Before the High Court

For Whom the Bell Tolls: Directors′ Duties to Creditors after *Bell*

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Abstract

It is now established, following High Court dicta in *Walker v Wimborne* and *Spies*, that directors owe a duty to consider creditors' interests upon corporate insolvency, and that such a duty is one of imperfect obligation that is incapable of direct enforcement by the creditors. Notwithstanding such orthodox authority, the precise nature and scope of directors' duties to creditors upon corporate insolvency remains a vexed issue that continues to plague the judiciary as a consequence of the absence of any detailed consideration of such issues by the High Court. The recent appellate court decision in the *Bell Group* case exemplifies the legal uncertainties on this topic, which arose upon the directors' exploration of corporate rescue plans in the context of looming insolvency. In particular, it is now unclear whether directors must go beyond consideration of creditors' interests and ensure that creditors are protected in conformity with the pari passu principle. The extent to which the judiciary can intervene to adjudicate on the directors' beliefs and business judgments is also clouded by uncertainty. The High Court of Australia will consider such issues in an upcoming appeal. This note discusses the context of the decision and argues that the directors' duties to consider creditor interests, while beneficial, should not be elevated to ensure pari passu treatment when directors make commercial decisions to save the company. To hold directors to be in breach of fiduciary duties in such circumstances, when they have acted in good faith, runs the risk of hindering corporate rescue opportunities, as well as undermining the business judgment of directors. Further, the goal of creditor protection can be achieved by existing legal rules and does not require the elevation of the duty from one of consideration to one of protection.

I Introduction

The defining tension in corporate governance today is that between deference to directors' decisions and the scope of business review, as noted by the former Chief Justice of the Delaware Supreme Court.[1] This observation, made more than a decade ago, rings true today — particularly in light of the majority judgment in

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[1] Norman Veasey, 'The Defining Tension in Corporate Governance in America' (1997) 52 *Business Lawyer* 393, 403.

Westpac Banking Corporation v Bell Group Ltd (in liq) (No 3)[2] concerning the duties of company directors in an insolvency context and the role of the judiciary in assessing whether directors failed in their duty to act in the best interests of the company.

The current tension in Australian company law, for purposes of this note, has arisen from the approach taken by the majority in *Bell*, which applied two key legal principles: (1) the duty of directors to act in good faith and in the best interests of the company,[3] which includes consideration of the interests of creditors upon insolvency;[4] and (2) the application of the judicial principle that, in this respect, the court should ask whether the directors acted for what they regard, rather than what the court regarded, as the benefit of the company in question.[5] The latter principle, in contrast to the first which is 'often indeterminate and sometimes arguably incoherent',[6] is well entrenched and commonly understood to mean that the courts are not to look over the director's shoulder and to second-guess their commercial decisions,[7] or determine if their decision was wise or not.[8]

When a company is in financial distress and directors' duties to consider creditors intrude, it creates a 'challenging framework'[9] within which decisions must be made to comport with the overarching duty to act in the company's best interests. The reason for the challenge is that judicial authorities in the Anglo-American jurisdictions to date, until the *Bell* decision, have not gone much beyond simply articulating a need to consider creditor interests when the company is insolvent to nearly insolvent[10] — save for confirmation by the High Court in *Spies*

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2 (2012) 270 FLR 1 ('*Bell*').

3 *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286; *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285. It has been noted that this legal concept is one of the most problematic in company law. See Daniel Prentice, 'Creditor's Interests and Director's Duties' (1990) 10 *Oxford Journal of Legal Studies* 265, 275. Similarly, other commentators have noted that the content of this duty has not been settled satisfactorily in Australia. See further, Shelley Marshall and Ian Ramsay, 'Stakeholders and Directors' Duties: Law, Theory and Evidence' (2012) 35 *University of New South Wales Law Journal* 291.

4 *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Spies v The Queen* (2000) 201 CLR 603 ('*Spies*'). For discussion of these seminal cases, see Anil 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; 'Geneva Finance and the "Duty" of Directors to Creditors: Imperfect Obligation and Critique' (2004) 12 *Insolvency Law Journal* 134.

5 *Re Smith & Fawcett Ltd* [1942] Ch 304.

6 See Prentice, above n 3, 275.

7 *Carlen v Drury* (1812) 1 Ves & B 154; (1812) 35 ER 61 ('This court is not required on every occasion to take the management of every playhouse and brewhouse in the Kingdom'); *Harlowe's Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL* (1968) 121 CLR 483; *ASIC v Rich* [2009] 75 ACSR 1.

8 *Richard Brady Frank Ltd v Price* (1937) 58 CLR 112.

9 Christopher Mallon and Shai Waisman (eds), *The Law and Practice of Restructuring in the United Kingdom and United States* (Oxford University Press, 2011) 27.

10 For instance in the UK, see *Winkworth v Edward Baron Development Co Ltd* [1986] 1 WLR 1512; *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250; *Facia Footwear v Hinchcliffe* [1998] 1 BCLC 218; *MDA Investment Management Ltd* [2004] 1 BCLC 217; *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638. For New Zealand authorities, see *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Hilton International Ltd v Hilton* [1989] 1 NZLR 442. For Australian authorities, see above n 4. For comprehensive discussion on the authorities in these jurisdictions, see Andrew Keay, *Company Directors' Responsibilities to Creditors* (Routledge, 2007).

that directors do not owe an independent duty to creditors capable of enforcement by the creditors in their own right.[11] It is through the mechanism of liquidation that the creditors' interests are protected.

