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Directors Negotiating and Contracting in the Wake of Their Companies' Financial Distress

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Abstract

The majority of commercial contracts around the world are negotiated and made by directors on behalf of their companies. Directors are subject to many obligations when they carry out these functions. This paper examines one of the most important ones, and that is the duty that directors owe when their company is in a state of financial distress. The duty owed is for directors to take into account the interests of their companies' creditors at this time. The paper considers when directors are subject to this duty and what they must do when negotiating and contracting for their financially distressed companies, and considers some of the ramifications for directors and those who deal with them.

Keywords

Directors' duties, creditors, insolvency, distress

Discipline areas

Law, corporate governance, finance

Introduction

It is trite to say that a large number of the contracts that are negotiated and entered into around the world are by companies. Probably the vast majority of commercial contracts are made by companies of different sizes. This is simply because of the fact that companies are the predominant business vehicle used globally to run businesses. Obviously companies, being legal persons (that is they are recognised by the law) but not human persons, cannot themselves negotiate and contract. They rely on directors and managers to act for them. There are some very important legal issues surrounding the negotiation and making of contracts for companies. This paper endeavours to examine one of them.

When directors are engaged in negotiating and contracting they are subject to certain obligations and the law, the companies' articles of association/by laws and board resolutions might also limit what they can do and how they can do it. What this paper focuses on is the fact that directors are required to exercise their powers while discharging certain prescribed duties. These duties are usually provided for in hard law, such as statutes or case law or both. When negotiating and contracting for their companies directors must make decisions that will be in the best interests of their companies. In fact directors in most jurisdictions have a duty of loyalty to their companies to do everything that they do in the best interests of their company. Many countries in fact provide that this is the leading duty owed by directors to their companies. It is a duty that has been regularly provided for in Commonwealth jurisdictions, such as the UK, Australia, Canada, New Zealand, South Africa and

Singapore, and it is the overarching duty of directors in over 40 jurisdictions around the world.¹ For instance, both under case law (*Pilmer v The Duke Group Ltd (in liq)*) and under statute (Corporations Act 2001, section 181) directors in Australia must exercise their powers and discharge their duties in good faith in the best interests of the corporation (the terms “corporation” and “company” are used interchangeably in this paper) . In Canada the Canada Business Corporations Act 1985, in section 122, provides for the same formula. When a company is solvent many countries either interpret the meaning of “the best interests of the company” to be the best interests of the shareholders or their law requires the directors to act in the best interests of the company and the shareholders, something that the OECD’s Principles of Corporate Governance 2004 provides for as does the United States’ Model Business Corporation Act. In other jurisdictions, such as the Netherlands and Germany and many other European countries, company interests are interpreted more widely and may encompass the interests of employees and other stakeholders.

The Company Law Review Steering Group, in its comprehensive inquiry into UK company law at the end of the last century, stated that the directors are to manage the company’s business for the benefit of the company, and this is taken to mean that it is managed for the benefit of the shareholders as a whole (Company Law Review, para 5.1.5). This approach seems to have been accepted by the UK’s Parliamentary Banking Commission on Banking Standards in its report, *Changing banking for good*, when it talked about directors owing duties to the shareholders. However, there are indications in the law of many countries, including the UK, Canada, Australia, Ireland, New Zealand, Singapore, Hong Kong and in some respects, the US, that this is not the case when a company is in financial distress; there is a shift in the nature of the duties of the directors. This matter is important as companies all around the world are, at any one moment, trading when they are experiencing some form of financial distress. Directors and those dealing with directors need to know what obligations the directors have if the contracting company on which the directors are acting is experiencing financial stress.

This paper identifies when directors must change their general approach and what they are to do when their company is in financial difficulty, particularly when it comes to negotiating and contracting for their companies. The predominant focus is on those jurisdictions where the duties owed by directors change when their company is in financial distress although the different approaches adopted by other countries are discussed more briefly.

Legal provisions and approaches can differ from country to country and so it is very difficult to make unequivocal, general statements about what is the position globally. It is necessary in the paper to provide reasonably detailed discussion and to refer to the law in individual countries, at least in order to provide examples of points being made. Having said that, there are different legal families in the world, such as common law, civil law, Islamic law, and within these families there is a tendency to adopt the rules applying within the relevant family. Also, there is in many fields of law today greater convergence of the rules and approaches across the globe, or at least more recognition of similar issues and the need to address them. But the focus of the paper is not intended to be on individual jurisdictions, save where it is necessary and helpful for the development of the paper; the paper attempts to be as international as possible so that it is of interest to a wide audience.

