Directors’ duties

MAKING DECISIONS DURING COVID-19 – AUSTRALIA
Directors need to carefully consider how to address the risks of the COVID-19 outbreak in relation to their company, given its unexpected impact on the global economy. As many companies now face significant, and increasing, cash flow pressure, directors should carefully consider their actions in the context of the legal framework (please see Key Legal Considerations on the following page).

For example, current public policy seems designed to inject liquidity into the economy, but directors should carefully consider the implications of taking on additional credit (and deferring settlement of existing liabilities). They should assess whether adding additional burden to the balance sheet will ultimately benefit the company:

- Do they have a realistic expectation that the business can recover once the crisis is over?
- Failing that, does their strategy ultimately minimise loss to creditors?

This is often a difficult decision to make, but is likely to be particularly challenging during this period given the uncertainty over market conditions.

Directors of Australian companies have statutory and fiduciary duties that require them, among other duties, to exercise their powers and discharge their duties with reasonable care and diligence. What is considered “reasonable” is likely to take into account the prevailing circumstances (among other matters), and in the current extraordinary climate, directors may be afforded more latitude given the uncertainties that their company faces and the fast-moving and wide-scale impact of COVID-19.

However, in Australia directors can face personal liability if they permit their company to trade while it is insolvent, so it is important that directors seek professional advice as soon as there is any concern regarding the solvency of the company.

This recommendation continues to apply despite the existing “safe harbour” provisions under the Corporations Act 2001 (Cth) (Act), which provide directors with a safe harbour from civil insolvent trading provisions where they are developing one or more courses of action that are “reasonably likely” to lead to a better outcome for the company than the immediate appointment, by the company, of an administrator or liquidator, and the passage of the fast-tracked “Coronavirus Economic Response Package Omnibus Bill 2020” as part of the Australian Government’s response to the economic impact of COVID-19. Further information is available [here](#).

While the new legislation provides for a relaxation of the application of the statutory insolvent trading provisions under the Act and effectively provides for a six month moratorium against directors having personal liability for a company carrying on business in the ordinary course while insolvent, it only provides protection from the insolvent trading provisions so does not shield directors comprehensively from personal liability under the Act beyond those provisions. Directors should therefore keep abreast of any further developments in this rapidly changing landscape and seek advice on their duties and potential exposure as a result of COVID-19.

In any case, directors should still carefully consider whether the actions that they are taking are in the best interests of their company.

We strongly recommend that they take practical steps to protect their company and its business as follows:

**GOVERNANCE**

Hold regular board meetings with the benefit of professional and legal advice to consider the company’s current financial position and directors’ duties. Ensure comprehensive minutes are taken, including recording the decisions made and the key information and factors that the directors took into account when making such decisions.

**CONSIDER VIABLE ALTERNATIVES**

Directors should ensure they have considered all available options and carefully analyse their respective merits and cost. This may extend to documenting any alternative options that the board has considered in making those decisions and the reasons why particular options were preferred or discounted.

**LIQUIDITY AND CREDITORS**

- Prepare up-to-date cash flow statements, management accounts and projections, consider availability of existing facilities (e.g. checking events of default which may prevent drawdown).
- Consider alternative means of support (e.g. stakeholders, parent company or group company (if applicable), key customers, government-backed facilities, disposals of assets).
Directors’ Duties

Decision making in a crisis

- Consider whether outflow of cash to creditors can be managed/delayed. In particular speak to landlords, the ATO and key suppliers.
  - Australian Government Real Estate Measures for Commercial Tenancies

OPERATIONS

Analyze the basis on which business can continue to operate. Are staff able to work remotely? Is workforce size sustainable?

CUSTOMERS/SUPPLIERS

Trading partners are to be faced with their own challenges. Take into account the likely size of future orders and robustness of supply chain. Carefully monitor legal and regulatory reforms relating to COVID-19, which may concern solvency and enforcement issues and may be fast-tracked.

SEEK PROFESSIONAL ADVICE

From your lawyers, your accountants and (potentially) from a licensed insolvency practitioner.

PLAN

Assess the willingness of key creditors to grant “breathing space” to companies facing a liquidity squeeze brought on by the current crisis. Directors will be best placed to take advantage of such assistance if they can present a clear plan as to how their company will weather the storm.

Experience demonstrates that a proactive and consensual approach, with early engagement, presents the best prospect of a successful resolution, protecting directors and preserving value for stakeholders. Clearly the current crisis presents enormous challenges, but the legal framework recognises that directors who act with due care and diligence in the best interests of the company will ordinarily be protected from sanction and legal liability.

Key considerations for your decision making process

CUSTOMERS
- Payment terms
- Existing and future order book
- Will they support business?

