"AN HISTORICAL AND COMPARATIVE ANALYSIS OF THE DEVELOPMENT OF THE AVENUES OF RECOVERY AVAILABLE TO CREDITORS OF INSOLVENT COMPANIES AND THE CONSEQUENTIAL EROSION OF THE PRIVILEGE OF LIMITED LIABILITY"

By

JUSTIN DABNER  B Comm LLB (Hons)

Submitted in fulfilment of the requirements for the degree of Doctor of Philosophy University of Tasmania April 1994
To my parents for their inspiration and assistance and to David Galvins, a friend and colleague sadly missed.

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I hereby state that this thesis contains no material which has been accepted for the award of any other higher degree or graduate diploma in any university. Furthermore, to the best of my knowledge and belief, the thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

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The limits of this thesis
This thesis analyses the development of judicial and legislative fiat's on the concept of limited liability in the context of claims on corporate members and/or directors by creditors. Strictly speaking it is only corporate members who are sheltered by limited liability and not directors. However with the trend towards the assimilation of ownership and management of corporations the distinction between members and directors has lost much of its significance in this context. Accordingly it is not proposed to dwell upon the nicety of whether an action against an individual arises out of their managerial capacity in relation to the company or by virtue of their proprietary interest in the company. Rather the perspective will be the ability of unpaid creditors of insolvent companies to recover their losses from individuals or entities associated with a company regardless of the exact nature of this association. Ultimately it would appear that the essential feature of this association will be one of control and, on this basis, the term "controller" will be used as a generic term to describe the persons or entities to whom unpaid creditors will typically look for satisfaction.

Similarly when considering the various avenues of recovery, in particular the common law avenues, it is not proposed to distinguish between those which pierce the corporate veil and those which technically rescind the privilege of limited liability. Regardless of the mechanics, given that the ultimate result is typically to effect a rescission of this privilege, the various avenues will be described in terms of having this effect.

The development of the power to examine corporate officials will not be explored, although, at a practical level, the availability of this facility is often intimately connected with the application of the defaulting officer provisions, as an examination will frequently supply the necessary evidence to enable proceedings against company officials to commence. Furthermore the thesis is confined to an analysis of creditors' recovery rights against those who have exploited the corporate form and the privilege of limited liability in such a way as to cause creditors to suffer loss. Whilst this will necessarily involve some consideration of the responsibilities of directors, it is not proposed to examine the wider issue of directors' duties and liabilities generally although to the extent that liquidators act for the benefit of creditors an
incidental analysis of the causes of action available to liquidators will be undertaken. This analysis will, however, be primarily directed to the issue of whether standing to pursue these causes of action could usefully be extended to creditors.

Similarly whilst the issue of creditor recovery is incidentally related to the issue of related party transactions and voidable preferences it is not proposed to canvass these matters in any detail. The emphasis will be on the recovery rights of individual creditors and these aspects will only be considered to the extent that they impact on this issue.

In chapters 9 and 11 it is argued that the analysis supports a division of the defaulting officer regime into three components each tailored to a particular type of company. Whilst this discussion necessitates an incidental consideration of the calls for the restructuring of the company laws generally into regimes more specifically orientated towards the different types of companies it is not proposed to enter into this more general debate. Although the proposal provides some support for this more general proposition a general division of the company laws is not a pre-requisite for the proposal canvassed in this thesis to be implemented.

Nomenclature
Throughout the thesis reference is made to the defaulting officer provisions, in particular the misfeasance, fraudulent trading and reckless trading provisions. Although the nomenclature used to identify these provisions is widely used, the notion of a reckless trading provision is probably less well understood. Apart from the United Kingdom, which has what is generally described as a "wrongful trading provision", Australia, New Zealand and South Africa have all possessed what will be referred to as a "reckless trading provision". This expression is simply adopted for convenience, and it is not meant to imply that these provisions share a common imposition of liability for reckless behaviour. Rather the nature of the provision varies with each country and, at least as regards Australia, over time. Since 1981 the Australian provision could possibly more aptly be termed a "negligent trading provision". Indeed, this expression might even be a more appropriate description for the South African provision, given its judicial interpretation, notwithstanding that it expressly adopts the term "recklessly".

Whilst the expression "insolvent trading provision" will be reserved to describe the provision inserted in the Australian legislation by the 1993 reforms, where the context does not indicate to the contrary a reference to the reckless trading provisions will include a reference to
Preface and Acknowledgments

this provision.

The law examined
The law is stated as at 1 January 1993 although it has also been possible for some selected later developments to be included. References are to the Australian legal and commercial environment unless it is expressly noted to the contrary. For ease of comprehension, when considering the caselaw dealing with the Companies Code provisions corresponding to the Corporations Law provisions, only the Corporations Law section numbers will be referred to. References to the Corporations Law provisions are references to the provisions predating those contained in the Corporate Law Reform Act 1992 which came into force during June 1993. These new provisions will be dealt with separately.

Acknowledgments
I gratefully acknowledge the assistance of, especially, Professors Bob Baxt and Don Chalmers and also of Professors Roger Brown and Micheal Tilbury in the preparation of this thesis. I also wish to thank the Law Faculty secretarial staff, past and present for their unending patience and skill at deciphering my scribbles. Thankyou also to Angela.

Law Faculty,
University of Tasmania,
December 1993.

J.H.B. DABNER
This thesis provides an historical and comparative analysis of the development of the avenues of recovery from corporate controllers available to creditors of limited liability companies.

The thesis proposes that the conflicting goals of the promotion of enterprise through the provision of the privilege of limited liability and the protection of creditors through the provision of a recovery regime have presented both the judiciary and legislatures with a difficult balancing act. This will be demonstrated with evidence of a history of piecemeal and reactive common laws and legislation.

In particular it will be observed that the common law has identified a limited category of circumstances where the privilege of limited liability will be rescinded although these have seldom been of advantage to creditors with the exception of a limited fiduciary duty owed by directors to creditors.

It will also be demonstrated that whilst the legislature initially perceived creditor protection in terms of corporate disclosure together with a simplified procedure to enhance the effectiveness of the common law remedies, the inadequacies of these remedies soon witnessed the creation of statutory remedies in the form of fraudulent and, latter, reckless/wrongful trading provisions. These became the lynchpin of the creditor recovery regime notwithstanding a history of deficiencies. The thesis acknowledges that although recent legislative reforms, in the form of an insolvent trading provision, are an improvement these reforms are also not without their limitations.

The thesis will also explore issues that have arisen in creditor protection with the emergence of group companies. It will be acknowledged that the legislative response has been limited and creditors have sought to exploit other legal avenues, with torts law providing some assistance. However, against the complexities raised by the multinationalisation of company groups little avenue for redress exists.
Abstract

From a comparative analysis of the development of creditor recovery regimes overseas (the United Kingdom, South Africa and New Zealand) it will be concluded that, whilst the Australian approach has merit, experiences in these jurisdictions provide some useful lessons.

Possible responses to the inadequacies of the law, including the thematic development of the fraudulent and reckless trading provisions, are then explored and a tentative reform proposal consisting of a tripartite structure which distinguishes between small private companies, "typical" trading companies and group companies is put forward. This proposal is compared with the Government's recent legislation which will be shown to essentially satisfy one limb of the reform equation. Outstanding reforms are elaborated upon.