This valuable development aside, the law on this significant issue is remarkably short of specific judicial guidance as to how directors should discharge their duties, without harming the interests of creditors, when engaged in commercial risk-taking with a view to corporate rescue.

The conventional wisdom based on the seminal judicial authorities,[12] prior to the appellate decision in *Bell*, is that the duty requires directors of insolvent or nearly insolvent companies to have regard to the interests of the company creditors — the duty is not pitched any higher, for example, to ensure that directors acted to the best advantage of creditors,[13] nor is it impermissible for a director to advance the interests of a particular creditor so long as he or she believes in good faith that this action will be in the interests of creditors as a class.[14]

In light of this, there are two key propositions espoused in the majority judgment in *Bell* that form the central focus of both this note and of the High Court's deliberations in the appeal. These propositions are:

1. that directors have an elevated duty at general law to ensure that creditor interests are properly protected during commercial decisions taken prior to insolvency to ensure a pari passu outcome,[15] as opposed to having their interests merely considered as one of a number of stakeholder groups;[16] and
2. that the courts will no longer show the deference to the business judgment of directors who honestly believed they were acting in the interests of the company in order to ensure that creditor interests are properly protected when the company is sufficiently financially distressed.[17]

Absent self-dealing and/or shirking, the juridical basis of such a wide interpretation of the law by the majority in *Bell* is highly questionable.

This note considers the context of the *Bell* decision and comments on the legal and policy basis of the twin propositions underpinning the majority judgment. It is submitted that the High Court should not accept the twin propositions, especially when applied to the facts of this particular case, due principally to the inherent tension it causes when directors have made commercial decisions in good faith in the context of financial distress. The majority view is arguably out of touch

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11 *Spies* (2000) 201 CLR 603. For detailed analysis of this significant case, see Hargovan, above n 4. For a similar position in the UK, see *Yukong Lines Ltd of Korea v Rendsburg Investments Corp* [1998] 4 All ER 82.
12 See authorities cited above n 4.
13 See *Re Welfab Engineers Ltd* [1990] BCC 60.
14 *GHLM Trading Ltd v Maroo* [2012] EWHC 61.
15 *Bell* (2012) 270 FLR 1, 361 [2031] (Drummond AJA).
16 See authorities cited above n 4.
17 *Bell* (2012) 270 FLR 1, 360 [2029] (Drummond AJA).

with commercial realities and will cause numerous practical problems for companies attempting to restructure their affairs during times of financial distress.

The discussion in the next part of this note centres on the theoretical and legal framework concerning the duty to act in good faith in the interests of the company before discussing the facts and result in the *Bell* case. The note thereafter critiques the novel application of directors' duties to creditors by Drummond AJA. It concludes by offering reasons why the High Court should reject any move towards a direct duty by directors to consider the interests of individual classes of creditors. The potentially adverse consequences such a duty is likely to have on corporate rescue efforts involving distressed companies is a prime reason.

II Nature and Rationale of the Duty to Consider Creditor Interests

Directors' fiduciary duties include the duties to act in good faith in the best interests of the company, to act for proper corporate purposes and to avoid conflicts of interest.[18] At general law, when a company is solvent, directors owe fiduciary duties to the shareholders as well as to the company. There is an expectation that creditors, during solvency, will protect their interests by contractual means.

From an economic perspective, shareholders in a solvent company are viewed as the residual claimants of the company's assets and as the residual risk bearers.[19] In the event of corporate insolvency, however, the dynamics may change. The value of shareholder's equity can be greatly diminished and, more often than not, can become worthless. In such circumstances, shareholders are no longer viewed as the residual claimants. As Street CJ noted in one of the leading authorities, insolvency displaces the power of the shareholders to deal with the company's assets, which in a practical sense become the assets of the creditors (or rather, creditors have a right to a distribution from the assets in preference to shareholders).[20] There is thus a moral hazard problem where the directors are accountable to shareholders but the shareholders may encourage the directors to take increasingly risky bets with the company's assets to the detriment of creditors. The law addresses this problem by a range of statutory measures such as insolvent trading[21] and voidable transactions.[22] The duty to consider creditor interests also has a role to play, but is not the only regulatory tool.

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[18] See further Robert Austin, Harold Ford and Ian Ramsay, *Company Directors: Principles of Law and Corporate Governance* (LexisNexis, 2005); Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart, 2010).

[19] See Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991).

[20] *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722, 730, affirmed by the High Court in *Spies* (2000) 201 CLR 603.

[21] *Corporations Act 2001* (Cth) pt 5.7B divs 3 and 4.

[22] Ibid pt 5.7B div 2.

In times of financial distress, the interests of shareholders and creditors can be 'starkly divergent',[23] thus the fiduciary relationship is modified or expanded to include directors' duties to the company's creditors at a time when the company is insolvent or near insolvency. The practical application of such a duty to a particular company is more troublesome.[24] Directors have little guidance on when the duty will begin and end and what exactly it requires of them.[25] It is for such reasons that a commentator has labelled the doctrine a 'mess',[26] noting that 'it is extraordinarily difficult to slice the world into categories of solvency, insolvency, and the vicinity of insolvency'.[27] Indeed, the question of whether a company is, or is not, solvent requires detailed accounting analysis and is not one that directors can easily judge when making commercial decisions, particularly during times of financial distress.