OPERATIONS
- Employee resource
- Remote working
- Staff absences
- Ability to meet commitments

PROFESSIONAL ADVICE
- Lawyers
- Accountants
- Insolvency practitioner

STAKEHOLDERS
- Secured and unsecured creditors
- Shareholders
- Employees

GOVERNANCE
- Fiduciary duties
- Insolvent trading
- Regular meetings
- Comprehensive minutes
- Parent/subsidiary conflicts of interest

CREDITORS
- Landlords
- Hostile/ransom suppliers
- Creditor stretch
- Ability to pay debts

LIQUIDITY
- Existing facilities
- Events of default
- Government support/grants
- Stakeholder support:
  - Shareholders
  - Lenders
  - Key customers
- Asset disposals
- Parent/group support

SUPPLY CHAIN
- Over reliance
- Complexity
- Financial strength
- Credit insurers

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Key legal considerations

- **General duties of directors:** Directors are subject to general law and statutory duties which will apply to them whether or not the company is, or is likely to become, insolvent. Directors should continue to comply with these duties and seek advice as to how they should do so if insolvency is suspected or possible.

- **Duties during insolvency or potential insolvency:** In the event that the company experiences financial difficulties which could result in insolvency, the directors are required to give greater weight to the interests of the creditors of the company. It is often challenging for directors to determine precisely when they must switch their focus to the interests of creditors, and the weight that must be given to such interests at a particular point in time. This task will be made more difficult given the rapidly evolving nature of the coronavirus COVID-19 crisis, but prudent directors will err on the side of caution.

- **Non-executive directors:** Non-executive directors are subject to the same standards of care as executive directors but the application of the legal tests may differ due to differences in role and function. Also, directors with a greater level of skills or experience will ordinarily be subject to a higher standard of care.

- **What if I've not been formally appointed as a director?** Persons who may have played a role in the company's direction or management could be deemed to be shadow or de facto directors and fall within the statutory definition of “director”. A de facto director is treated as a director as a result of acting in the position of a director despite not being formally appointed to the role. A shadow director is a person in accordance with whose instructions or wishes the board is accustomed to act e.g. someone who is “pulling the strings” behind the scenes. Both involve the exercise of real influence and both are subject to the same duties as formally appointed directors.

- **Group of companies:** Where a business operates via a number of companies, directors should also consider how conflicts may arise between those entities and for themselves if they serve on more than one group company’s board, because directors owe their duties to each separate entity (rather that the group as a whole). If any companies are in overseas jurisdictions, then the directors of those entities will be subject to the laws of that country and should seek advice promptly if unsure of their obligations in that jurisdiction.

**INSOLVENT TRADING**

A director (or directors jointly) can be held personally liable for the debts of the company if they allow it to continue trading whilst it is insolvent or insolvency would objectively have been suspected. Insolvency occurs when a company is unable to pay its debts when they are due. Insolvent trading occurs when a company incurs a debt whilst insolvent or becomes insolvent by incurring the debt. There are a limited number of defences to this form of liability, although the COVID-19 crisis has promoted the urgent legislative reforms discussed above to offer directors additional protection at this time.

**PENALTIES**

Directors who breach their duties can be subject to a range of civil penalties (including disqualification orders and being ordered to pay a pecuniary penalty and/or compensation) and, where the relevant test is satisfied, criminal penalties (including fines and/or imprisonment).

**VOIDABLE TRANSACTIONS**

Directors can face liability if the company pays an “unfair preference” to a creditor or engages in an “uncommercial transaction”, as defined in the Act. Directors can also face liability in relation to “unreasonable director-related transactions” under the Act.

**SHOULD I RESIGN?**

Resignation may not be an effective defence to potential liability. A director should seek advice urgently if they are considering resigning to avoid liability.

**International responses to the COVID-19 crisis**

Our international DLA Piper teams have created a range of helpful resources to assist directors throughout the COVID-19 pandemic. Some of these are included below:

- Coronavirus Resource Center
- Coronavirus: Directors’ duties and making decisions in a crisis
- Issues for directors to consider in light of Coronavirus COVID-19
- Coronavirus: Global overview and supporting business guide
- Coronavirus: Room for manoeuvre for directors of UK companies
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Adding value through experience

- Advising an international freight forwarder on Australian governance and structuring issues and directors' and officers' duties, including amending its constituent documents and assisting with the implementation of officer protection arrangements in light of global insurance cover.

- Advising the Australian subsidiaries of an international service provision group on directors' and officers' duties.

- Advising the foreign parent of an international design and manufacturing group on the restructure of its Australian distribution arrangements and Asia-Pacific operations.

- Advising a listed Australian company on the design and implementation of its director and executive protection arrangements across all group companies.

- Advising a confidential Australian based boutique corporate advisory firm and its directors on various corporate governance and ASX issues in respect of distressed investments.

- Acting for the former executive directors of an ASX-listed global financial services company (Receivers appointed) in relation to investigations by ASIC.

- Acting for the shareholder of a mining project development company in respect of derivative and personal actions brought against directors alleging breach of directors duties, Corporation Act claims, contract claims and injunctive relief.

- Acting for the Executive Director of one of Australia’s largest manufacturers of complementary medicines on issues relating to the unravelling of a company as a result of the most extensive product recall in Australia’s history.

- Undertaking a Board review for a national peak body, including designing the necessary surveys, presenting outcomes and recommendations to the Board and preparing a report. We also assisted the entity in reviewing and updating its internal Governance Manual and Operations Manual.