The thesis concludes with the proposition that the underlying theme of the creditor recovery regime is that the transfer of risk inherent in the provision of the privilege of liability involves an implicit undertaking by corporate controllers that they will not transfer an inappropriate degree of risk onto creditors and, through them, the community. This is embodied in the requirement that they maintain the solvency of their company or risk recision of the privilege.
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<tr>
<td>AGPS</td>
<td>Australian Government Printing Service</td>
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<td>Cohen Committee</td>
<td>United Kingdom, Report of the Company Law Committee 1945, London (Cmd 6659)</td>
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<td>Cork Committee</td>
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Part 9

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"There is little doubt that the separation of the corporation from the entrepreneurs behind it provided the 'essential impulse' to the most remarkable economic development of the last 200 years".

Kirby P.,
*Metal Manufacturers Ltd v Lewis* (1988) 6 ACLC 724 at 727.

**Limited Liability - A Necessary Evil**

This thesis precedes from the basis that the availability of the privilege of limited liability is a necessary stimulus to the successful functioning of the capitalist society. However it is also acknowledged that there is a cost to society, or at least a wealth redistribution effect, arising from the provision of the privilege. This cost is, at least initially, borne by the creditors of insolvent corporations.

**The Evolution of Abuse**

The privilege of limited liability was originally perceived as applicable to the "traditional" corporate form which was characterised by a separation between management and the providers of capital. Implicit in this was the understanding that the privilege might shelter shareholders from the full impact of the unavoidable vagaries of commercial life, at the expense of a corporation's creditors, but the separation of interests would ensure that any managerial misconduct, possibly including gross incompetence, would not go unchecked and so creditors would not bear losses arising from such misconduct. However with the adaptation of the corporate form to arrangements exhibiting an assimilation between management and the shareholders this check was removed. The avenues of managerial impeachment available to shareholders were obviously not availed of in such circumstances. Thus creditors had little protection from managerial misconduct or incompetence now sheltered by the combined effect of incorporation and limited liability.
A Balancing Act

It was incumbent upon the law to address this concern. However a fine line had to be negotiated lest the benefits perceived as arising from the availability of limited liability were stifled by a concern to protect creditors. A balancing act between the protection of creditors and the promotion of enterprise was required.

Piecemeal Reactive Reforms

The response was legislation directed at a specific type of abuse. Thus began a history of piecemeal, reactive and typically deficient legislative reforms. These inadequacies prompted creditors to explore other legal avenues for assistance. The common law dealing with fraud, fiduciaries, contract and torts have all had an application spawning further anomalies and judicial failings. Similarly other legislative provisions have occasionally been availed of thereby jeopardising the integrity of the corporations jurisprudence. The result has been a history of ad hoc decisions and precedent lacking in coherency.

It is arguable that the various ad hoc measures have significantly eroded the availability of the privilege of limited liability vis-a-vis creditors. The trend of both legislative and judicial development appears towards a general recognition that duties of both care and good faith are owed by corporate officials to creditors. Furthermore developments in the law of torts point to the derivation of either a common law or statutory action for misfeasance or nonfeasance in a corporate office.

The Modern Face of The Problem

As the entrepreneurial imagination has expanded into the realm of the corporate group and, more particularly, the international corporate group the protection of creditors has taken on a new dimension. Again the legal response has been reactive and piecemeal. Again a balancing act is required of the law.
The Thesis- An Historical and Comparative Analysis

The thesis proposed is that there is a need to establish a coherent regime for the protection of creditors of corporations, or more particularly, a regime which enables creditors to recover their debts, in appropriate circumstances, from the controllers of corporations. This thesis draws upon an historical and comparative analysis of the development of the avenues of recovery available to creditors of corporations in Australia leading to the introduction of the insolvent trading provision.¹

This analysis is also instructive in identifying the deficiencies in the law which inspired the reforms. The results of the analysis are then used to assess the adequacy of the new provision and whether the need exists for further reforms and, if so, whether some insight into the nature of these reforms can be identified.

More particularly it will be demonstrated that whilst the fraudulent and reckless trading provisions contained in S.592 and S.593 are deficient, developments drawing on the theme of these provisions could be envisaged which address these concerns. Given the interpretational and design issues associated with the insolvent trading provision it will be argued that there is some doubt as to whether the thematic development of the fraudulent and reckless trading provisions may not have been a more prudent exercise than the introduction of a new untested provision with which the business community is unfamiliar. Additionally the insolvent trading provision will be demonstrated to have embraced some of these deficiencies itself whereas many of the issues it does address had already been resolved in relation to the fraudulent and reckless trading provisions through ameliorative judicial pronouncements.

Furthermore this analysis will reveal that an issue at the centre of the development of the defaulting officer provisions has been whether individual creditors ought have standing and if so whether they ought be able to sue in their own or in a derivative or representative capacity. The resolution of this issue will be demonstrated to have significance for the design of the defaulting officer provisions. Given the conclusion

¹ During 1993 a new defaulting officer regime came into force in Australia replacing the Australian reckless and fraudulent trading provisions focused on this thesis. Whilst, from the perspective of identifying any theme to the development of the creditor recovery regimes operating in Australia and elsewhere, these earlier provisions with their many years of operation provide a more useful analytical base, any reform implications derived from this historical and comparative analysis will be assessed in the context of the new provisions.
in support of the provision of individual rights this casts further doubt on the desirability of the insolvent trading provision both from the perspective that it does not provide standing to individual creditors nor does it contain the necessary design features to adequately support such actions.

Notably if individual rights were provided then various issues identified in relation to the fraudulent and reckless trading provisions would gain currency and require resolution.\(^2\)

Other issues identified in the analysis have implications for the structure of the creditor recovery regime, specifically whether a distinction ought be drawn between the various types of companies for the purpose of defining the approach to be adopted, and emphasise the need for the maintenance of a balance between the protection of creditors and the encouragement of risk taking.

Indeed the need to ensure the appropriate sharing of risk is identified as the underlying rationale for the creditor recovery regime. It will be argued that the existence of the regime is a reflection that limited liability and incorporation are concerned with risk transfer. There is a price to be paid by incorporators for the privilege of transferring some of the commercial risk of a venture onto creditors and, through them, the general community and, furthermore, there is a proscription on what risks may be transferred. This underlying rationale manifests itself in two principles, namely that the price to be paid for the privilege of limited liability is that the enterprise must be appropriately capitalised and that where the solvency of the enterprise is doubtful the enterprise must be conducted with regard to the interests of its creditors as it is their financial interests that are at stake.

**Sub-Themes**

Within this broad thesis a number of sub-themes are explored.

*A tripartite structure*

Whilst it is argued that creditors are not a homogeneous group such an observation also applies to corporations and the people who control them. The types of corporations vary widely from small family concerns to substantial trading enterprises through to members of large multinational groups. Similarly the management and controllers

\(^2\) For example, as to what is required to establish insolvency, the determination as to the quantum of awards, the implications of negotiated settlements and whether directors can seek reimbursement from their company.
of corporations differ widely in levels of sophistication and comprehension. Certainly many corporate managers complain of the perception of over-regulation and overly complex laws.

A recovery regime for creditors ought to reflect this diversity, respond to the need to promulgate understandable and practical laws and avoid the potential stifling of entrepreneurial activity through excessive regulation. The legislation, whilst drawing on the general theme described above, should also be tailored to the characteristics of the entities which it seeks to regulate.

These considerations are reflected in the suggestion that a creditor recovery regime should differentiate between small closely held companies, the "typical" trading concern and members of corporate groups. The suggested form of response in each case is, respectively:

- a minimum capital level or, possibly, adoption of the commenda principle for small corporations,
- a defaulting officer regime for the "typical" trading concern, and
- a general but guided discretion in the courts to rescind the privilege of limited liability in the case of corporate groups.

