Director’s duty to prevent insolvent trading

Student’s Name

Institution

Course Code

Date

**Introduction**

The Corporation Laws have changed in Australia over the last decade. Several amendments have been included for the protection of corporations against insolvent and shareholders from incurring losses. The Corporation Act has imposed positive duties on individuals and therefore, the Act has provided the directors with the responsibility to prevent insolvent of a corporation. Insolvent is a state where a corporation is unable to pay its liabilities and therefore, it cannot operate efficiently. Most companies get to the position of insolvent due to mismanaging or lack of effective strategy to make a niche from the market. According to Pitman (2018, p. 13), the director of a corporation is liable to the action taken by the company, which leads to its current status of the insolvent. And therefore, if a director walks out when an attempt is being made to rescue the company, the director would take personal liability, which might lead to criminal and civil fines. This paper, therefore, analyses whether the duty to prevent insolvent trading a fiduciary duty. It illustrates How does the safe harbor defense s588GA operate, and illustrates who does it (s588GA) protect, and is this different from the business judgment rule s180. The paper also illustrates whether there are any restrictions on the operation of the s588GA defence and establishes why changes to Division 3 will have an effect on the number of voluntary insolvencies in Australia in the future.

**Is the duty to prevent insolvent trading a fiduciary duty?**

 The directors are solely responsible for the management of corporations to profitability. However, under the Corporations Act 2001, the directors are delegated or entrusted with the responsibilities to ensure that a company trade without incurring any debt. Any debt incurred by a company the director become solely responsible for those debts. Therefore, the duty to prevent insolvent trading is a fiduciary duty. According to Pitman (2016), the directors are direct reports to the shareholders and therefore, it means that the shareholder's trust directors with the responsibilities to ensure that a company is managed profitably. Under sections 180-185 of the Act, the directors have the responsibilities to oversee the whole management of a company. Directors are also the sole advisers of the shareholders and therefore, he or she is required to make an appropriate decision on behalf of the company (James, Clayton, & Ramsay, 2014). Those decisions should be based on the interest of the shareholders and the customers to ensure that corporations do not incur losses and even debts which they cannot repay. Under section 180-185 of the Company Act, the directors have duties to act with diligence and care and in good faith. It is also illustrated that directors should not use their positions in the company for their own selfish gain, which can cause detriment to the company (James, Clayton, & Ramsay, 2014). The act gives a lot of responsibilities to the directors which are only given to an individual who is trusted by the shareholders and therefore, the duty of the director to prevent the company from insolvent is the fiduciary duty.

**How does the safe harbor defense s588GA operate?**

A safe harbor defense is a new act, introduced with clear intention to protect directors of companies from being direct personally liable from insolvent trading. It came into effect to provide a safe harbor for dieters and also allow the company to come up with a workable solution to the problem of the insolvent. The Act came into effect in 2017, to promote more positive business culture in the society and provide directors with opportunities to look into different ways of turning around a company into a fortune. The 588GA Act stipulates that directors are provided with a safe "harbor" from the insolvent trading accusation when a specific company is declared insolvent. The Act, therefore, protects the integrity of the directors and excuse directors of corporations from taking personal liability against the insolvent of a company. Winter (2017) pointed out that the act relies on the decision whether the said directors received specific advice from qualify experts and what actions are taken to prevent the situation. It is, therefore, means that directors cannot be solely be blamed for insolvent trading. Under section 588GA (b), the directors are given the mandate to consult experts in the relevant field in order to help prevent the company from being declared insolvent. However, in order to protect both the corporation and the directors, the Act prevents the appointed person from having a prior discussion with the appointed person before appointed. It is to ensure that the appointed directors are protected from liability. Therefore, the act was enacted to protect directors of corporation trading in insolvent from direct blames on the condition of the company. The safe harbor under section 588GA (2) protects the director against the debts incurred by a company. It also meant to ensure that the directors remain in charge of the management of a company during the insolvent trading until the problem is properly addressed.