The Rationale for a Shift in Duties

In order to provide some form of protection for companies' creditors the law in many countries holds that at certain times, when their company is in financial distress, the duties of directors shift in focus to the point where they have to take into account the interests of their companies' creditors. The reason given for this is that if the company is insolvent, in the vicinity of solvency or embarking on a venture which it cannot sustain without relying totally on creditor funds, "the interests of the company are in reality the interests of existing creditors alone." (Brady v Brady, 552) At this time, it is often said that the shareholders are no longer the owners of the residual value of the firm, having been, in effect, supplanted by the creditors, whose rights are transformed into equity-like rights (Schwarcz, 668). Thus, at this point, the creditors may be seen as the major stakeholders in the company (Kinsela v Russell Kinsela Pty Ltd; McDonnell; de R Barondes; Sarra), because the company is effectively trading with the creditors' money, and as a result the directors have an obligation not to sacrifice creditor interests (Sarra). According to the views of financial economists, directors could be expected, when their companies are in financial difficulty, to take more risks in their management of the company which might be a problem for creditors (Nicolls; Hartman; de R Barondes; Modern Company Law for a Competitive Economy: Final Report, para 3.15). When a company is in financial distress the directors are said to be tempted to engage in excessive risk-taking² in order to try and drag the company out of its malaise and the shareholders are often in support of this as they have essentially lost the capital that they have invested if nothing is done to turnaround the company's fortunes, but if the directors are successful with their risk-taking action the shareholders will ultimately benefit from it, provided that creditors can be paid out in full. In contrast, the creditors are not usually in favour of much risk-taking at all as they are the ones to lose out if the risk does not bear fruit. Robert Scott puts it this way:

"As long as the debtor's business prospects remain good, a strong reputational incentive deters misbehaviour. But once the business environment deteriorates, the [company's manager] is increasingly influenced by a 'high-roller' strategy. The poorer the prospects for a profitable conclusion to the venture, the less the entrepreneur has to risk and the more he stands to gain from imprudent or wrongful conduct." (Scott, 624)

There is empirical evidence to support the fact that this tends to occur (Daniels), and it has become axiomatic that this risk-taking will take place (Adler; de Barondes), particularly where the directors are also the shareholders/owners (Mokal) in the context of closely held corporations (private companies).

The effect of this shift can be good news as far as those dealing with directors, and who become creditors of the directors' company as it means that directors could be personally liable for losses that creditors experience as a result of the directors not discharging their duties properly. This provides some possibilities of protection for those entering into contractual relations with the directors' company. But where there is a shift in duties and directors breached their duty in failing to take into account the

interests of creditors, creditors are not permitted to bring legal proceedings against the directors as the duty is actually owed by the directors to the company, and not to the creditors. The creditors have to wait for a liquidator/trustee/administrator to be appointed over the company's affairs and for this person to bring proceedings, effectively on behalf of the company.

Other Approaches

A shift in duties, something that we will return to shortly and discuss in detail, is not the only way that the law has dealt with companies in financial distress and the actions of their directors in managing their companies' affairs. There have been other methods used to provide creditor protection. A majority of jurisdictions across Europe, for instance, do not provide for a shift in directors' duties when their companies are in distress.³ Many Member States of the European Union provide that directors can be held liable for failing to file for bankruptcy when their company is insolvent or insolvency is imminent.⁴ Also several Member States provide that directors may be held to be liable in tort by creditors of the company where the company has experienced financial difficulties and subsequently ended up in bankruptcy and cannot repay creditors in full. Torts are civil wrongs, the prime example being negligence. The commission of a tort means that a court might order the wrongdoer to compensate the person(s) who has been injured by the tortious action.

A good instance of the use of this tort approach to the issue raised by the paper is to be found in the Netherlands where directors might be subject to legal proceedings brought by a creditor with whom they negotiated and entered into a contract on the company's behalf when the directors knew or should have known that the company would neither be able to meet its obligations to the creditor nor would there be sufficient assets to discharge the obligation to the creditor. This rule is called the "Beklamel-rule" (Garner-Beuerle et al) and named after the Dutch Supreme Court case that decided that directors could be liable on the aforementioned basis. Obviously directors must be careful in the countries where this approach has been employed that they do not enter into contracts for their company when they know that the company will not be able to fulfil the terms of the contracts. But directors will be liable even where they do not know, but should have known that their company would not be able to discharge its obligations. The latter consideration involves an objective approach and places a greater burden on directors to be constantly aware of their company's financial position. It means that those contracting with a company that is in financial distress might hold directors liable where the latter have failed to ascertain the financial position of their company. But what this approach does not do that a shift in duties does is to make directors liable in relation to past debts, that is, debts that were contracted before the company entered a period of financial stress. Actions can only be commenced against directors by those creditors who make contracts with companies after the companies are in a position where they cannot meet their obligations to parties with whom they have contracted (via the work of the directors).