**Individual cause of action or a collective regime?**

Recent legislation provides a mandatory collective regime for the recovery of corporate debts and denies individual creditors a direct remedy. Whilst a mandatory collective regime has some merit it is argued that this feature of the legislation precedes from a flawed view that creditors are a homogeneous group. Once it is recognized that creditors rights and interests differ widely and, in fact, some creditors may have built into their pricing structure a premium for the risks of contracting with a corporation whilst others may not have, then there is an argument for providing individual creditors with a cause of action.

**Directors' responsibilities and inadequacies of the current defaulting officer regime**

Whilst it is outside the parameters of this thesis to examine in detail directors' responsibilities, to the extent that creditors' rights have traditionally been protected through the medium of a defaulting officer regime, the analysis will incidentally examine the issue of directors' responsibilities, at least as they are relevant to creditors. It will be acknowledged that there is a perception that the pendulum has swung too much against directors. The proposals for reform seek to address this concern.
Finally, to the extent that the analysis reveals deficiencies in the legislation reviewed these deficiencies will be identified along with the necessary thematic development to address these concerns.

Chapter Outline

These themes and sub-themes are explored in ten chapters.

Chapter 2 - Limited Liability and Creditors' Recovery Rights
Chapter 2 examines the origins of limited liability and the circumstances which have given rise to the need for a creditor recovery regime. It will be argued that the legal avenues by which creditors can recover from controllers of corporations are varied and ad-hoc. At common law the privilege of limited liability may be rescinded in a number of circumstances. Furthermore there are equitable and tortious avenues for recovery from corporate management. Statute law also provides avenues for recovery. These avenues are primarily, but not exclusively, contained in the companies legislation. All these various common law and statutory remedies will be explored. It will be concluded that the protection thereby afforded to creditors of limited liability companies lacks any theoretical underpinning. The search for a theoretical base on which to establish an integrated and coherent creditor recovery regime and as to the most appropriate manner in which to give it legislative expression, will require a detailed analysis of the major categories of the existing regime. This analysis is the subject of chapters 3 to 6.

Chapter 3 - The Common Law Fiduciary Duty to Creditors
In an attempt to supply the defects of the creditor recovery regime contained in the companies legislation the judiciary embraced the equitable origins of company law and derived a fiduciary duty owed by the corporate management of insolvent companies to creditors. The development of this duty will be explored in chapter 3. It will be observed that it presents many theoretical and practical difficulties. Whilst providing some insight into the theoretical basis of a creditor recovery regime, it is argued that it otherwise has little to recommend it.

Chapter 4 - The First Defaulting Officer Provision - the Misfeasance Provision
The first legislative provision directed at the means of recovery by both shareholders and creditors from corporate management was, and still is, known as the misfeasance provision. In chapter 4 the development and current status of this provision will be examined from the
perspective of the avenue it provides for creditor recovery. It will be argued that the provision is significant for a number of reasons. Firstly it was initially interpreted as providing a general cause of action against misbehaving directors. Whilst this interpretation was subsequently over-ruled the concept provides an interesting reform possibility. Secondly, to the extent that the provision provides an important summary procedure by which to enforce various causes of action against defaulting corporate management, it is a critical element in the creditor recovery mechanism provided by the common law duty considered in chapter 3. Thus the adequacy of the provision from the perspective of the support it provides for the enforcement of this duty will be explored.Whilst it will be argued that the provision is generally adequate for this purpose there must be some doubt as to the appropriateness of the summary procedure in the difficult cases which typically arise in the enforcement of the common law duty. This serves to cast further doubt on the desirability of the common law duty as an element of a creditor recovery regime.

Chapter 5 - The Legislative Development of the Fraudulent and Reckless Trading Provisions

The inadequacies of both the common law and the misfeasance provision as the mechanism available to creditors seeking to recover from delinquent corporate management was the catalyst for a history of legislative activity that has continued unabated to the current day. The resultant legislation, known as the defaulting officer provisions, typically has embraced two provisions pursuant to which corporate management may be liable to creditors. The first of these applies where a fraud has been committed against the creditors and, accordingly, is known as the fraudulent trading provision. The second deals with managerial liability where a company has incurred debts in circumstances where these debts are unlikely to be paid. Whilst this latter provision differs in its precise form from jurisdiction to jurisdiction it can generally be described as a reckless, insolvent or wrongful trading provision.

The fraudulent and reckless trading provisions have been the centre piece of the regime providing creditors with a means of recovery from corporate controllers. Thus any themes discernible from an examination of the historical development of these provisions may be instructive for the identification of both the theoretical base of the creditor recovery regime and the likely future development of the legislation. This historical development will be explored in chapter 5. It will be observed that the Australian legislation has exhibited theoretical and practical deficiencies, many of which relate to the pivotal issue of whether individual creditors ought be provided with a cause of action.
under the provisions or whether a collective regime ought to apply.

Chapter 6 - The Judicial Interpretation of the Fraudulent and Reckless Trading Provisions
Many other deficiencies have been identified by the judiciary. Furthermore the judicial analysis of the defaulting officer provisions has shaped the scope and application of these provisions and contributed to an understanding of their theoretical basis. This judicial consideration will be explored in chapter 6. It will be argued that there has been a discernible trend towards extending the application of the provisions in furtherance of a policy of protecting creditors and strengthening the obligations imposed on directors. As a result many of the defects identified in relation to the provisions were remedied by ameliorative judicial pronouncements. Nevertheless problems have remained.

Chapter 7 - Creditors and Corporate Groups
With the greater sophistication of commerce the potential difficulties facing creditors of corporations have taken on an added dimension. The emergence of groups of companies, and especially multinational groups, have provided creditors with new obstacles when seeking to recover a debt owed by an insolvent company. The inadequacies of the law have provided the controllers of these groups with virtual immunity from the claims of unsatisfied creditors. Furthermore new avenues for abuse have evolved.

In chapter 7 the extent of this problem and the existing legal avenues available to creditors will be explored. It will be observed that the common law response has been inadequate, with the exception of certain tortious developments which are yet to be fully explored. Similarly the legislature has been slow to respond although reforms are beginning to belatedly materialise. It will be argued that reforms are urgently required although in the interim creditors might be able to seek some recovery through torts law remedies. The uncertainty and expense associated with this avenue does not, however, recommend it as a mechanism for recovery other than for creditors who have suffered major losses. Furthermore the divergence in policy considerations on which torts remedies are based from those underpinning the companies law raises a concern as to the integrity of a creditor recovery regime that encompasses tortious remedies.

Chapter 8 - Some International Perspectives
In assessing the Australian experience it is appropriate to compare it with developments overseas. The Australian legislation was born of United Kingdom precedents and so subsequent developments in the
United Kingdom are clearly relevant. Whilst these developments are explored throughout the body of the thesis, developments of significance in two other jurisdictions will also be canvassed in chapter 8.

The South African experiment presents a contrast to the creditor recovery regimes adopted in Australia and the United Kingdom. It will be observed that the United Kingdom Jenkins Committee had, amongst other recommendations, recommended the introduction of a reckless trading provisions in 1962. Whilst many of that committee's recommendations were adopted in both the United Kingdom and Australia, South Africa was the only jurisdiction to embrace that particular recommendation. The history of the resulting legislation will be explored. It will be argued that the subsequent judicial interpretation of the legislation has been such as to assimilate the scope of the provision with that of the subsequent Australian initiative. It will be further argued that the form of the Australian provision was preferable to that adopted in South Africa as it avoided the potential for the adoption by the Australian courts of the strained interpretation placed on the provision by the South African judiciary and was more suitable as a cause of action for individual creditors.