**Who does it (s588GA) protect, and is this different from the business judgment rule s180 (2)?**

The act 588GA is meant to protect the directors from personal liability from a company trading in insolvent. Under section, 588GA directors are protected and therefore, they cannot be a liability for the decision they made in good faith. As stated by Tomasic, Bottomley, & McQueen, (2017), the act was drafted to ensure that directors are not wrongly accused and become culprits when a business fails to gain profit hence become insolvent. However, the judge rule does not make expose directors but it ensures that directors become responsible when conducting their duties as head of corporations. However, under rule s180 (2), directors have a safe harbor in regard to civil liability, which can arise from breaches of their duties of care of diligence as established in s 180 (1) (Tomasic, Bottomley, & McQueen, 2017). The fact that section 588GA protects directors from direct personal liability, it does not mean that directors are excused from personal responsibilities to protect the corporation from insolvent. The fundamental of judgment was to protect the authority of directors when exercising the duties but not insulate them from liabilities. Though directors are expected to show and practice a high level of accountability when exercising their duties, it is not appropriate to hold them liable for the decisions, which directors made in good faith. But in the case of recklessness and intended decision to cause loses are made knowing against the advice of experts then, directors are liable and take personal liability under section 588GA (1).

**Restrictions on the operation of the s588GA defense**

There several restrictions on the operation of s588GA defense. These restrictions are a safe harbor period. The directors or administrators are expected to provide liquidator with required detailed information, which can lead to the open analysis of the performance of a corporation. The directors are abided by under the law to ensure that information needed for liquidation is made available. The restrictions are drafted to ensure that directors do not keep the books of accounts from inspection in case of liquidation. It is also noted that the restrictions are made to ensure that the information especially financial information, which was not made available are prepared and submitted to the liquidator for inspection. It is, therefore, evident that the restriction was made to ensure that section 588GA operate efficiently and avoid a situation where a director can decline to provide critical information to liquidators. The restrictions also state that the directors would not be able to depend on the safe harbor in a situation where the company is unable to meet its obligations when it comes to financial reporting.

**Changes to Division 3 will have an effect on the number of voluntary insolvencies in Australia in the future**

Division 3 illustrates that directors have responsibilities to address the insolvent trading. The change made by the treasurer will have an advance effect on the voluntary insolvencies in Australia. The changes under Treasury Laws Amendment (2017 Enterprise Incentives No.2) Bill 201, provide a safe harbor for directors from facing any civil liability for insolvent trading of the company if the said company is restructuring outside the formal insolvency. This, therefore, is likely to affect the voluntary insolvent of companies. It is because the directors are in charge of the company even during the insolvent period and therefore, voluntary insolvent cannot address the problems and help the company realizes better outcome (Michael, 2017). The fact that directors have safe harbor makes them not liable for actions done in good faith and therefore, voluntary insolvent cannot help the company in addressing the problems until it comes out of the insolvent trading.

**Did Mr. Daly breach any directors' duties? If so, which ones and how?**

Mr. Daly breached the duties of directors has provided under section 588GA. The Company Act requires directors to be honest, diligent and act with care when dealing with the management of the company (AustLII, 2019). Mr. Daly violated ASIC Regulatory Guide 217, which stated that directors have the responsibilities to prevent the company from experiencing difficulty in cash flow. The analysis established that Mr. Daly took cash to settle his divorce without permission and therefore, it is a violation of the responsibilities of directors. The Corporate Act requires that directors should make all decisions regarding the affairs of the company in good faith. But Mr. Daly did not follow the regulation and the decision as stipulated under the law. The company Act 588G requires that the directors should act in honest and provide information when needed. The firm was not telling the regulators the truth about the challenges it was facing regarding the cash flow. The director is required by the law to be honest to regulators, shareholders, and customers but Daly failed to comply with the Company Acts and therefore, he is not protected under the safe harbor.