The European approach chimes to some extent with the law that applies in some US states where directors can be held liable for wrongly prolonging the life of their distressed companies. This also involves an action in tort, known as the tort of deepening insolvency, and is most often considered when the directors have entered

into contracts that the company, which is insolvent, cannot honour, usually by not being able to pay what is owed under the contract. The concept originated in the New York case of *Re Investors Funding Corp* in 1980, with the term “deepening insolvency” being first used in 1983 in the case of *Schacht v Brown*. Subsequently, for instance, in the Pennsylvania case of *Official Committee of Unsecured Creditors v R. F. Lafferty & Co* in 2001 the tort was given greater application and has been explained more. However, the concept still has not been fully defined and developed and is still to be regarded as being in its infancy. Some commentators even deny its existence. Importantly the action is only available when directors were acting improperly when their company was in fact insolvent, and the action has to be brought by the company as it is the one harmed by the tort committed by the directors, although creditors will benefit indirectly from any success the company has in such proceedings. Actions are not likely to be brought until a company enters formal insolvency proceedings, such as liquidation (Chapter 7 bankruptcy in the US) or Chapter 11 bankruptcy. In liquidation proceedings, for instance, the liquidator /trustee will take action against the directors if he or she is advised by lawyers that the directors committed the tort of deepening insolvency.

Another approach that has been adopted in a range of countries is to provide that if their company is insolvent, likely to become so or likely to end up in insolvent liquidation the directors have to embrace certain action when managing their company’s affairs. Two classic instances are “wrongful trading” in the UK and “insolvent trading” in Australia. In the former the UK legislation, section 214 of the Insolvency Act 1986, provides that directors are liable to compensate their company which is in insolvent liquidation where they have engaged in wrongful trading prior to their company’s entry into liquidation. Wrongful trading involves directors trading when they knew or ought to have known or ascertained that the company’s insolvent liquidation was inevitable and they failed to take every step with a view to minimising the potential loss to the company’s creditors as they ought to have taken. If directors fail to take the necessary steps then they can be held personally liable. The steps that directors should take are not articulated in the legislation, but things like not engaging in making contracts that incur more debt for the company and putting their company into some form of insolvency procedure, such as administration or liquidation, are possible ways for directors to proceed and to safeguard themselves. While there are numerous shortcomings with the action (Keay, 2014) it has been considered and supported by many in Europe and a variant of it applies in some Member States of the EU.

The general American position used to be similar to that found in the UK, Australia, New Zealand, Ireland and elsewhere, namely that when a company is in the vicinity of insolvency there was a shift in the duties of the directors. In what was the leading case, *Credit Lyonnais Bank Nederland, NV v Pathe Communications Corp*, Chancellor Allen of the Delaware Court of Chancery (Delaware is the leading State in relation to company law and its law is highly respected all over the US) said that where a company is operating in the vicinity of insolvency the directors owed a duty to the corporate enterprise and this appeared to mean the community of interests that sustain the company. Thus this would, as was generally acknowledged, include the creditors. Following this case creditors were able to bring direct actions against directors if they breached their duty to consider creditors’ interests. This was not consistent with the approach in other common law countries where directors could not

themselves initiate legal proceedings; proceedings had to be left to the liquidator or administrator of the company once insolvency proceedings were commenced either by court order or voluntarily by the company itself. After the Credit Lyonnais case there was a lot of debate in the US literature as to whether a duty was owed to creditors by the directors. There was considerable discontent with the Credit Lyonnais case and this culminated in 2007 with the decision of the Delaware Supreme Court in *North American Catholic Education Programming Foundation Inc v Gheewalla*, where the Court said that directors did not owe any particular duties to creditors and certainly not when their company was in the vicinity of insolvency. But the case provided, and it is the situation in the US still, that creditors may bring an action (known as a derivative action) on behalf of the company to whom the directors owed their duties where the directors have breached their duties to the company if the company was insolvent at the time of the breach. This has been affirmed recently in the case of *Quadrant Structured Products Co v Vertin*. Thus in the US directors must be very careful how they manage the affairs of their company when the company is insolvent, and it is only then that there is a shift in the duties of directors. Probably much of what is said in the next part of the paper will apply to US directors when their companies are in fact insolvent.

The Shift in Duties

The main focus of the paper is on those jurisdictions where directors are subject to a shift in the nature of their duties when financial distress exists. The term “financial distress” is not a term of art and its meaning and extent has not been determined judicially. To ascertain when directors have to consider the interests of their companies when they are engaging in any negotiating and/or contracting for the company the case law has to be examined. Unfortunately the case law is not clear on when directors’ duties shift to the point where they have to consider the interests of creditors. The cases have variously described the circumstances when directors can be required to consider the interests of creditors.

It should be noted that the result of the shift that is examined in the paper is that directors are subject to a legally enforceable duty. That is, the law has specifically provided that directors must take certain action or else they are liable for the losses of their company. It also needs to be emphasised that the obligation placed on directors is one that is owed to the company itself and generally, leaving aside the US as explained above, creditors themselves cannot institute proceedings.