III The Bell Litigation

A Facts

The *Bell* litigation[28] concerned a refinancing arrangement to reorganise the debt obligations owed by The Bell Group Ltd and its offshore fundraising entity to separate groups of banks. At the time of the refinancing (known as a 'workout') the loans were unsecured and several subsidiaries in the Bell group of companies had assets that were not exposed to the parent company's debt obligations. The key feature of the workout was to convert the unsecured loans into secured obligations and to bring all the companies in the group into the security agreement so that their assets could be used to pay down the secured debts. The workout contained a cash sweep provision that required all free cash generated by the group companies to be paid to the banks to pay off the restructured secured loans. The banks did, however, allow some of these funds to be used for general operating expenses.

The central company involved in the case was The Bell Group Ltd ('BGL'), which was a listed holding company for the Bell group that had previously been controlled by Robert Holmes à Court before being taken over by Bond Corporation in 1988. BGL had a significant interest (39 per cent) in another listed company, Bell Resources Ltd (BRL). Both BRL and BGL were controlled and managed by persons associated with Bond Corporation. There were more than 100 companies in the domestic and international group that comprised the Bell group. The primary executive director of BGL and BRL was Aspinall, who led the refinancing

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23 *Prod.Res. Grp., LLC v NCT Grp Inc,* 863 A.2d 772, 790 (Del. Ch. 2004).

24 Royce Barondes et al, 'Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies — History & Background' (2007) 1 *Journal of Business & Technology Law* 229; Len Sealy, 'Directors' "Wider" Responsibilities — Problems Conceptual, Practical and Procedural' (1987) 13 *Monash University Law Review* 164.

25 Ian Ramsay, 'In the Best Interests of the Company (Including Creditors?)' in Robert Austin and Andrew Bilski (eds), *Directors in Troubled Times* (Ross Parsons Centre, 2009).

26 Barondes et al, above n 24, 238.

27 Ibid 239.

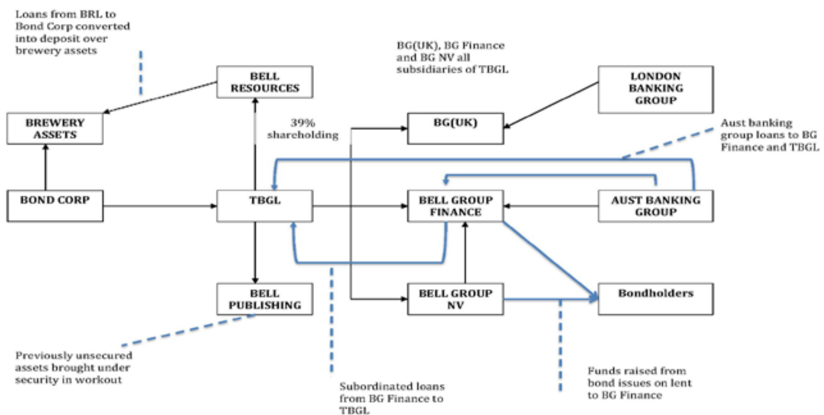
28 *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)* (2008) 39 WAR 1 (trial) ('*Bell Group (No 9)*)'; *Bell* (2012) 270 FLR 1 (appeal).

discussions with the banks. The other directors were Oates and Mitchell, who both acted in a non-executive capacity. Each of these directors had worked closely with Alan Bond in various Bond Corporation entities and worked in various companies in the Australian division of the Bell group. Mitchell and Bond were also directors of Bell Group (UK) Holdings Ltd (BGUK), along with two other directors.

The major assets of BGL consisted of the controlling interest in BRL and a publishing division that centred on West Australian Newspapers. The shares in BRL had generated significant funds to BGL over the years, but in 1989, close to A$1 billion was taken out of BRL by Bond Corporation via a series of loans. Complications with the loan transactions caused Bond Corporation to convert them into a deposit for the acquisition by BRL of Bond Corporation's brewery assets, which were valuable assets that were later sold for a significant amount. The stock market crash of 1987 had caused the Bell group of companies to engage in a program of asset sales to help pay down debt. This left the group with valuable and income producing assets aside from the publishing division, shares in BRL and the deposit in the brewery assets.

Prior to being taken over by Bond Corporation, the Bell group had engaged in large external financing programs both from bank loans and by issuing bonds in both domestic and overseas markets. The group had a treasury subsidiary (Bell Group Finance Pty Ltd) and had an offshore company (Bell Group NV) that issued European bonds from the Netherlands Antilles. The group's British operations were controlled by BGUK. The funds from these bond issues were then lent to BGL and Bell Group (Finance), although the transactions were not formally documented. One of the major legal issues in the case was whether the intra-group loans from Bell Group NV were subordinated or not. This went to the heart of what prejudice the bondholders (as creditors) suffered as a result of the workout.

The key corporate participants in the case are best explained using a diagram.



After the stock market crash of 1987, the Bell group's banks became increasingly concerned about the repayment of the unsecured loans. While Bell group executives initially believed that the asset sale program would generate sufficient funds to pay off the Australian bank debt and had advised the banks of this, by mid-1989 it was clear to the Bell group executives that there were would not be sufficient funds to clear the debts. This left the banks opposed to providing any further funding to the group. All of the Australian loan facilities at this time were operating 'on demand' so that any of the banks could call for full repayment. If any bank pressed a demand for repayment it would have been likely that others would follow suit and the company would have to enter liquidation. This left the group little choice but to pursue workout negotiations.

The workout negotiations involved two groups of banks, one based in Australia and another based in London. Each of the groups was owed in excess of A$130 million. There were more than A$540 million in bonds outstanding at this time which required regular interest payments. During the time of the workout negotiations (December 1989) the banks received internal financial information from the Bell group companies and were also advised that their debts might rank equally with bondholders if the bonds were not subordinated. At the same time, receivers were appointed over Bond Corporation's brewery assets which complicated their transfer to BRL, although this was subsequently completed when the court overturned the receiver's appointment.