The other jurisdiction considered is New Zealand. For many years the New Zealand legislature embraced Australian developments with the exception of a special small company regime which provided a unique creditor recovery regime based on bankruptcy law. Subsequently a hybrid South African and Australian position was adopted. Most recently major reforms have been mooted which would involve a substantial departure from the traditional approach to a creditor recovery regime, embracing the concept of an insolvency test as a prerequisite to the entering into by a company of certain transactions.

It will be argued that the principle of a special small company regime has much to recommend it and, in fact, points to the general dichotomisation of the creditor recovery regime in recognition of the various types of corporate arrangements. Whilst the hybrid reckless trading provision also exhibits some benefits over the Australian approach, it is the current reform proposals that are most significant. It will be argued that these proposals assist in identifying the fundamental principles underlying the creditor recovery regime and, whilst probably too radical for legislative endorsement, provide an insight into the theoretical basis for any resultant legislation.
**Chapter 9 - Blueprint for Future Reforms**

The conclusions identified in the preceding chapters are drawn together in chapter 9 with a view to identifying a framework for future reform. The history of patchwork reforms and the need for a coherent creditor recovery regime is re-iterated. The common law duty to creditors is considered and dismissed as an element of this regime. The possible thematic development of the fraudulent and reckless trading provisions is identified together with the lessons provided by the New Zealand, South African and United Kingdom experiences. Reforms to cater for the position of creditors of group companies are also suggested.

A proposal that the creditor recovery regime differentiate between three types of corporate arrangements, namely small closely held companies, "typical" trading companies and members of corporate groups is advanced. Whilst defaulting officer provisions ought provide an adequate recovery mechanism for creditors of the "typical" trading company, the regime requires greater flexibility if it is to adequately protect creditors of group companies. To this end a provision empowering the judiciary with a substantial, although guided, discretion, modelled along the lines of certain taxation provisions, is mooted as a mechanism for group company creditor recovery. On the other hand, the problems of recovering from assetless controllers, the difficulties of establishing a case in the absence of access to detailed records and the desirability of keeping minor claims out of the courts suggest that, in the case of small closely held companies, preventative measures are more desirable than those providing a means of recovery. As these companies feature an assimilation between shareholder and managerial interests and as the cause of failure is typically attributed to under capitalisation it is proposed that the creditors of these companies be protected by either a partial denial of limited liability or a capitalisation requirement.

Finally it is emphasised that these reforms seek to balance the interests of creditors with the encouragement of entrepreneurial activity and recognise that although some commercial risk is to be legitimately transferred to the creditors there are some risks which the incorporators remain accountable for and at the point of insolvency the interests of the creditors become paramount.

**Chapter 10 - The Government's Response**

The inadequacies of the existing creditor recovery regime have not been lost on the Government and during the last six years a number of enquires have been commissioned with consequential reform
recommendations. The result has been the *Corporate Law Reform Act* 1992, the relevant provisions of which apply from June 24, 1993. These proposed and actual reforms are detailed in chapter 10. Essentially the defaulting officer provisions are recast as a duty to prevent a company from engaging in insolvent trading. Furthermore, provision is made for a cause of action against holding companies where subsidiaries have been allowed to trade whilst insolvent, although notably this provision does not go as far as the recommendations propose. It will be observed that whilst these reforms have generally been well received there has been some comment to the effect that certain deficiencies of the former provisions have been perpetuated and that the group company proposals are misguided. It will be argued that although the reforms satisfy the need to repair the defaulting officer provision the circumstances of small companies and also of members of corporate groups are not adequately addressed. Furthermore it is argued that the withdrawal of a cause of action from individual creditors is unsound.

Chapter 11 - A Comparison of the Government's Response to the Chapter 9 Proposals

These concerns are further explored in chapter 11, where the Government's reforms are examined in the context of the propositions expounded in chapter 9. Whilst it is argued that the insolvent trading provision generally satisfies one limb of the reform equation the legislation has failed to differentiate between types of corporate structures and to adequately address the problems presented to creditors by group companies, especially, multinational group companies. The approach to a recovery regime for creditors of group companies outlined in chapter 9, that is the provision of a general, although guided, discretion in the judiciary, is examined in greater detail. It is argued that this approach achieves a consensus between the twin, but often competing, aims of flexibility and certainty.

Furthermore, the case for maintaining a cause of action in individual creditors is explored. It is argued that a mandatory collective regime fails to appreciate the disparity characterised by creditor interests and is falsely based on the premise that all creditors are equal. Furthermore once it is recognised that the creditor recovery legislation is essentially about ensuring a legitimate transfer of risk and what is legitimate may, at least to some extent, depend on the circumstances of a particular creditor, the case for individual rights of some form is overwhelming.
Chapter 12 - Conclusion
Finally it is argued that an approach which embraces these proposals appropriately balances the protection of creditors with the promotion of enterprise and reflects that the foundation on which a creditor recovery regime is established is the need to ensure that creditors, and through them society, bear only the acceptable risks and costs associated with permitting the privilege of limited liability. It is the event of insolvency which provides the determining point for ascertaining what risks are, and what risks are not, acceptable.
1. Introduction

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CHAPTER 2

LIMITED LIABILITY AND CREDITORS' RECOVERY RIGHTS

"Either the limited company was a legal entity or it was not ... it is impossible to say at the same time that there is a company and there is not"

Lord Halsbury L.C.,

1. Introduction

A question of balance
Limited liability has often been cited as a great stimulus for enterprise. On the other hand there are those who cite the potential for abuse that it affords. Certainly in the last 125 years many creditors of corporations have had reason to lament the inception of the concept. The history of limited liability is, thus, one of a struggle to maintain a balance between the provision of this privilege and the availability of a recovery regime for creditors who have suffered loss as a result of the inappropriate reliance on the privilege.

Limited liability - a shield for abuse and incompetence
This chapter will explore the opportunities for abuse and the shield for incompetence provided by the availability of the privilege of limited liability. In particular, it will be argued that as a result of the assimilation of management and ownership it has been possible to abuse the privilege through the undercapitalization of an enterprise and poor management. These problems are compounded by the fact that the use of companies to conduct small enterprises has been on the increase. One consequence of this would appear to be that more

1 Generally see the discussion in Gower, chapter 3, especially at 41-47 and see Blumberg, "Limited liability and corporate groups", [1986] Jnl of Corp Law 573 at 573 - 605.

2 See Blumberg, ibid. For a recent expression of concern in the Australian context see the press release of an address by Senator Gareth Evans to a Business Seminar on Limited Liability and Minimum Capital Requirements organised by the Monash University Law Faculty, Regent Hotel, Melbourne, 30 August 1983. Prentice argues that the principle creates a perverse incentive for an insolvent company to continue to trade: "Creditor's interests and director's duties", (1990) 10 OJLS 265.

3 Of the 700,000 plus companies in Australia in 1987, less than 200,000 employed ten or more people. See the study by Professor Williams of the Faculty of Economics and
people are becoming involved in corporations who do not possess adequate skills or have access to sufficient funds. Symptomatic of this phenomenon is the increase in company failures.\(^4\)

Furthermore, the complex nature of commerce has manifested itself in the form of intricate corporate structures, often involving two or more related companies. These corporate structures have provided further opportunities for the privilege of limited liability to be inappropriately exploited.