The Time of the Shift

The case law provides that there is to be a shift in the following situations.⁵ First, when the company is insolvent (*Re HLC Environmental Projects Ltd; Liquidator of West Mercia Safetywear Ltd v Dodd; Kinsela v Russell Kinsela Pty Ltd*). Insolvency is usually defined, in broad terms and in most jurisdictions, as a situation where a company is unable to pay its debts as they fall due or the value of the assets of a company is outweighed by the value of the liabilities. The former is referred to as cash flow or commercial insolvency and the latter is known as balance sheet insolvency. Some jurisdictions, such as Australia, provide that a company is only insolvent if one of the two approaches are found to exist and other jurisdictions, such as the UK, hold that a company can be regarded as insolvent under either definition of

insolvency. While insolvency is not always easy to determine it is probably true to say that it is more definite than the other situations in which directors' duties are said to shift. However, on the down side it is possible that companies move in and out of insolvency, and thus it does complicate matters for directors. It does mean that it is obligatory for directors to be even more watchful of the state of their companies' finances and particularly so where there is concern over solvency.

The second situation where duties are to shift is when the company is nearing (Nicholson v Permakraft (NZ) Ltd; Re New World Alliance; The Liquidator of Wendy Fair (Heritage) Ltd v Hobday) approaching (Geneva Finance Ltd v Resource and Industry Ltd), on the borderline of (Eastford Limited v Gillespie, Airdrie North Limited), or on the verge of (Colin Gwyer v London Wharf (Limehouse) Ltd), insolvency. Third, where the company is of doubtful solvency (Nicholson v Permakraft (NZ) Ltd ; Brady v Brady; Colin Gwyer v London Wharf (Limehouse) Ltd). Fourth, where the company is subject to a risk of insolvency occurring (Grove v Flavel; Kinsela v Russell Kinsela Pty Ltd; Nicholson v Permakraft (NZ) Ltd; Winkworth v Edward Baron Development Ltd; Hilton International Ltd (in liq) v Hilton). Fifth, where to the knowledge of the directors there is a real and not a remote risk of insolvency and creditors would be prejudiced by the action being considered (Kalis Enterprises Pty Ltd v Baloglow; Re HLC Environmental Projects Ltd). Finally, there are cases where there is no reference to insolvency/solvency at all and the courts have been content merely to say that the company is in a dangerous financial position (Facia Footwear Ltd (in administration) v Hinchliffe), a parlous financial state (Williams v Farrow), financially unstable (Linton v Telnet Pty), or in financial difficulties (to the extent that the creditors are at risk) and where the state of affairs would endanger creditors' interests (Re MDA Investment Management Ltd; Re Idessa (UK) Ltd).

The judicial commentary suggests that the closer a company moves towards a state of insolvency the more likely it is that the shift in duty will occur. The circumstances pinpointed by the courts are imprecise and this is undoubtedly a major worry as far as certainty is concerned. It is likely that the imprecision emanates from the fact that the courts have been deciding cases as they have come before them and deciding them on their own individual facts (and not intending to develop a particular line of jurisprudence), and thus it might be such that the judges do not intend their comments to be taken too strictly, with the consequence that the various situations all mean much the same thing. In the Australian case of Kinsela v Russell Kinsela Pty Ltd Chief Justice Street said: "I hesitate to attempt to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors."(223)

Clearly all of this means that directors must be circumspect about taking any action when their company can be said, in broad terms, to be in financial distress. Certainly it might well be thought to be advisable for directors to err on the side of caution when contemplating entering into any negotiations that might lead to a contract that will further extend the obligations of their company. The difficulty facing directors is that, as we have seen, the point of time when duties shift is far from precise and there might be pressure from shareholders to do deals that could be risky and potentially injurious to the creditors. It means that directors have to be vigilant and keep on top of the financial position in which their company finds itself. This is not to suggest that

directors are entitled to neglect keeping on top of their company's financial position when the company is not in apparent financial straits, as the duty of care to which directors in most jurisdictions around the world are subject requires them to do so. A good instance comes from Australia in the case of *Australian Securities and Investments Commission v Healy* where directors were held liable for a breach of their duty of care in relation to a company that was clearly solvent because they failed to maintain familiarity with the financial status of the corporation by undertaking a regular review and understanding of the financial statements.

