhaustive range of stakeholder interests. Pluralism was rejected on the basis that, inter alia, it would allow directors to serve whichever interest coincided most closely with their own and that it would involve far-reaching changes to the law, including takeover regulation.[14] However, Owen J's reference to the company's 'ability to continue as a going concern' and the idea that the company can have an interest which is not defined by reference to the interests of one or more of its stakeholder constituencies seems to come closer to the continental European notion of the interests of the company in itself. This theory has been most famously elaborated by Gunther Teubner, who argues that this means that the law must abandon instrumental regulation in favour of imposing processes which steer corporate governance so that the company's effects on its environment (including creditors, shareholders, employees, the environment) are internalised, thereby achieving corporate social responsibility.[15] Were Australian law to adopt such an approach, this would be an extremely radical departure.

It is intriguing because it would appear to entail abandoning the use of the director's duty to act in the best interests of the company as a mechanism of accountability. Sealy argued in 1987 that, if the law imposes 'duties to persons with potentially opposed interests… it abandons all effective control over the decision-maker.'[16] Sealy took the view that requiring the directors to act in the interests of the enterprise would not assist because 'without some system of legally ordered priorities between the different groups having claims to recognition as part of the corporate enterprise, there is no way in which any one such claim could be positively enforced.' That would leave market mechanisms (hostile takeover, incentive pay) and the legal aspects of corporate governance (shareholder rights to remove and appoint the board) as the principal mechanisms of accountability to shareholders (as they no doubt are in practice). Indeed, the idea that the duty to act in the best interests of the company is – at best – marginal in terms of

[14] See for example A. Johnston, 'After the OFR: Will UK Shareholder Value Still Be Enlightened?' (2006) 7 *European Business Organization Law Review* 817 at 825-6.

[15] See for example G. Teubner, 'Enterprise Corporatism - New Industrial-Policy and the Essence of the Legal Person' (1988) 36 *American Journal of Comparative Law* 130 and more generally, G. Teubner, Law as an Autopoietic System *Law as an Autopoietic System* (Oxford: Blackwell 1993).

[16] Sealy (supra n1) at 175

ensuring director accountability to shareholders is confirmed by a brief perusal of the case law. Leaving aside the cases on creditor interests discussed in John's paper, the other cases are either of considerable antiquity or based uncritically on very old authority. In the US, we have to go back to the historical (1919) and marginal (Michigan Supreme Court) authority of *Dodge v Ford Motor Co*.[17] In Australia, authority is similarly scarce. *Woolworths Ltd v Kelly*[18] implicitly refers back to *Hutton*, although the conclusion that the director's pension was justifiable could have been reached on either a pluralist or strengthened entity approach: 'To adapt what was said long ago, the directors may have cakes and ale and, now, jet planes, but they may have them only if it is for the benefit of the company that they have them. And, of course, only to the extent that it is so.'[19] Accordingly, changing the law so that directors know they are free to concentrate on enhancing enterprise value would provide them with better guidance as to their function, but would not significantly detract from existing mechanisms of accountability to shareholders.

[17] 204 Mich 459; 170 N.W. 668 (1919)

[18] (1991) 4 ACSR 431.

[19] per Mahoney JA in *Woolworths* at 446.