The result has been that, traditionally, creditors of limited liability companies have borne a considerable risk of non payment and have, thus, ventured into contracting with corporations at their peril.\(^5\)

**A history of patchwork reforms**

This state of affairs has been exacerbated by the inadequacies of the statutory and common law avenues for recovery. The legal avenues available to creditors seeking redress from those involved with an insolvent company will be outlined. It will be argued that the response of both the judiciary and parliament to control the abuse of limited liability and provide an avenue of recovery for creditors has been both ad hoc and reactive. Little evidence that the recovery regime has embraced a coherent underlying theme is available nor has there been any real attempt to analyse the issues and possible responses in terms of the nature of the corporate structures at issue.

The recovery regime established to protect creditors has, typically, focused on corporate controllers or, more particularly, corporate officials. Whilst fraudulent behaviour by company officials has long been recognized as a disqualifying factor for those seeking the privilege of limited liability, the extent to which inadequate or irresponsible conduct short of fraud should be shielded by the privilege has proved a more vexed issue.

Originally, the judiciary assimilated the position of company officials with that of agents and trustees, and recognized the liability of these officials to the company for breaches of trust.\(^6\) Creditors, however, in

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4 See generally, Ibid. Amazingly approximately three quarters of new companies do not survive their first five years.

5 Not surprisingly self-help remedies have become a feature of commercial existence. Reliance on directors' guarantees, chattel mortgages and retention of title clauses is common. Collection agencies, creditor organizations and associated publications and information bureaux and collectives have also provided a source of protection.

6 In re Wincham Shipbuilding, Boiler and Salt Company (1878) 9 Ch D 322, 328;
the absence of fraud or exceptional circumstances, had no recourse except by virtue of proceedings by liquidators upon the winding up of the company. The liquidator in such circumstances could bring an action against such officials on behalf of the company, the fruits of which would normally be devoured by the creditors. The utility of such proceedings was recognized early by the inclusion in the Companies Act 1862 (UK) of a provision providing liquidators with a summary procedure by which to pursue such claims. This provision became known as the "misfeasance provision" by virtue of the description of the categories of reprehensible conduct to which it applied.

Although there was some initial hesitation it soon became settled that this provision did not provide any new statutory cause of action. The first statutory cause of action was the fraudulent trading provision contained in S.75(1) of the Companies Act 1928 (UK). Both this and the misfeasance provision were to form the nucleus of the recovery regime contained in the companies legislation. Whilst, over the years, many ad hoc and narrowly focused statutory causes of action have materialized, contained both in the companies legislation and other statutes, only recently has a more general cause of action been developed in the form of a provision imposing liability on company officials for reckless trading or, at least, the incurring of debts without any reasonable prospects that they would be paid, and now insolvent trading.

The common law has also witnessed some developments. Whilst the initial assimilation of the position of a director with that of a trustee recognized the director as owing a fiduciary duty of good faith to the company, recently this duty was extended to encompass the interests of creditors. However, the duty would appear to remain owed solely to the company. Whilst creditors might indirectly obtain some benefit from the enforcement of the duty by a liquidator of an insolvent company, no duty towards individual creditors would appear to exist, nor do creditors have standing to bring proceedings themselves.

The judiciary has yet to consider whether a similar metamorphosis in relation to the duty of care should occur. Nevertheless, there are some indications that should the corporate law duty not offer sufficient scope for the imposition of liability on corporate associates, then

Russell v Wakefield Waterworks Co (1875) 20 Eq 474; Re Oxford Benefit and Investment Society (1886) 35 Ch D 502. Gradually distinctions emerged: Re Forest of Dean (1878) 10 Ch 450; Smith v Anderson (1880) 15 Ch D 275; In re Faure Electric Accumulator Co (1889) 40 Ch D 150; Regal v Gulliver [1942] All ER 378. But see In re JE Hurdley & Son, Limited (in liq) [1941] NZLR 686, 725-726. Directors are probably best described as administrators of the corporate fund.
developments in the law of torts may fill this lacuna. In particular the torts arising from intentional unlawful acts, the tort of interference with contractual relations, the tort of conspiracy, the action for misfeasance in a public office and the general principles of negligence may provide creditors with some redress.

It will be concluded that any reform proposal must balance the need for a creditor recovery regime with the desirability of not excessively eroding the advantage secured by the privilege of limited liability. Furthermore for the recovery regime to effectively counter abuse of the privilege a clear vision is required of the underlying principle sought to be defined. The resultant legislation must also be adequately designed and expressed for the task required of it.

2. Origins of and Relationship between Incorporation and Limited Liability

Prior to examining the opportunity for abuse provided by the privilege of limited liability it is appropriate to explore the origins of the concept and, in particular, its relationship with the mechanism of incorporation.

Whilst the corporate form and the privilege of limited liability are distinct institutions, nevertheless it was the existence of the former which provided the opportunity for the general availability of the latter. Certainly the essential feature of a corporation from a creditor's perspective is the limited liability of its controllers. Piercing the corporate veil is for a creditor synonymous with rescinding the privilege of limited liability.

Prior to the introduction by the Joint Stock Companies Registration and Regulation Act 1844 (UK) of a routine method of obtaining incorporation by registration, companies were created either by charter, statute or at common law in the form of unincorporated joint stock companies or deed of settlement companies. The purpose of these companies was predominantly to provide the framework whereby a large number of persons could undertake a commercial venture in circumstances where most viewed the venture as an investment and wanted no managerial input but rather the ability to liquidate their investment at will.

7 For a detailed analysis of the origins of limited liability and its relationship to the entity principle see Gower, chapter 3, Ford, chapter 4 and Blumberg, "Limited liability and corporate groups", [1986] Jnl of Corp Law 573, especially at 577-605.
Limited liability was only occasionally a feature of such arrangements. Often the charter or statute limited liability of members by allowing creditors to recover only from the assets of the corporation. Similarly the common law companies often sought to limit the liability of their shareholders. However this limitation of liability applied only as between the shareholders unless third parties outside the company were given adequate notice that persons making contracts for the company did so only on the basis that the liability of the members was limited. This notice often took the form of a clause in the contract to the effect that the creditor could only recover from the common fund of the company.

With the enactment of the Limited Liability Act 1855 (UK) members were authorised to limit their liability to the amount not paid up on their shares. Thus, third parties dealing with a limited company were to be conclusively presumed to know of and to have accepted a term that they should have only limited recourse to the personal funds of the members. The Act did, however, provide for the joint and several liability of directors to creditors where loans or dividends were made or paid to shareholders by an insolvent company. The liability extended to the amount of the dividend or of the loan.

During the following year all the legislation relating to joint stock companies was consolidated in the Joint Stock Companies Act 1856 (UK). A further consolidation resulted in the enactment of the Companies Act 1862, the first version of the modern companies legislation.

This legislative recognition of the institution of limited liability eventuated only after considerable public debate. The major argument in support of its recognition was the national economic benefit which would accrue from the mobilisation of capital contributions in one enterprise by a large number of investors who would readily invest in the knowledge that their reserved resources would not be endangered.8

Thus, although limited liability has been associated with the process of incorporation it is not necessarily a feature of incorporation. Rather incorporation facilitates the granting of limited liability by virtue of the creation of a separate entity such that claims against the enterprise are restricted to the assets of the corporation. Only in the event that these assets are inadequate to meet these claims will the question of the liability of the members, and indeed corporate controllers, arise.