The debt refinancing documents were executed on Australia Day 1990 and involved the following key features:

- An extension of the bank loan facilities to the end of May 1991.
- The companies in the Bell group agreed to mortgage their assets to cover the bank loans under a guarantee to cover the refinanced bank debt. Many of these companies had no prior exposure to the bank debt owed by TBGL and BGUK.
- Proceeds from asset sales within the group were to be used to pay down bank debt (subject to several exceptions).
- Subordination of all intra-group debt (subject to certain exceptions involving Bell Group NV and BGUK).
- Bell Group NV and BGUK were obliged to use their best efforts to subordinate any group debts owed to them (this was subsequently done)

At this time the financial position of the group was poor and several companies in the UK division of the Bell group were in the process of being liquidated. The banks did not enforce their new security for a further 16 months, although they received some proceeds of asset sales during that time. It should be noted that had the banks enforced their security within six months of its creation the security may have been rendered void.[29] Given the poor financial position of the companies and the difficulty in paying interest payments to the bondholders it

[29] See *Corporations Act 2001* (Cth) s 588FJ.

seemed likely that the group would not be able to comply with the terms of the refinancing arrangement without considerable cooperation from the banks. It was clear that the purpose of the workout was simply to give the group time to restructure its affairs, as no new funds were provided by the banks to support the workout. When no viable restructuring developed, the companies in the group were placed into liquidation and the banks realised their security and recovered A$283 million from asset sales.

B *The Proceedings*

The liquidators commenced proceedings against the banks and the directors (although the actions against the directors were discontinued) claiming that the refinancing was a breach of directors' duties because the directors knew the companies were insolvent and knew that the refinancing benefited the banks to the prejudice of the companies' other creditors. Importantly, the liquidators claimed that the banks had knowledge of these matters and therefore were liable to disgorge the proceeds gained from realising their security over the group companies' assets. This was the main claim for relief and was based on:

- Knowing participation by the banks in breaches of directors' duties and knowing receipt of assets resulting from these breaches;
- Equitable fraud; and
- Voidable transactions in the *Bankruptcy Act 1966* (Cth), which applied to companies at the time of the events, and other statutes.

These claims arose from the fact that the banks used the refinancing arrangement to obtain a better position for themselves compared with other unsecured creditors by obtaining security over the group's assets which they were not previously entitled to. The liquidators' arguments were based on a failure of the directors to act in the best interests of each of the companies on whose board they sat. The allegation was that the directors merely considered the interests of the group and ultimately Bond Corporation. The liquidator's claim against the banks amounted to A$1.5 billion after allowing for interest over the more than 10 years that the case proceeded through the court.

The banks responded that they had no knowledge of the insolvency or of any breaches of duty. Further, the banks claimed that the directors could have reasonably believed that the refinancing was in the best interests of the companies because it gave the group time to develop a long-term rescue proposal.

C *Judicial Findings*

The *Bell* case has been subject to four separate sets of judicial reasons: the trial judge (Owen J) and on appeal (Lee, Drummond and Carr AJJA). The High Court of Australia granted special leave to appeal on 15 March 2013.

The case involves several important legal issues including contractual subordination, equitable fraud and the rule in *Barnes v Addy.*[30] This note will focus on directors' duties to consider creditor interests.

1 *The trial judge*

The trial judge (Owen J) held that the companies in the Bell group were insolvent at the time of the refinancing.[31]

The banks conceded that they knew that without a refinancing the group was likely to have gone into liquidation.[32] However, Owen J held that liquidation or the refinancing agreement entered into were not the only two possible scenarios and other alternative restructuring strategies could have been pursued. His Honour held that the conduct of the banks prejudiced the external creditors of the companies in the Bell group (such as the ATO) because the banks took security over assets for their refinancing that had not previously been subject to security. His Honour also found that the bondholders, despite their subordination through the on loan transactions, were still prejudiced by the banks taking effective control of the assets in the group.

The directors' duties arguments centered on whether the directors of the Bell group companies acted in the best interests of their particular company, or rather acted to promote the other interests, namely the interests of the holding company (BGL) or the ultimate controller Bond Corporation.

Justice Owen applied the long-established rule that the duties of company directors are owed to the company.[33] In considering what were the interests of the company, his Honour noted that while the interests of the company (as a separate legal entity) may intersect with the interests of members, the two interests are still distinct. Similarly, when the company is insolvent, the interests of the creditors may intersect with the interests of the company but the two sets of interests are not one and same.[34]

His Honour went on to state that while the content of the duty will usually include consideration of the interests of shareholders, there may be other considerations that should also be included.[35]

Importantly, Owen J held that the assessment of good faith is to be done subjectively but with the proviso that the court is entitled to have regard to objective circumstances to determine whether the director's conduct is capable of being characterised as acting in good faith.[36] Clearly, a mere suggestion by the director that they acted in good faith will not be sufficient. His Honour held that

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30 (1874) LR 9 Ch App 244.

31 See *Bell Group (No 9)* (2008) 39 WAR 1, chs 9 (in particular the summary of findings at [9.20]) and 10.

32 *Bell Group (No 9)* [2008] WASC 239 [190]. This paragraph was omitted from the edited WAR version of the case.

33 *Bell Group (No 9)* (2008) 39 WAR 1, 533–4 [20.3.2].

