RESTRUCTURING IN THE *Twilight Zone:* DIRECTORS' DUTIES IN AUSTRALIA

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Australian governance imposes three sources of duties on directors—the Corporations Act, other statutory and common law, and equitable duties based. Anglo-Australasian jurisprudence and statutes have developed a series of good faith, skill, and diligence duties that directors must satisfy in making decisions. Additionally, directors must not engage in self-profit or conflict decisions without disclosure and, as appropriate, without obtaining shareholder approvals, when these can be given. Those duties, although deriving mostly from common law, are sometimes coextensively fiduciary in nature.

The characterization of a duty as fiduciary or not can be important and may impact the value and range of claims that can be maintained against directors. For example, the measure, causation, and remoteness of damages are each worse for directors facing fiduciary-based claims. Likewise, stricter approaches can be applicable for fiduciary breach cases, especially when misfeasance is involved in the dissipation of company assets.

Additionally, fiduciary directors can be exposed to proprietary remedies and barred from setting up certain defenses (such as contributory negligence to a more orthodox duties-based claim or time limitations). Also, importantly, fiduciary breaches may not be covered by director and officer insurance policies, which is often a matter of concern to directors.

In Australia, the traditional view is that these duties are owed to shareholders. But in more recent times, this has evolved to a better approach that these duties are owed to a company's stakeholders at large—including shareholders, creditors, employees, customers, and the community in which the company operates.

This article presents the proposition that during a restructuring or turnaround event, the “safe harbor” legislation in Australia allows directors a method for properly working out distressed situations without exposing themselves to the prosecution of breach-of-duties claims.

The “better outcomes” test provides a useful proxy for proper discharge of good faith and due performance

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DISTRESSED CONDITIONS
Directors
lenders
SUPPLIERS
SAFE HARBOR PROTECTION
CREDITORS
INVENTORS
Turnaround Enterprises
SHAREHOLDERS

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decision-making. Specific statutory responsibilities must continue to be met. Likewise, directors should ensure they continue to meet no-profit, no-conflict, and proper disclosure requirements.

Directors Duties in Failing or Turnaround Enterprises

Directors owe duties not to incur debts or engage in property dispositions or in uncommercial transactions when a company is insolvent. Failing to do so can expose directors to personal liability. These specific duties run corollary to the corporation's law good faith, skill, and diligence, and other duties mentioned above.

In considering the nature of duties in distressed conditions, modern Australian law owes much to a proposition advanced by Justice Anthony Frank Mason (later Chief Justice of the High Court of Australia) in *Walker v Wimborne:*

> ... [T]he directors of a company in discharging their duty to the company must take into account 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.

A later High Court made quite clear that the duty is one to the company or enterprise and not to the creditors themselves, adopting this statement from an earlier case:

> ... [T]he 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 seen as having a direct interest in the company and that interest cannot be overridden by shareholders. ... This restriction does not, in the absence of any conferral of such right by statute, confer upon creditors any general rights 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.

As liquidity or financial pressures arise, directors should be careful making decisions affecting the viability of an enterprise to keep trading, especially since shareholders cannot ratify director duties-based breaches of ailing companies. This is explained in the 1986 *Kinsela v Russell Kinsela Pty Ltd* case:

> ...where a company is insolvent the interests of creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of shareholders and directors to deal with the company's assets.

No specific duty owes to creditors, merely that the interests of the company as a whole and the impact of decisions on those with an economic interest in the assets should be considered. In *The Bell Group Ltd v Westpac Banking Corporation,* Justice William Owen remarked:

> ...[I]t would be going too far to state, as a general and all-embracing principle, that when a company is in straightened financial circumstances, the directors must act in the interests of creditors, or they must treat 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.

The "consider creditors" concept has found recent favor in the United Kingdom in *BTI 2014 v Sequana SA*. It is more aptly put as a "consider stakeholders" test. Again, back to *Bell*:

> [*Walker v Wimborne*] ... did not say that the interest 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.

So when it comes to the "interests of the company," whose interests are those, exactly? Shareholders, employees, and creditors are not always a single community.

Shareholders may have a combination of desired outcomes—some may seek dividend distributions while others have longer-term wealth accumulation objectives. Some are invested because the enterprise has ESG-focused strategies or support directors they follow for one reason or another. Other shareholders may be long-term employees, suppliers, inventors, or part of the community in which the enterprise operates.

Sophisticated shareholders may be short sellers or have interests across the capital structure and may have other ambitions for their investment (especially when the investor has protective counter-

value investments across a portfolio or across different derivatives).

Across creditors, suppliers and trades will presumably wish to be paid and to see the enterprise continue as a going concern. Their interests may differ from mezzanine or convertible creditors, or those holding title reservation rights or having the benefit of liens or specific securities over fulcrum assets. Some of these may wish to follow debt/equity swap strategies, while others prefer enterprise break-up options.

Even within syndicated senior lenders, the willingness of some lenders to support a restructuring plan in order to protect coupon payments (even if paid-in-kind for a time) may differ from the desire of other creditors to protect assets and remove management from control of those assets during financial or covenant breach periods. Other lenders may resist investment buckets, working capital facility drawdowns (either because of impacts on waterfall priorities or because of fee erosion or, sometimes even because working capital view facility drawdown as a "carry" of other lenders), or equity cures from sponsors.

The point here is to illustrate that directors cannot be expected to make decisions based on an assessment of individual needs of investors, creditors, employees, and the surrounding community.

How then to reconcile these positions when the company is struggling to survive? What objective standard can be applied?