But courts in cases that have involved consideration of the actions of directors when their company has ended up in bankruptcy/liquidation have emphasised the greater responsibilities that fall on the shoulders of directors as far as finances are concerned. This could involve even more substantial questioning of other directors and managers who have greater responsibility for the company's finances, requiring the drawing up of accounts more frequently, the taking of professional advice on a more regular basis, and the convening of more board meetings to discuss financial commitments and the general financial position of the company. It also encompasses directors making sure that they are fully apprised of the extent of their company's financial obligations under any contract which they seek to make for their company in case the obligations might lead to worsening the company's financial position, at least potentially. Another important thing to note is that the possibility of a shift could be regarded as a sword of Damocles hanging over the heads of the directors, and that state of affairs might dent the entrepreneurial and risk-promoting aspect of the role of directors of for-profit companies. Directors are likely to be caught between self-preservation, which leads them to act in an overly conservative manner for fear of liability, on the one hand, and fulfilling their role to take the company forward by taking advantage of opportunities which their company might be able to exploit, on the other hand. This tension is probably one of the reasons why legislatures and courts alike have been slow to lay down specific details concerning the duties imposed on directors

Directorial Response to the Shift of Duties

If directors are in a position where they are to take into account the interests of the creditors of their company, the next thing we have to examine is how they are to act and what affect that might have on their negotiating and contracting for their company. It is impossible to specify what particular actions should or should not be taken. It will depend very much on various factors such as the nature of the proposed contract, the obligations imposed on the company by the terms of the contract, the overall benefit that the contract would bring to the company, the prospects of the company, the extent of the company's financial distress, the kind of company that is involved, and the type of business in which the company is involved. When negotiating any contract directors need to appraise the risks involved in making a contract, and added to these, when a company is in financial distress, they need to consider the risk of creditors not being paid. In determining what they have to do, the directors need to realise that the circumstances that dictate what they are to do might change (*Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*). While the exact circumstances facing directors will be critical and one cannot anticipate them with any degree of certainty, the following discussion seeks to examine what principles might guide any action that is to be taken and they should provide some guidance as to what directors should do if there is a shift in duties.

Complicating things for directors is the fact that there is some divergence of opinion as far as the views of judges are concerned where judges have actually got to the point of explaining what directors should do when their duties shift, something that has not occurred frequently. Many courts around the world have merely said that if there is a shift in duties the directors have to take into account the interests of creditors and they say nothing about what this might entail. Naturally, simply stating that directors are to take into account the interests of creditors is not all that helpful for directors, their advisers and those who might be creditors of the directors' company as it is a too general statement.

Some distinction is made in some courts between when companies are insolvent and when they are not. The preponderance of judicial opinion in the UK, for instance, appears to be that if a company is insolvent the interests of the creditors are paramount (*Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd*; *Roberts v Frohlich*; *Re HLC Environmental Projects Ltd*). Whereas in contrast, in Australia and New Zealand the dominant approach is that directors, in discharging their duty, must take account of the interests of its shareholders and its creditors, and thus the interests of creditors do not supplant those of shareholders (*Nicholson v Permakraft (NZ) Ltd* ; *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*). What does it mean to say that the creditors' interests are paramount? It is likely that the directors have to concentrate on the interests of the creditors to the exclusion of others, and particularly the interests of shareholders, which for directors in many jurisdictions where shareholder primacy/value tends to be practised, is something of a sea-change. Many see directors as agents of the so-called owners of the company, the shareholders, and consequently they must do the bidding of the shareholders. But the fact of the matter is that, as I have indicated already, the obligation that we are considering here is enforced by law and the directors are not to be consumed with concern for the interests of shareholders alone.

The consequence of the creditors' interests being regarded as paramount is that the company's affairs are to be administered in such a way as to ensure that actions will enhance the wealth of creditors, that is, the creditors will be repaid more of the funds that are owed to them if an action is taken. The first thought of the directors is to be, when considering a course of action such as entering into contractual arrangements : how will this affect the creditors? This can obviously be a difficult matter for directors. Perhaps we can say that everything that the directors do must provide an advantage for creditors (Keay, 2014). According to the case of *Colin Gwyer v London Wharf (Limehouse) Ltd*, directors, in the process of taking into account the interests of creditors, have to consider the impact of any decision on the ability of the creditors to recover the sums due to them from the company.⁶ Obviously entering into a fresh contract could potentially attenuate the chances of existing creditors being paid as well as adding new creditors to the list of people who are owed money by the company. Yet, of course, a new contract could lead to benefits which would see creditors being paid a large portion of what is owed to them, or even, conceivably, being paid in full.

It might be thought that paramouncy simply entails directors "refraining from disposing of assets improperly or diverting property to insiders in the company, which are obviously actions detrimental to the creditors (and arguably to the shareholders

save where all of the insiders constitute the entire shareholding body)” (Keay, 2014 : 458) but it does in fact go further than that. There will be clear breaches of duty in some cases, such as situations where directors make a contract that could not possibly bring advantages to the creditors, but in many other cases the directors’ actions will not be able to be assessed without significant analysis. It will often be a difficult call for directors when they are considering entering into a contract with a third party as to whether the contract will benefit the creditors. The concern that directors might have is that unless a particular contract is entered into the company’s operations will stagnate and that could end up leading to the death of the company, but they will have to recognise that the liabilities of the company will increase and these will not be offset unless the contract is fruitful for the company.