34 Ibid 534 [4393].

35 Ibid 534 [4395]. See further *Teck Corp Ltd v Millar* [1973] 33 DLR (3d) 288.

36 *Bell Group (No 9)* (2008) 39 WAR 1, 580 [4608].

there was no evidence to support the argument that the directors had actually considered the interests of their companies and their companies' creditors; the evidence suggested that the directors had acted only to benefit the parent company (BGL) and to support its workout efforts.[37]

His Honour held that the Australian directors were aware of the financial problems faced by the companies in the group but:

> looked at the problem of solvency 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.[38]

The UK-based directors were in a different situation. They seemed to be acting diligently and were actively engaged in trying to ensure that the refinancing transaction would benefit their company. However, they identified that the ongoing solvency of BGL was critical to the success of the refinancing and they did not have sufficient financial information available to determine its future prospects. They relied upon assurances as to the company's solvency from the Australian directors (Bond and Mitchell).[39] His Honour found that the actions of Bond and Mitchell were primarily concerned with promoting the interests of Bond Corporation.

Owen J held that the conduct of the directors had failed to demonstrate consideration of the interests of the creditors of the group companies that were pledging their otherwise unsecured assets for the benefit of the parent company (BGL). Importantly, his Honour stated the assessment constituted a balancing exercise where the risk to creditors could be included as one of several considerations to be taken by management. The greater the risk to creditors, the more directors and executive officers should take those considerations into account.[40]

His Honour noted that the relevance of creditor interests will wax and wane depending upon the circumstances and the significance of the risk to creditors. He stated that:

> 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.[41]

The balancing exercise that directors must undertake to include the interests of different stakeholders that make up the interests of the company does not mean that creditor interests must necessarily be paramount, however. Owen J held that such a

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37 Ibid 583 [4618].
38 Ibid 658 [6040].
39 Ibid [26.13].
40 Ibid 540–4.
41 Ibid 545 [4440].

view was 'going too far' as it would come perilously close to substituting a duty to act in the interests of creditors for the duty to act in the interests of the company.[42]

2 *Appeal decision*

All of the banks appealed to the Western Australian Court of Appeal, originally on 144 grounds.[43] The appeal judgments, by a 2:1 majority (Lee and Drummond AJJA; Carr AJA), confirmed the banks' liability but for slightly different reasons to the trial judge. Significantly for the banks, the appeal court determined that a different measure of calculating the compensation should be used which effectively doubled the banks' liability (to as much as A$3 billion).

While accepting that the duty to act in good faith was subjectively assessed, Lee AJA agreed with the trial judge that the court must analyse the assertions of the directors that they acted in good faith and genuinely believed that the company's best interests would be served by their conduct in the surrounding circumstances. His Honour held that directors could not have genuinely acted in the interests of the company where it was clear that the creditors' interests would be prejudiced.[44] His Honour went further and held that the duty to act in the interests of the company would necessarily be breached by conduct during a time of insolvency that would prejudice creditor interests.[45] In this case, the directors made no enquiries as to how the refinancing would affect the group companies' non-bank creditors and hence had failed to consider their interests. Lee AJA also placed considerable emphasis on the conduct of the banks and the directors as constituting equitable fraud because the directors acted to prefer one group of creditors (the banks) over another (the bondholders and the ATO).[46] In his Honour's view, the equitable fraud case supported the breaches of directors' duties because it demonstrated the failure even to consider how the transaction would affect the non-bank creditors of each company.

Drummond AJA took a different approach and focussed primarily on the ability of the court to assess objectively whether creditor interests had been adequately considered by the directors. His Honour went beyond the trial judge's focus on balancing by holding that:[47]

> [t]he duty will not ordinarily be satisfied by directors who consider the impact that entry into a particular transaction by the company will have on its creditors but proceed with the transaction even though it causes significant prejudice to those creditors. By doing that, the directors will usually, in my opinion, be in breach of their fiduciary duty to the company to exercise their powers for proper purposes and the transaction will be voidable at the election of the company or its liquidator.

Drummond AJA's reasoning showed readiness to depart from the deference courts usually give to the decisions of directors when involving judgments on

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42 Ibid 545 [4439].
43 *Westpac Banking Corp v Bell Group Ltd (in liq)* [2009] WASCA 223 [14].
44 *Bell* (2012) 270 FLR 1, 188 [1092].
45 Ibid 176 [993].
46 Ibid 171 [953].
47 Ibid 363 [2042].

matters of business or management.[48] Such an approach was considered necessary in order to ensure that creditor interests are properly protected.[49] His Honour viewed the test for breach of the duty to act bona fide in the interests of the company as subjective and the test for breach of the duty to act for proper purposes as objective.[50] This allowed his Honour to review the directors' decisions, and supports a more interventionist approach in commercial decision-making.

In a detailed dissenting judgment, Carr AJA treated the duty to act in good faith and for a proper purpose as a composite duty and therefore applied a subjective test. Such an approach, absent dishonesty and irrationality, means less judicial interference with commercial decision-making. His Honour observed that directors are not trustees and recognised that the law gives greater latitude to business people to conduct their company's affairs.[51]

His Honour viewed the role of law as facilitating, rather than stifling, the exercise of business skills and did not see the need for any legal intervention if directors acted honestly and not irrationally in making their business decisions.[52] His Honour expressed the concern, in relation to the facts of the Bell case, that directors would be limited in their choices and take the easy option of liquidation rather than exploring possibilities corporate rescue if the law was otherwise.[53]