Enter Safe Harbor Reform

The Sequana case concerned an attempt by creditors of a filed company to clawback a large dividend payment made by the company nine years before it became insolvent. Their lordships accepted the proposition that when considering the interests of a company as to whether to pay the dividend, the board of directors should consider the nature of the company's remaining assets and its solvency state both pre- and post-payment of the dividend.

Lord Patrick Hodge went on to say:

> A reasonable decision by directors to attempt to rescue a company's business in the interests of both its members and its creditors would not in my view involve a breach of the common law duty.

Which brings us back to the "consider interests" matters set out above.

Australian law took a turn in 2017 when the Commonwealth Parliament legislated safe harbor protection for directors attempting to rescue distressed entities. The defense to an insolvent trading action applies if the directors begin a course of action from the time they suspect the company is or may become insolvent. That course of action must be designed to lead to a better outcome than might be expected in a liquidation process.

A board activating safe harbor protection would typically:

- Engage turnaround advisors.
- Prepare 13-week cashflow forecasts and three-way financial models to assess liquidity and crisis points.
- Consider the ability of the company to flex contractual or financial rights to improve liquidity; capital raising options; workout and balance sheet options to deleverage; or simplify capital structures, operations, or strategy and/or improve liquidity.
- Analyze unprofitable business lines for closure or sale and valuable assets capable of being sold to reduce leverage.
- Identify opportunities to seek sponsor cushions; undertake asset disposals; seek covenant relief; and propose debt for equity deleverage, capitalization of interest, capital raising, or one of the many other forms of transactional support still open to the distressed entity.
- Improve cash utilization or security enhancement.
- Provide for trade-ons with reset contractual terms.
- Reset strategies around workforce, product, logistic, supply chains, and relationships with stakeholders.

The "consider interests" approach requires a balancing of interests.

Cash utilization or security enhancement given to facilitate a plan may well be to the disadvantage of senior lenders (especially working capital lenders) and employees—cash dissipation, if the plan fails, would disadvantage those parties. A plan involving a trade-on may benefit suppliers and parties benefiting from an ongoing trading enterprise, over mezzanine lenders—the latter seeing equity margins in the balance sheet reduce as cash reduces, new leases or obligations are taken on, or security is given over previously unencumbered assets.

Here, so long as gateway prerequisites are met, directors undertaking a turnaround plan to achieve better outcomes than might be present in an insolvent situation, and assuming negative duties are not breached, are appropriately discharging good faith and skill and diligence duties.

Other Legislative Imposts

Australian Competition & Consumer Laws and Corporations Act. Directors have active responsibilities to ensure the enterprise, and those within, do not mislead or deceive parties, especially if such conduct (including silence) is made in trade or commerce.

Tax. Directors must ensure the enterprise meets "Pay As You Go" withholding and superannuation guarantee charge obligations (essentially to ensure tax deducted from pay and superannuation rights of employees are separately accounted for by the enterprise).

Each commonwealth and each state can impose personal obligations on directors to pay unmet tax obligations out of its own funds. That penalty risk and the safe harbor requirement to maintain current employee entitlements tend to be powerful tools in ensuring enterprises do not utilize employee entitlements to self-fund failing operational needs.

Workplace/Safety. The Workplace Health and Safety Act of 2011 requires directors and officers (usually those in management or other decision makers) to ensure the enterprise exercises due diligence to satisfy workplace and safety standards. Each Australian state and territory has its own safety legislation that was designed to mirror the "model" Commonwealth legislation but, while some differences remain in all states and territories, directors can be personally liable for breaches that constitute offenses.

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Although a very technical area requiring the assistance of legal and other specialists, workplace health and safety legislation is focused on monitoring and eliminating, as much as possible, physical and mental hazards, incidents, and risks from businesses.

Both the enterprise and directors/officers can be exposed to high penalties and compensation risk to those affected by poor safety or workplace practices. Most applicable legislation prohibits insurance from covering fines and penalties that can be awarded against directors personally for failures to comply with workplace health and safety legislation, which can include imprisonment for industrial manslaughter in some Australian states and territories.

Further, the range of wage theft situations in Australia has recently bloomed as enterprises deal with confusing, overlapping, and complex industrial instruments. Although many of these situations involve inadvertent underpays to employees, directors who "knowingly contravene" obligations can also be personally liable for penal and, possibly, compensatory claims.

Australia also has some strict anti-discrimination, anti-bullying, and, ebbing and flowing with changes in government, anti-hate speech laws—each of which can give rise to director risk.

Environmental. Federal, state, and local authorities jointly administer environmental regulation. Several compliance obligations sit on enterprises. Those obligations can be extended out to directors as personal obligations if reasonable precaution has not been taken to prevent a polluting or environmental threat event.

Anti-Bribery & Corruption (ABC). As with many of Australia's largest strategic partners, including the United States, ABC legislation imposes personal obligations on directors to prevent corrupt practices and to take steps to stop bribery risk inside the enterprise. (Directors can assume liability if they fail to connect the dots on a practice).

Directors & Indemnity Restrictions. The ubiquitous director and officer policy has seen more exclusions put in than coverage extended over recent years. Some indemnities are restricted by statutory construct and others by contractual exclusions (especially around insolvent trading and asset clawback transactions).

Directors are encouraged to check policy coverage and exclusions with the company broker to determine if a situation of the type mentioned above is covered, can be the subject of an extension policy, or open to another form of protection.

Pulling It All Together

The decision by directors of distressed entities to access safe harbor protections, to meet gateway requirements, and to seek a better outcome with the support of turnaround professionals is a useful objective test to consider when assessing the skill and diligence expectations on directors in distressed situations.

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