As mentioned above, there is some disagreement in the courts in some jurisdictions as to what directors should do when their company is not insolvent, but in financial difficulty. A clear instance is the UK. Some cases hold that, just as when a company is insolvent, the directors are to treat creditor interests as paramount. For example, in the English Court of Appeal case of *Brady v Brady* one of the appeal judges said that where the company is doubtfully solvent the interests of the company are in reality the interests of existing creditors alone, just as they are when a company is insolvent. But, again, this is not the view in other jurisdictions. For instance, in Australia the same approach that Australian courts take when companies are insolvent is applied when companies are in distress but short of insolvency. The courts say that the creditors’ interests are to be taken into account along with those of the shareholders. This approach is also in evidence in New Zealand where a Court of Appeal judge said that he did not think that the interests of the shareholders should be put aside (*Nicholson v Permakraft (NZ) Ltd*). I mentioned above that the approach in the UK is not uniform. Some British courts have taken the same view as the Australian courts have taken and said that when a company is in financial difficulties, although not insolvent, the directors’ duties owed to the company are extended so as to include the interests of the company’s creditors as a whole, in addition to those of the shareholders (*Re MDA Investment Management Ltd*). This appears to be view that has been taken of the law in the US, or, at least, in Delaware (*North American Catholic Education Programming Foundation Inc v Gheewalla ; Quadrant Structured Products Co v Vertin*).

Certainly there seems to be some merit in arguing that the nature and extent of consideration that directors must show in relation to creditor interests is the same whether a company is insolvent or short of insolvency. The main reason for saying that it is meritorious is that directors do not, in deciding what to do, have to make any distinction between whether their company is actually insolvent or not. Directors should know that the company is in financial difficulty and so their approach will be the same even if the company then moves into actual insolvency, and of course when this precisely happens might be difficult to ascertain on many occasions.

The advantage for directors in following the approach that creditors’ interests are always paramount when financial distress exists is that it is arguably easier for them to operate as they know that their focus must be completely on exercising their powers in such a way as to benefit the creditors. Added to this it might be thought that it is a much easier task to focus on the interests of only one group. But while that might be true in some companies, considering the interests of creditors can be an

onerous assignment when there are various kinds of creditors. The difficulty is that different creditors might want different things. This might well occur when a company has general unsecured creditors (such as suppliers of goods and services), creditors who are landlords, creditors who will be granted priority status in a liquidation, and secured creditors. Where this situation exists it might be argued that if the company's funds/assets merely cover the debts owed to the secured creditors and the priority creditors, the directors should not take into account the unsecured creditors' interests as their money has effectively gone, just like the shareholders' funds, and any trading would effectively involve using the funds of the secured creditors and priority creditors, and at their risk (Keay, 2014). In such a position it might be thought appropriate that, in order to protect the interests of the secured creditors, the directors should take the company into some formal insolvency regime, such as bankruptcy/liquidation.

“To trade on and risk further funds might suit junior and unsecured creditors who have the hope that the company might be turned around, but it would not usually be favoured by secured creditors. Of course, it is not always possible for the directors to ascertain easily at a given moment whether or not the company has funds/assets that exceed the liabilities owed to the secured creditors.” (Keay, 2014 : 463).

But while there are problems in determining what the interests of creditors entail when there are groups of different creditors it is a far harder task to have to consider both shareholder and creditor interests because the interests of the two groups can be far more diverse. While in relation to only considering creditors' interests there can be difficulty as the claims of the creditors will differ, at least the interests considered are those of people to whom money is owed. But how do directors approach the situation where they are to consider both shareholder and creditor interests when on the one hand there are people who have an investment in the company and all that that brings, and on the other there are people who are owed money? Like creditors, shareholders are diverse. Some want short-term benefits while others are in for the long haul. But, at least, most directors might be regarded as being used to deciding what is best for the shareholders as a whole, and, indeed, many jurisdictions provide either that directors are to act for the benefit of the shareholders or that the directors are to act for the benefit of the company and this latter requirement means acting for the shareholders as a whole. Leaving the diversity of shareholders aside, and as discussed earlier in the paper, shareholders, or at least many of them, will want the directors to take risks in the management of the company, because if no risks are taken (and do not bear fruit) the shareholders have lost little or nothing, while the creditors will see the portion of their recovery reduced or disappear totally. Given that shareholders will not receive anything from the company, given its plight, the difference in the interests and views of shareholders might not be a major issue. As indicated already, that is not the case as far as creditors are concerned, as they might certainly receive something from the company even if it is insolvent. And, if the directors act appropriately then they might see their benefit increased, or, to put it another way, their loss reduced.