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8 The advantages and disadvantages of limited liability are detailed by Blumberg (Id) at 611-623. He concludes that limited liability is not essential for large scale economic activity.
Enterprise comprising numerous persons envisaged
Importantly the notions of incorporation and of limited liability both envisage a large enterprise comprising numerous members, some fulfilling a managerial role and others an investment role. The partnership form was clearly inadequate to accommodate such a structure and in the absence of a commenda type entity\(^9\) a corporation was the obvious framework for pursuing the enterprise. This was inherently recognized by the original legislation by virtue of the fact that the initial minimum shareholding in order to enjoy the benefits of limited liability was 25, although reduced to 7 by the time of the 1862 Act and since reduced to 2.

3. The Origins of Abuse of the Privilege of Limited Liability

3.1 Salomon v Salomon

The opportunity
This short history partly explains why the 1862 Act did not contain any provisions directed at creditor recovery from incorporators or corporate management other than the misfeasance provision. It was envisaged that the corporate owners would check the excesses of management thereby indirectly protecting creditors who otherwise had no recourse against a management sheltered by the corporate personality. The assumption was the existence of a dichotomy between management and ownership together with a balance of power, the inevitable consequence of the numbers associated with the enterprise. The assumption was however false and the opportunity thereby presented is well illustrated by the facts that gave rise to the Salomon v Salomon litigation during 1895 and 1896.\(^{10}\)

The facts
Mr Salomon had for a variety of reasons, the prime of which being to secure limited liability, transferred his boot manufacturing business to a company of which he and his immediate family were the only seven shareholders. Mr Salomon held 20,000 one penny shares whilst each of the other shareholders held one share each. Debentures forming a floating security on the capital were issued to Mr Salomon in part payment of the amount for which he sold his business to the company.

\(^9\) See the discussion in chapter 9, section 7.2.
\(^{10}\) Broderip v Salomon [1895] 2 Ch 323; 336 (CA); Salomon v Salomon [1897] AC 22 (HL).
The business went into decline leaving the unsecured creditors out of pocket. The issue was as to the liability of Mr Salomon.

**The Trial Judge**
*Vaughan-Williams J.,* at first instance, had little hesitation in holding that the company was the mere nominee or agent of Mr Salomon. To allow such an arrangement to stand would in the opinion of his Lordship have the effect of defeating and delaying creditors and accordingly there had to exist an implied agreement that Mr Salomon would indemnify the company against the debts which its assets were insufficient to pay.

**The Court of Appeal**
The Court of Appeal affirmed the decision although on a different basis, namely, that the object of the whole arrangement being contrary to the intent of the legislation it could not stand and rather the company was to be seen as the trustee for Mr Salomon. The Court considered it was never intended that limited liability would be extended to sole traders (or to a fewer number than seven) as was the effect of this arrangement. In their view if the legislature was in due course to extend the privilege to sole traders it would no doubt do so with such safeguards as it thought necessary.

The Court condemned such an arrangement as that effected by Mr Salomon. *Lindley L.J.* stated that:

"They do infinite mischief; they bring into disrepute one of the most useful statutes of modern times, by perverting its legitimate use, and by making it an instrument for cheating honest creditors....the scheme is a device to defraud creditors."13

In the words of *Lopes L.J.*:

"...to legalise such a transaction would be a scandal".14

When the *Davey Committee* reported its approval of this decision few would have given Mr Salomon's appeal to the House of Lords, much hope of success.

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11 [1895] 2 Ch 323.
12 [1895] 2 Ch 336.
13 Id, 339.
14 Id, 341.
15 1895 C 7779.
The House of Lords

However, as is well known, the House of Lords was to hand down the singularly most important decision for the development of company law.16 Their Lordships refused to impose liability on Mr Salomon. The mere existence of control was insufficient to render the company the agent of Mr Salomon in the absence of other evidence. Furthermore the company had been duly incorporated according to the express provisions of the 1862 Act and, in the absence of fraud, was not a sham. It was not possible to imply from the object and intent of the legislation that such a company was prohibited and its incorporation an improper application of the legislation. There simply was no evidence that it was contrary to the intent of the legislation and even if it was this did not of necessity mean that the company was then a trustee for Mr Salomon.

The judgments of their Lordships both implicitly and expressly imposed an onerous duty on creditors in their dealings with companies, justified as a necessary burden if the nation was to derive the benefits of a business community prospering under the mantle of limited liability. It was up to the creditors to protect themselves by checking the documentation filed by the company in which they would have discovered the terms of the purchase of the business, the issue of debentures to Mr Salomon and the number and value of shares held by each member. Indeed, Lord Watson stated that it was the duty of creditors to make such enquires and there was no obligation on the company or its shareholders to warn the creditors that they ran a risk of not being paid. The fact that, as the Court of Appeal acknowledged, in practice such enquires were not made, or were only made once a fear of not being paid had manifested, was not the point. In the words of Lord Watson:

"... the apathy of a creditor cannot justify an imputation of fraud against a limited company or its members, who have provided all the means of information which the Act of 1862 requires; and, in my opinion, a creditor who will not take the trouble to use the means which the statute provides for enabling him to protect himself must bear the consequences of his own negligence".17

The judgments also reveal that their Lordships were concerned with the possibility of opening the flood gates should Mr Salomon be personally liable. Where was the line to be drawn? This was a case where one out of seven shareholders controlled the company. Would it make any

16 [1897] AC 22.
17 Id, 40; Also see p.46 and p.53.
difference if three or four of the shareholders were "dummies" rather than six? In any event, it should not matter to the creditors how the shares were held given that the liability of the shareholders was limited.

Lord Herschell acknowledged it may have been that the arrangement at issue was not within the contemplation of the legislature when limited liability was given statutory recognition. His Lordship conceded that had it been then it was possible that a minimum sum may have been fixed as the least denomination of any particular shareholding.\(^{18}\) Presumably this would ensure a balance of power and accountability.

Lord Macnaghten agreed adding that in the absence of such provisions or provisions requiring that the members be independent or unconnected or that they should have a mind and will of their own or that there should be anything like a balance of power in the constitution of a company the arrangement had to stand.\(^{19}\)

3.2 Implications of Salomon v Salomon

The principle
The principle for which this case is authority is that a company has a separate identity from its controllers. The implications of this principle are profound and it has played a part in the development of virtually every aspect of company law.

In the context of the subject matter of this thesis the result of the case was that no matter how contrived and close the arrangement the active participants in the management of an enterprise could derive the advantages of limited liability through the medium of incorporation. This is arguably the real mischief of the decision.\(^{20}\) By permitting limited liability companies to exist where there was an assimilation of management and ownership the inherent checks which secured the integrity of the arrangement were removed. Who was now to complain of incompetent management or breach of trust? Who was to ensure that the enterprise was appropriately capitalised?

\(^{18}\) Supra, 46; The Companies Act 1980 (UK) requires that public limited companies have a minimum paid up capital of £50,000.

\(^{19}\) Supra, 51.