Carr AJA was critical of the judicial approach adopted by Owen J for two main reasons. First, his Honour held that Owen J was looking over the directors' shoulders and applying a business judgment when determining whether the directors had breached their duty to the company.[54] After making a realistic assessment of the facts, Carr AJA concluded that with the benefit of hindsight, the Bell directors can be seen to have made the wrong call but, importantly, that did not equate to breach of fiduciary duties given the absence of dishonesty or irrationality.[55] Relying upon the *Charterbridge* test,[56] which Owen J did not apply, Carr AJA held that it could not be said that the directors' decisions to enter into the transactions were such that no intelligent and honest director could have made in the interests of each company in that group.[57]

Both the trial judge and the majority on appeal had considered that reference to the *Charterbridge* test was unnecessary because on the facts it was clear that the directors had not considered any other creditors apart from the banks. This was based in large part on the clear prejudice that the non-bank creditors suffered as a result of the workout. However, as Carr AJA points out, a successful workout could have saved the business, which would have benefited all creditors. While the group's financial state might have made this an unlikely result, the

48 Ibid 360 [2029].
49 Ibid.
50 Ibid 351 [1988].
51 Ibid 539 [2797].
52 Ibid.
53 Ibid [2797].
54 Ibid 544 [2819].
55 Ibid 546 [2841].
56 *Charterbridge Corp Ltd v Lloyds Bank Ltd* [1970] Ch 62, 74.
57 *Bell* (2012) 270 FLR 1, 559 [2902].

decision about whether to undertake risky business decisions is one that is, in the authors' view, quite rightly left to the directors' managerial prerogative. Transactions that involve unreasonable risks can be addressed through insolvency law, namely voidable transactions and insolvent trading laws.

Significantly, Drummond AJA held that Owen J had misconstrued the seminal cases on directors' duties to creditors,[58] with his Honour going so far as to suggest that the directors' duties included a duty to protect creditor interests, as opposed to giving consideration to creditors' interests.[59] This goes even further than Lee AJA's judgment, which stated that entering into decisions that prejudiced creditors during times of insolvency would result in no rational belief that the conduct was in the interests of the company.

IV Critique

A receptive judicial ear by the High Court, and endorsement of the logic underpinning the approach of the majority judgment in *Bell* on the critical question of directors' duties to creditors, would impose considerable limitations on the ability of companies in financial distress to reorganise their affairs.

It is a legitimate concern that such a ruling would set inappropriate incentives for directors and senior executives, by threatening them (and their associates through *Barnes v Addy* liability) with breaches of fiduciary duty for acting to try to restructure the business. The mere fact that a corporate rescue may seem unlikely to succeed because of the company's insolvent state should not of itself prevent the senior management board from trying to save the business and preserve both enterprise value and jobs. Confirmation by the High Court of the majority's view in *Bell* sends the wrong message to directors and executives, that is: if in doubt, close the business for fear of prejudicing creditors. This could push more businesses into formal insolvency proceedings and impair strategies for business rescue, which would be a suboptimal outcome.

In formal insolvency proceedings it is often harder to trade on businesses while attempting a reorganisation. Formal insolvency proceedings often feature public sales of assets that are perceived by the market as being distressed sales, which generate lower returns than an orderly program of asset sales during an informal (and confidential) workout.[60] At a time when corporate insolvencies are increasing, this would be a highly unfortunate development in the law. There are strong policy reasons to return to the balancing exercise implemented by Owen J rather than the creditor primacy approach of the majority in the *Bell* appeal.

There are also strong jurisprudential arguments to support overturning the majority decision in the *Bell* appeal. It is respectfully submitted that the approach of Drummond AJA in *Bell* on the nature of directors' duties to creditors adds yet

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58 *Walker v Wimborne* (1976) 137 CLR 1; *Spies* (2000) 201 CLR 603.

59 *Bell* (2012) 270 FLR 1, 544 [2819].

60 For a discussion of directors' duties during workouts see Rebecca Maslen-Stannage, 'Directors' Duties to Creditors: *Walker v Wimborne* revisited' (2013) 31 *Company and Securities Law Journal* 76.

another layer of gloss[61] to the classical dicta in *Walker v Wimborne*[62] and should not be adopted by the High Court. This conclusion is aided by the instructive judicial remarks made by the High Court in *Spies*[63] on the nature of directors' duties to creditors, discussed below.

It is appropriate, at the outset, to repeat the influential and oft-quoted dictum of Mason J in *Walker v Wimborne* before analysing its conventional meaning:

> it should be emphasised that the directors of a company in discharging their duty to the company must be taken into account the interests of its shareholders and its 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.[64]

Walker v Wimborne cautions that directors must remember that creditors may also be affected by a particular management decision. The case indicates that when a company is in financial difficulty, directors must ensure that they balance the interests of various affected persons. The High Court majority in *Spies* endorsed the dicta in *Walker v Wimborne* and recognised that insolvency alters the relative weight that directors should give to shareholder interests as opposed to creditor interests, while rejecting the idea of directors' independent fiduciary to creditors. In offering insight on the meaning of the dictum in *Walker v Wimborne*, the majority judgment in *Spies*[65] supported the quote of Professor Sealy who offered the following rationale for the dicta of Mason J:

> [these] were words of censure directed at conduct which … comes within some well-established rule of law, such as the law imposing liability for misfeasance, the expropriation of corporate assets or fraudulent preference.[66]

Against this legal framework and judicial understanding, the approach adopted by Drummond AJA in *Bell* towards the issue of directors' duties to creditors warrants attention. In particular, the following sweeping statement by Drummond AJA in *Bell* invites further scrutiny:

> Directors, in discharging their fiduciary duties to their company must, if the company is sufficiently financially distressed, have regard *and give proper effect to the interests of creditors* ... courts will now intervene in an appropriate case, irrespective of the directors' beliefs and business judgments, to ensure that creditors are properly protected.[67]

The thrust of this judicial statement is problematic for two main reasons. First, it represents a radical departure from orthodox authorities.[68] Drummond AJA's approach unreasonably shifts the directors' duty to creditors away from its

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[61] See Len Sealy 'Directors Duties — An Unnecessary Gloss' (1988) 47 *Cambridge Law Journal* 175.
[62] (1976) 137 CLR 1.
[63] (2000) 201 CLR 603. For detailed analysis, see Hargovan, above n 4.
[64] (1976) 137 CLR 1, 7.
[65] (2000) 201 CLR 603, 636.
[66] Sealy, above n 61.
[67] *Bell* (2012) 270 FLR 1, 361 [2031] (emphasis added).
[68] *Walker v Wimborne* (1976) 137 CLR 1; *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722; *Spies* (2000) 201 CLR 603.

traditional focus of consideration (a balancing exercise), to become a positive duty to protect their interests when a company is in financial distress. In the authors' view, the balancing approach taken by the trial judge, and also adopted by Carr AJA in dissent, is preferable because it recognises the practical difficulties that directors face during times of financial distress. As noted above, if the workout had resulted in the Bell group being able to enter into a long term refinancing arrangement, all stakeholders would have been better off. Indeed, the introduction of voluntary administration into pt 5.3A of the *Corporations Act 2001* (Cth), just two years after the Bell group's collapse, was premised on the statutory recognition of the value of encouraging companies to avoid liquidation by pursuing restructuring options. A law that holds directors and their associates liable for pursuing restructuring options in good faith will lead to many more liquidations with potentially harmful effects for the broader economy.

Second, the approach undertaken by Drummond AJA seems to elevate the duty to a direct one to creditors, or at a minimum makes them the sole stakeholder group, rather than including their interests as merely one of a number that must be considered by corporate managers. The obligation to have regard to creditors' interests, as espoused in *Walker v Wimbourne*, arises as part of the process of acting in the best interests of the company. The ultimate goal of the duty is to benefit the company, and through it the creditors.[69] The interests of the company, in the context of impending insolvency and corporate rescue attempts, should not be subordinated to the interests of sharing pari passu between unsecured creditors.

The pari passu rule is one that is aimed at distributional equity where claims are of the same rank. The goal of creditor protection during times of financial distress is adequately addressed by existing statutory rules. It is not illegal to obtain security by contract, although in some cases the *Corporations Act 2001* (Cth) (and the *Bankruptcy Act 1966* (Cth) which applied at the time of the Bell facts) may allow transactions that were not illegal when made to be set aside by the court because they occurred too close to the date of liquidation.[70] It is submitted that these statutory rules provide an appropriate balance between creditor protection and commercial decision-making.[71] In addition, creditors are given a measure of protection through the insolvent trading provision, which allows a liquidator, ASIC or a creditor to take action against directors who allowed the company to continue incurring debts at a time when it was insolvent and there were reasonable grounds to suspect insolvency.[72] It is clear that the insolvent trading provision imposes a threat of financial penalty, or even criminal sanctions,[73] against directors and these are important factors in their decision-making processes during reorganisation attempts. The expansion of the liability regime for directors and officers during

[69] *Geneva Finance Ltd v Resource & Industry Ltd* (2002) 20 ACLC 1427, 1438.

[70] *Corporations Act 2001* (Cth) pt 5.7B div 2.

[71] See, eg, the carve outs to void security interests in *Corporations Act 2001* (Cth) s 588FJ(s).

[72] *Corporations Act 2001* (Cth) pt 5.7B divs 3, 4. Empirical evidence (based on 103 insolvent trading cases from 1961 to 2004) showed that the majority of cases are brought by creditors (60 per cent) and that in 75 per cent of cases the defendant was found liable. See further, Paul James, Ian Ramsay and Polat Siva, 'Insolvent Trading — An Empirical Study' (2004) 12 *Insolvency Law Journal* 210.

[73] The prospect of criminal penalties is not an empty threat. Empirical evidence showed 15 per cent of insolvent trading cases involved criminal proceedings. See James, Ramsay and Siva, above n 72.

financial distress by the majority in the Bell appeal is unnecessary and inappropriate from both a policy and doctrinal standpoint.

If the approach undertaken by the majority in Bell is confirmed by the High Court of Australia, it will have the effect of reformulating directors' duties to creditors in a manner that will have a chilling effect on corporate rescue initiatives by directors. The new elevated duty would not only include an obligation to safeguard creditor interests generally, but an obligation to see that creditors of the same degree were treated equally. It will be exceedingly difficult to comply with such a duty. While trading on the business may involve prejudice to creditors, as it uses up scarce resources, shutting the business down prematurely for fear of potential prejudice may itself cause greater harm to creditors due to the lower returns in formal insolvency compared with informal workouts.

The majority judgments in Bell may also be criticised for departing from long-standing judicial practice of non-interference with directors' business decisions.[74] The non-interventionist tradition of second-guessing directors' commercial decisions acknowledges the limitations of judicial capacity[75] and the general undesirability of judging commercial decisions via a rear-view mirror. Such an approach is viewed as a 'hallmark' feature of commercial law,[76] and is unsurprisingly adopted across many jurisdictions.[77] Hindsight, of course, is a 'wonderful thing' as recognised by the court.[78]

Clearly, director decision-making, in the context of impending insolvency, aimed at corporate rescue, will not always be perfect or successful. Outside of situations concerning self-dealing and/or shirking, the court ought not to substitute its opinion for that of the board even though later events may cast doubt on the board's determination. As long as the directors have selected one of several rational alternatives, the judicial view that deference should be accorded to the board's decision is both defensible and appropriate.[79]

The approach taken by both the trial judge and Carr AJA in dissent allows directors to make business decisions in an attempt to rescue the company from

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74 See authorities cited above n 7.