One approach to addressing the issue of how to deal with these different groups is to say that the directors have to balance the interests of the two groups. However, because the interests of the two groups or at least significant members of each group

are likely to differ, it is not easy to know how to proceed. If the directors are to engage in balancing what does that actually mean for directors when they are concerned with running the company's business? Balancing interests is difficult, as many have pointed out in relation to the use of stakeholder theory in corporate governance (Steinberg; Sundram and Inkpen; Keay 2011), as it requires directors to balance the interests of all stakeholders when managing the affairs of the company. Probably the main difficulty is knowing how to proceed when there are conflicts between the various interests. On what basis would directors decide conflicts between the interests of the shareholders vis à vis the creditors?

Instead of endeavouring to balance interests, directors might be better served by employing an entity maximisation approach (Keay, 2005), which entails, essentially, the directors making decisions in order to maximise the general wealth of the company entity and enhance its sustainability. This amounts to directors engaging in actions that:

“value maximises the corporate entity so that the net present value to the company as a whole is enhanced (maximising the total financial value of the firm and taking into account the sum of the various financial claims that are made on the company) and not just its equity.” (footnotes omitted) (Keay, 2007, 241-242)

What lies behind this approach is the idea that directors will seek to increase the market value of the firm (Jensen). This approach takes into account, indirectly, the interests of the shareholders and the creditors, because both of them will have claims on the company (whether either get anything from their claims will depend on the position that the company ends up in) and so if there is wealth creation for the company entity the shareholders and creditors should benefit as a consequence.

It seems that this is more appealing than balancing. It means that directors can look at maximising entity wealth and not have to undertake an active balancing between the interests of particular groups. The directors can seek to enhance the overall position of the company with the aim of ensuring that it continues as a going concern, which, of course, will be attractive for both the shareholders and the creditors. If the company survives the creditors might be able to expect a greater portion of their debts being repaid or even full discharge of the debts. The shareholders might again see some dividends and their shares become worth something. It is clear that the directors will not be able to avoid some balancing even if they embrace an entity maximisation approach, but any balancing can have a focus, namely what will best maximise entity wealth?

Whatever approach directors adopt, there will be transaction costs involved in negotiating and contracting for their company and so directors will have to weigh up, when their company is in financial distress, whether the costs to be expended in negotiating and contracting are worth it. Is it likely that these transaction costs can be recouped in a reasonably short period and thus able to be justified, because they will enable the creditors to see some benefit from the contract? Perhaps directors have to try, more than usual, to ensure that costs are kept to a minimum in the negotiation and preparation of contracts. It might be appropriate in some circumstances that directors do not seek to enter into fresh contracts and that their company might need to try and

consolidate its position in relation to existing arrangements until the period of financial distress ends. Of course, there might be situations that come to the notice of the directors that represent good opportunities to benefit the company and hence the creditors. Or, taking up these opportunities might be the only way that creditors are going to receive some or all of the amounts that are owed to them. In doing this seeking a benefit for the creditors must be in the minds of the directors and not the continuing viability of the business (*Sydlow Pty Ltd v Melwren Pty Ltd*), or the interests of others, such as the employees.⁷ HERE

Restructuring/Reorganisation

In companies that are subject to distress the directors might endeavour to restructure the company's financial position or even seek to be more radical and reorganise the company's whole set-up. Taking the former, the directors will usually have to seek fresh financing. This will, of course, add to the company's liabilities. Naturally, it would be optimal if the directors of the company could finalise a restructuring plan before taking any action that might favour one class of creditor over another, but that would be rarely possible (*Maslen-Stannage*, 80). In negotiating any restructuring deal with a third party the directors will need to assess, as part of their need to consider the interests of creditors, the likely benefits to the various groups of creditors of the contract being entered into. Any party that is contemplating lending to a company that is seeking to restructure will need, obviously, to consider the risks of non-payment, and whether directors might be liable on the basis of a breach of duties if their companies are not able to repay. Those who have not provided credit to the distressed company before might, of course, demand some form of security (collateral) to protect their position.

Counterparties

The topic of the paper is something that does not only concern directors, their companies and any liquidator/trustee/administrator of companies that end up in insolvency proceedings. Those who negotiate and contract with companies must be cognisant of the position in which they might find themselves when talking to directors of companies that might be experiencing financial problems. The problem is that many companies cannot turn their backs on dealing with companies who are struggling financially to some extent.