\(^{20}\) Some would argue that the real mischief of the decision was that it foreclosed the adoption in English law in relation to small enterprises of the commenda principle. Ford; Principles of Company Law (4th ed), Butterworths 1986 (Not taken up in the 6th edition.). Others would argue that it is the unreality and formalism into which the decision has led the law: Windeyer J, Gorton v FCT (1964-65) 113 CLR 604 at 627.
The exceptions
The subsequent developments directed at regulating this principle are the subject matter of this thesis. The decision itself recognizes that the principle is not unchallengeable and indeed postulates some limits of the principle. The veil may be pierced, and importantly for creditors the privilege of limited liability rescinded, where the company is a sham or where it can be shown that it was created in order to facilitate a fraud. Furthermore the privilege will be effectively lost if an agency or trustee relationship can be shown to exist.²¹

It will be argued below that an analysis of the case law in which these exceptions to the Salomon principle have been considered reveals no general theme as to their application which seemingly has been on an ad hoc basis.²²

The exceptions do, however, have one common feature namely that they were recognized in Salomons case. Thus the question arises as to whether the judgments in that decision provide an indication of any general theme underlying the exceptions? Furthermore does an investigation of these judgments provide or engender any other useful principles or indeed do these judgments provide assistance in determining the existence or otherwise of a central theme for the imposition of liability on corporate controllers for a corporation's debts?

Disclosure - the creditors' panacea?
One of the most notable aspects of the House of Lords decision is the emphasis placed by their Lordships on prevention rather than cure and on self help rather than regulatory intervention. Companies are under an obligation to disclose certain information and the onus is on creditors to satisfy themselves as to the desirability of dealing with the company. This philosophy of disclosure rather than regulation has been a feature of company law since its inception. In this context it is apparent that it derives from the freedom of contract principle, namely that a party can obtain limited liability provided that that is a term of the contract known and accepted by the other party. The requirement that the name of the company disclose the fact that the liability of its members is limited ensures that creditors have knowledge of this term. The financial disclosure requirements ensure that a source of information is available to creditors to enable them to ascertain whether

²¹ In such circumstances it is not correct to characterize the veil as being lifted, an error often made by the courts, for example see the House of Lords criticism of the decision of the Court of Appeal in Salomons case.
²² For example see the comprehensive analysis of these cases in Gower, Modern Company Law (4th ed) Stevens & Sons 1979, especially at pp.130-131 and pp.136-138. The analysis in the 5th edition is more truncated: see pp. 132-134.
they should accept this condition or make alternative arrangements such as securing personal guarantees.

The philosophy of freedom of contract is undergoing revision by those engaged in contract law reform and it is notable that this new attitude embracing regulation and control by the State has filtered through to company law manifesting itself in the form of increased control by regulation rather than by disclosure.

Control by disclosure or regulation?
The conflict between the House of Lords and the Court of Appeal may also provide some guidance for the future development of company law. The Court of Appeal emphasised the origins of the legislation - the need for a structure to accommodate large mixed groups of investors and managers at the same time encouraging investment by the availability of limited liability. The arrangement before the Court was not in the contemplation of the legislature with the result that no safeguards to regulate such arrangements had been enacted. Accordingly their Lordships saw it as their duty to protect the business community from this "perversion" of "one of the most useful statutes of modern times".

The House of Lords on the other hand took the conservative literalist approach that their duty was "to interpret the law not to make it" and that "the sole guide must be the statute itself". Given that the legislature had not contemplated the arrangement and there were, accordingly, no provisions in the legislation regulating it, the arrangement stood.

A question of classification
What this conflict highlights, apart from the philosophical schism between the courts, is an inadequacy in the relevant legislation that has been perpetuated through to modern times. The same legislation simply cannot deal with such dissimilar scenarios as a small closely held company and a large public investment enterprise. There is

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23 For example see the plethora of recent amendments to the Trade Practices Act 1974 (Aust), especially those effected by the Trade Practices Revision Act No.17, 1986, in particular the introduction of the basis of setting aside a contract for unconscionable conduct. The enactment of this provision follows the lead of the High Court in Commercial Bank of Australia Limited v Amadio (1983) 46 ALR 402; (1983) 57 ALJR 358; (1982-83) 151 CLR 447.
24 [1895] 2 Ch 336 at 341.
25 Id, 339.
26 [1897] AC 22 at 46.
27 Id, 29.
nothing new in this conclusion. The novelty is simply in the recognition that it has been obvious for so long.

A possible conclusion arising from this observation is that control by regulation of corporate conduct ought be a feature of the legislation authorising the creation of small closely controlled corporations. Control by disclosure might be restricted to legislation authorizing the creation of large corporations in the nature of investment vehicles.

Their Lordships provided some indications as to the type of regulatory safeguards that might be desirable. Minimum capital levels together with minimum share denominations are envisaged. Alternatively provisions requiring that members be independent or unconnected, or that they should have a mind and will of their own, or somehow ensuring that there is a balance of power in the constitution of a company, could be enacted.

However whatever regulations are enacted their Lordships warned of the danger of imposing too extensive restrictions or obligations, as in their view the decisions of the Court of Appeal and the Trial Judge would have done, as otherwise the national interest in fostering limited liability would be jeopardised. A balance is required.

Their Lordships also referred to the need to determine the point at which a controlling influence in the affairs of a company is manifested. This indeed is an acknowledgment of the major difficulty presented by an attempt to draw a dichotomy between large investment companies and small closely held entities. How and where is the line to be drawn?

The problem of group companies
A. Salomon and Company Ltd can be contrasted with a large listed public company but the grey area is clearly significant. In this context group companies present a particular problem. Where does a subsidiary of a large public company stand? If the company is wholly or substantially owned by its parent then the control factor is made out. Does it make any difference that the parent is a large public company, possibly a multinational corporation? The controlling shareholder in the

28 For example, see "Company Law and the Smaller Firm", (1988) 9 Co Law 118.
29 Ibid. The commentator acknowledges the need for reforms to the present legal regime for smaller businesses and notes the differing views as to whether more or less disclosure should be required of small companies. The arguments in favour of more disclosure do not take into account alternative control mechanisms and merely advocate more disclosure in the absence of any other form of control. To the extent that some control by disclosure is better than nothing no issue can be taken with these arguments.
subsidiary might be an artificial entity unlike Mr Salomon but nevertheless the purpose of the arrangement is most likely the same, to obtain the advantage of limited liability in respect of a particular enterprise.

Another problem presented by a group of companies arises if the creditors of such a company adopt the advice of the House of Lords and examine the financial information disclosed by the company. In the case of a typical company envisaged by the 1862 Act they will discover a large pool of investment funds and other financial information arguably sufficient for them to make a decision as to the prospects of repayment. Where the company is a member of a group the creditors might discover the connection with a large conglomerate of corporations. Most likely the affiliation of the company with these entities would already be known given the common practice of advertising in the corporate letterhead the impressive connections of the company. Connections however without strings. A creditor seeking to rely on these connections to support the financial position of an insolvent subsidiary may be rudely disappointed. In effect the disclosure, far from protecting creditors, may act to their disadvantage by luring them into a false sense of security.

The judgments handed down in the Salomon litigation provide little assistance in answering the question as to how corporate groups should be dealt with. The concept of a corporate group was not only not within the contemplation of the legislature; it was not within that of their Lordships nor even the business community.30

The issue of creditor recovery in the context of group companies is the subject matter of chapter 7.

4. Circumstances where the Privilege is Rescinded

Whilst the privilege of limited liability has become institutionalised in capitalist society, the law has developed limits to the principle which provide creditors of insolvent companies with some scope to recovery from corporate controllers. It is proposed to briefly outline the various avenues of recovery available. It will be argued that these are ad hoc and provide no central theme.