**Did any of the other directors breach their duties?**

The director of the Investment fund also breached the directors’ duties. It is stated that the director borrowed client’s money to cover his financial problems. The director borrowed money without the client's consent and therefore, it can be viewed as stealing. It also reported that the director approves a loan for cover for his fellow director's divorce. Some directors also lied to the regulators regarding the investment associated with many companies. The fact that these directors lied violated the corporate activities, which requires directors to act in good faith and practice honesty throughout their terms as directors. The Act also requires directors to be always aware of the financial position of the company (Federal Register of Legislation, 2019). In this case, the law requires directors to act within the law when dealing with the company. It is the responsibilities of the directors to protect the finances of the company. But based on the report, the directors failed to protect the finances of the companies rather misuse their position in the company to enrich themselves.

**Do you think the company was trading while insolvent?**

It is likely that the company was trading when in insolvent. The investigation established that the company was being monitored by regulators. This could mean that it was being monitored because it was facing insolvent and therefore, it was put on the radar to finding out the outcome of the insolvent. It is also noted that the director borrows cash to cover the cash flow problem. This could mean that the company was having serious financial problem, which the director never wanted the shareholders, board and the regulators to know and therefore, it decided to cover it up. This was a mistake and creates mistrust between the shareholders, and the director. It is required of the directors to be honest and inform the shareholders of any difficulty, which the company might be facing. But the director decided to cover up by borrowing money to ensure that the cash flow is stable, which was merely for a shorter period.

If Company was trading while insolvent – are there any defenses available to Mr. Daly

If the company was operating under insolvent there would be no defense available for Mr. Daly. First, Mr. Daly did not inform the board and the shareholders about the challenges even though he was aware. This already has violated the company Act section 588G, which requires directors to act in good faith and for the interest of the company

**New safe harbor' defense assists the directors**

The new safe defense protects directors against taking the liability of the decision made in good faith without any biases. Again, the company was not operating insolvent and therefore, if he is not protected by the safe harbor. The safe harbor was derived to protect directors but to prevent them from honestly carrying out their duties. First, the directors of the company including Mr. Daly acted knowingly to misappropriate the finances of the company. This is not protected under section 588GA and therefore, the directors would be personally liable for the losses the company incurred during the period (Murphy, 2017). Even if the company was operating insolvent Mr. Daly and other directors would have not been able to get protection under section 588GA of the Company Act 2001. The Company Act is very strict when it comes to the violation of trust and based on the analysis the directors of the company violated all the regulations and laws which stipulate how a company should be managed. The safe harbor only protects directors who serve with purpose and diligence and care but out of control, the company went to insolvent. But in the case of Mr. Daly and his fellow directors, the decision made was wrong and clearly shows misuse of a company’s funds. The behavior of the directors was also very inappropriate since Mr. Daly gave one of the directors’ soft loans from the client funds.

In conclusion, the Corporate Act 2001 is an important law, which streamlined the operations of most corporations in Australia. It ensured that directors and any other person involved in the management of an organization become reliable and accountable to avoid causes losses to the shareholders. This has been a key factor for the successful operations of most companies in Australia in the United States.

# References

AustLII. (2019). CORPORATIONS ACT 2001 - SECT 588GA. *Commonwealth Consolidated Acts*, 2-15.

Federal Register of Legislation. (2019). Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights) Rules 2018. *https://www.legislation.gov.au/Details/F2018L01669/Explanatory%20Statement/Text*, 2-34.

James, P., Clayton, U., & Ramsay, I. (2014). INSOLVENT TRADING – AN EMPIRICAL STUDY. *Centre for Corporate Law and Securities Regulation*, 2-18.

Michael, S. (2017). A safe space for directors: the ‘safe harbor' defense to insolvent trading. 2-15.

Murphy, J. (2017). Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Bill 2017. *Law and Bills Digest Section*, 2-15.

Pitman, B. (2016). Director’s duty to prevent insolvent trading. *http://mba-lawyers.com.au/articles/directors-duty-prevent-insolvent-trading/*, 2-15.

Tomasic, R., Bottomley, S., & McQueen, R. (2017). *Corporations Law in Australia.* Sydney: Federation Press.

Winter, J. (2017). Providing Safe Harbour Advice - Issues for Insolvency Practitioners to Consider. 2-34.