The lack of precision in determining when directors' duties will shift in focus from shareholders/stakeholders to creditors means that parties who contract with financially distressed companies whose position might be questionable, if not precarious, need to realise that they cannot depend on the directors being held liable for losses sustained under the contract. Furthermore, even if directors are held liable they might well be impecunious or their whereabouts cannot be ascertained. Even if a court would be willing to accept that the duties of the directors have shifted, it might not be prepared to say that the directors failed in their obligation to take into account creditors' interests. As we have seen, what directors have to do in many situations is not clear. It really means that those negotiating and considering contracting with directors have to return to the most basic point that in dealing with a company they are dealing with an entity that is separate from its shareholders, directors and other stakeholders, and an entity in which the shareholders have limited liability. They must recognise that even

if directors are liable for the liabilities of all or some of their companies, they might well be impecunious and not able to meet the terms of a court order. This will not be uncommon where private (closely-held) companies are concerned as often the directors will be the shareholders and might well have sunk all their money into the company and mortgaged personal assets to the hilt.

When negotiating with directors, especially where credit or loans are to be extended to the directors' company, parties must consider what terms they might include in the contracts to protect themselves generally, and particularly to lessen the risk involved, given the uncertainties that surround the issue of a shift in duties of directors. Of course, where negotiations are undertaken with small companies guarantees might be required from the directors who are often the "owners" of the company. Guarantees are all well and good, but they do not protect the creditor from the fact that directors might end up unable to pay when the company defaults. What actions are taken by those dealing with companies will depend on many variables, such as the nature of the deal(s), the standing and size of the company that is being dealt with and the nature of the company's business. Other possible actions, besides guarantees, are to include in contracts covenants that : circumscribe what the company can do; require financial records to be provided at periodical intervals; prescribe that the company must maintain certain financial ratios; place constraints on dividend policy and/or on the creation of new debt; provide for an acceleration in the payment of the outstanding balance if it is determined that the directors have entered into transactions that would reduce the company's net worth; prescribe what loan funds are to be used for; provide a term, if the party is a supplier that entitles it to retain title in the goods supplied until payment is made. But, as most recognise, ex ante contracts have their limitations in so far as protecting a creditor (**Whincop**). As Halpern, Trebilcock and Turnbull have said: "The difficulty of specifying such constraints in sufficient detail to provide protection against all the possible means by which the corporation could increase the risk to creditors limits the usefulness of such a strategy" (125). Including particular terms in a contract might safeguard the creditor to some degree, however, it is impossible to draft a contract that encapsulates all of the matters that the parties might want to address and which covers every possible contingency because of bounded rationality (Tauke, Keay and Zhang).

Future Research

The fact that the conditions that must exist for the shift of duties are imprecise, particularly prior to actual insolvency, means that there is scope for some normative research that will determine when there should be a shift in duties in order to provide greater certainty and fairness for all. In this respect it would be of assistance to ascertain when directors have perceived that they needed to change their focus and what problems they might have in shifting their focus. The present position concerning the actions that directors must take when there is a shift is not clear and so normative research on this point would also be of help. Ascertaining the views of directors as to what they feel that they ought to do when their company enters a stage of financial distress, and what sort of factors might they take into account and why, would be informative and inform arguments for determining what taking into account creditors' interests should involve. In dealing with all of these issues research might be able to determine whether courts are being overly prescriptive. Furthermore, it would be instructive to ascertain through empirical research whether directors are

cognisant of their need to shift their emphasis when their company is in financial stress, and whether they are or are not, what sort of actions they employ in address the company's position and their view of the shareholders and other stakeholders of the company.

Conclusion

When directors' companies are in some form of financial difficulty it is likely that the way that they approach the negotiation and making of contracts will be different from where their company is clearly solvent. Besides all of the things that might/must be taken into account ordinarily when directors are undertaking negotiation and contracting, directors must also not lose sight of the interests of creditors and consideration of how contracts will affect the financial position of the company.

There are various ways that jurisdictions seek to protect creditors. The paper has mentioned some of them and has focused on one major one, namely, the shifting of the nature of directors' duties in periods where their company is in some form of financial stress. The paper has identified some of the problems that exist for directors with this approach to creditor protection, identified when this shift occurs and sought to make suggestions as to how directors should conduct themselves when the shift has occurred.

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NOTES

¹ Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and other Business Enterprises, 'Corporate Law Project : Overarching Trends and Observations,' July 2010, (accessible at <http://www.reports-and-materials.org/Ruggie-corporate-law-project-Jul-2010.pdf>) (accessed 7 April 2014). Also, see Clarke 2013 : 17.

² See, Easterbrook and Fischel 1991: 60; Jelisavcic, 1992 : 148.

³ Ones that do in various ways are : Cyprus, Denmark, Estonia, Hungary, Ireland, Latvia, Malta and the UK

⁴ For instance, France, the Czech Republic, Portugal.

⁵ The following were noted and considered in Keay 2015

⁶ This view was also voiced by Lesley Anderson Q.C. (sitting as a deputy High Court judge) in *Re Idessa (UK) Ltd* at [120].

⁷ But see the decision of Hoffmann J. in *Re Welfab Engineers Ltd* where the court permitted the directors to do a deal that considered the interests of the employees.