75 Paul Redmond, 'Directors' Duties and Corporate Social Responsiveness' (2012) 35 *University of New South Wales Law Journal* 317, 325.

76 For a similar approach in the US, see David Rosenberg, 'Supplying the Adverb; The Future of Corporate Risk-Taking and the Business Judgment Rule' (2009) 6 *Berkeley Business Law Journal* 217.

77 For instance in Canada, see *Kerr* v *Danier Leather Inc* [2007] 3 SCR 331; [2007] SCC 44. In the UK, see *Re Welfab Engineers Ltd* [1990] BCC 60; *Facia Footwear v Hinchcliffe* [1998] 1 BCLC 218. In Ireland, see *Heffernan v Murphy* [2013] IEHC 113. In Singapore, *see Falmac Ltd v Cheng Ji Lai Charlie* [2013] SGHC 113.

78 *Linton v Telnet* (1999) 17 ACLC 619, 628.

79 *Maple Leaf Foods Inc v Schneider Corp* (1998), 42 O.R. (3d) 177 (C.A.). Norman Veasey, former Chief Justice of Delaware, remarked that: 'no responsible judicial doctrine or scholarly writing has suggested that the courts should supervise business decisions, second-guess directors, or substitute their own judgment for that of the board in the conduct of the corporation's operations': Norman Veasey, 'Further Reflections on Court Review of Judgments of Directors: Is the Judicial Process Under Control' (1985) 40 *The Business Lawyer* 1373, 1374. For a similar observation two decades later, see Norman Veasey and Christine Di Guglielmo 'What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments' (2005) 153 *University of Pennsylvania Law Review* 1399.

liquidation. This at least offers the chance for the company to be saved and its value to be maximised, or at least preserved. Ultimately, it should be for the directors, not the courts, to assess prospects of corporate rescue unless the decision of business management is tainted by self-interest or is clearly made in bad faith. Such a position has long applied to decisions made by directors prior to insolvency.[80] In the authors' view, the position of the minority judge on appeal is preferable from both a policy and a doctrinal perspective. Carr AJA's judgment in the *Bell* appeal, and the balancing exercise undertaken by Owen J at first instance gives directors and officers flexibility to act in a commercially realistic manner that gives the company a chance to be saved. Placing greater liability on the directors, particularly by expanding the inherently uncertain duty to consider/protect creditors, puts directors and officers in a commercially uncertain position that will lead the risk averse to shut down the company prematurely based on such liability concerns.

V Conclusion

The time is ripe, particularly in light of the global financial crisis, for the High Court to resolve the legal 'conundrum'[81] which has plagued this area of law for over three decades since the classic, simple but imprecise, dictum of Mason J in *Walker v Wimborne*.

In revisiting the controversial issue of directors' duties' to creditors, it is hoped that the High Court, in the closely watched *Bell* appeal, clearly delineates the ambit and scope of this duty which is shrouded in ambiguity. This is important, given the myriad of 'ill-defined'[82] judicial formulations as to when exactly is the duty triggered.[83] It has been judicially recognised that the phrase, in the vicinity of insolvency, is 'incapable of definition and has no legal meaning.'[84] There is dire need for an authoritative view by the High Court which adds substantive content to this duty, which is currently an unworkable challenge for directors and their professional advisors.

As part of that task, High Court guidance in the *Bell* appeal is warranted in deciding how the balance is to be struck between competing stakeholder interests in a financially distressed company. The idea that directors, at general law, owe direct duties to individual creditors must be put to rest.

It is recognised that there is no single blueprint, in the context of corporate distress, which a board must follow to fulfil its fiduciary duties to the company.[85]

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80 *Re Smith and Fawcett Ltd* [1942] Ch 304; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

81 See Robert Baxt, "Just to Whom do Directors Owe their Duties? Will This Conundrum Ever be Satisfactorily Resolved?' (2002) 30 *Australian Business Law Review* 455; 'The Conundrum Thrown Up by the Bell Group Decision in the Western Australian Court of Appeal: To Whom Do Directors Owe their Duties?'(2012) 30 *Company and Securities Law Journal* 534.

82 *Berg & Berg Enterprises, LLC v Boyle*, 178 Cal.App. 4th 1020 (2009), 1037.

83 See Andrew Keay, 'The Director's Duty to Take into Account the Interests of Creditors: When is it Triggered?' (2001) 25 *Melbourne University Law Review* 315.

84 *Peoples Department Stores Inc (Trustee of) v Wise* [2004] 3 SCR 461, 505–6.

85 *Barkon v Amsted Indus* 567A2d, 1279, 1286 (Del. 1989).

That, however, does not mean judicial avoidance of the issue. Clear guidance or rules , to enable directors and their advisers to act with a greater degree of certainty and predictability when attempting corporate rescue in a situation of impending insolvency, are urgently needed to address the gap in the current law.[86] Failure to provide such guidance will only exacerbate the defining tension in Australian corporate law.

[86] For a wider discussion on the gaps in Australia law on directors' duties and resultant poor guidance which deny directors the clarity of protection required, see Redmond, above n 75.