4.1 The common law

Traditional heads of rescission
The analysis of *Salomon v Salomon* identified four\(^{31}\) traditional circumstances in which the corporate veil might be lifted in such a way as to rescind the privilege of limited liability;\(^{32}\)

(i) where the company was formed in order to enable fraud or improper conduct to be perpetrated,

(ii) where the company is a "sham" or "facade" or merely an "alias" of its controller, including circumstances where the company has failed to satisfy the essential conditions of incorporation,

(iii) where an equity arises such that the company is properly the trustee for its controller, and

(iv) where there is evidence that the company is acting as the agent of its controller.

A fifth category-the economic unit?
Since the English Court of Appeal decision in *DHN Food Distributors Ltd v Tower Hamlets London Borough Council*\(^{33}\) it has been argued that there is a fifth category namely that the veil will be lifted and the privilege of limited liability rescinded where the business realities are such that in truth there is one economic unit in existence.

Much was initially made of this decision. It was said that it was "but a short step" to "the proposition that the courts may disregard *Salomons case* whenever it is just and equitable to do so".\(^{34}\) Subsequent cases have, however, casts serious doubts on the decision. In *Woolfson v Strathclyde Regional Council*\(^{35}\) the House of Lords distinguished and

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31 A further exception of national emergency will not be considered (see for an example of the application of this exception Daimler Co Ltd v Continental Tyre and Rubber Co Ltd [1916] 2 AC 307).

32 For current purposes no distinction will be drawn between circumstances and legislative provisions which result in the actual piercing of the corporate veil as distinct from some other form of rationalisation as to the basis upon which liability has been imposed on corporate officials. Where the effect is the imposition of liability on corporate officials this will be described as lifting or piercing the veil notwithstanding that a more precious rationalisation could be formulated. Note Ford, (Op. cit.) (4th edition), 92.

33 [1976] 1 WLR 852 (CA).


35 [1978] SC (HL) 90; Followed in Stewarts Supermarkets v Secretary of State (1982) 8 NILRB 1; Discussed in a note in (1986) 7 Co Law 157; Williams & Humbert Ltd v W &
doubted it, Lord Fraser stating that he doubted that the Court of Appeal had properly applied the principle that the corporate veil could only be pierced where special circumstances exist indicating that it is a mere facade concealing the true facts. As a result of this comment it has been argued that the case is best understood as an improper application of either the fraud or sham categories of lifting the veil.\textsuperscript{36}

More recently Young J. of the Supreme Court of New South Wales in Pioneer Concrete Services Ltd v Yelna Pty Ltd expressed strong disapproval of the DHN case stating that it ought to be viewed as "one of those too hard cases in which judges have for policy reasons justified the lifting of the corporate veil" rather than as a "case which lays down any great principle".\textsuperscript{37}

His Honour stated that the DHN principle ought to be confined to cases where:

"...the court can see that there is in fact or in law a partnership between companies in a group or alternatively where there is a mere sham or facade".\textsuperscript{38}

This has not surprisingly led to the argument that the DHN principle has been rendered completely impotent. Either the fraud and sham categories would cover any potential field of operation of the principle or if the company is in a partnership the actions of the company will bind the other partners according to normal partnership law without any recourse to notions of lifting the corporate veil.\textsuperscript{39}

Furthermore, there are numerous authorities which support the existence of the separate legal identity of holding and subsidiary companies. These cases together with an analysis of the reasoning and authorities relied on the DHN decision add to the doubts associated with that case.\textsuperscript{40} Taking all these factors into account, it would seem an "unchallengeable" proposition that that decision "was
an aberration".41

Thus there remain four traditional categories although there is even disagreement as to the integrity of these four categories. For example, Gower merges the first three of these categories into the "mere facade" category which he describes as the only true veil lifting category. He notes the lack of judicial guidance as to when a company will be treated as a mere facade. Gower then adds a further category, namely that the courts will effectively lift the corporate veil where the construction of a statute, contract or other document requires it. Ultimately, however, he acknowledges that the judicial inroads into the corporate entity principle would appear to have contracted in recent years.42

No central theme
This uncertainty as to how to categorise the instances of piercing the corporate veil illustrates what has been acknowledged by many commentators, namely that these instances disclose no central theme and the circumstances in which the common law will pierce the corporate veil is difficult to accurately predict.43 Recent decisions support this sentiment. For example, in Briggs v James Hardie & Co Pty Ltd44 the New South Wales Court of Appeal refused to lift the veil between group companies in the context of a tort action. The caselaw was comprehensively reviewed but the Court conceded that no general principle was identifiable. Certainly complete ownership and control by itself was insufficient.45 Particular weight was attached to the English Court of Appeal decision in Maclaine Watson & Co Ltd v Department of Trade & Industry46 which had reached a similar conclusion.

41 Id, 422. The lifting of the corporate veil in the context of group companies will be explored further in chapter 7.
42 See Gower, chapter 6.
44 (1989) 7 ACLR 841. Also see the New Zealand decision of Trevor Ivory Ltd & Anor v Anderson & Ors (1992) 6 NZCLC 67, 611.
45 Also see Denis Willcox Pty Ltd v FCT 88 ATC 4292; (1988) 79 ALR 267.
Little reliance on these principles by creditors

In any event the existence of a central theme to the application of these exceptions to the principle in *Salomons case* is arguably not of major concern in the context of creditors' rights. This is because there are few reported decisions where creditors have sought to rely on the application of any of these exceptions.

In the context of the fraud or sham exceptions the absence of cases can probably be explained by the existence of alternative actions available to creditors in the event that a company is used to perpetrate fraud, such as that provided by the fraudulent trading provision. The greater certainty surrounding the application of these provisions makes them more attractive to creditors than reliance on the uncertain application of the Salomon exceptions.

Nevertheless there are some examples of the application of the fraud exception for the benefit of creditors. In *Re Darby*47 an action against a bankrupt director for secret profits upon the sale of the company's business at an overvalue to a company owned by the director succeeded notwithstanding the director's claim that the profit was derived by the other company and not himself. More recently in *Re A Company*48 a prospective insolvent divested himself of his assets to a complex network of corporations for the purpose of defeating any future recovery by his creditors and the Court had no hesitation in piercing the veil where necessary in order to ensure that justice was done.

Similarly the agency and trustee exceptions have rarely been relied upon by creditors probably because, as *Salomons case* demonstrates, the courts require substantial evidence before they will infer such a relationship. This would appear to be so regardless of whether it is the creditors of the company who are seeking to lift the veil or the creditors of an insolvent company controller. The case of *Clarkson Co Ltd v Zhelka* 49 illustrates that the courts are just as hesitant to lift the veil in the latter circumstances. This was so notwithstanding that the bankrupt, who was in complete control and domination of a family of companies, had conducted their affairs with the view of delaying and

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47 [1911] 1 KB 95.
49 (1967) 64 DLR (2d) 457.
hindering their creditors. The Court examined the various heads of exceptions but, although agreeing that the case was close to the line, concluded that the facts did not support the application of one of these exceptions.

This is not to say that in appropriate circumstances an equity might not arise between the creditor of a company and its directors. In *Lion Breweries Ltd v Scarrot* 50 the New Zealand High Court held directors liable to account for the proceeds of a sale by auction carried out by a since insolvent company in circumstances where the directors were aware of the facts and party to the company's breaches of fiduciary duty. Thus where a creditor is owed a fiduciary duty by the debtor company equity may supply a remedy against the company's directors.

4.2 Contract and torts law 51

In addition to the limited common law instances in which corporate controllers may be responsible for corporate obligations liability may attach by virtue of the general principles of contract and torts law.

*Contract law*

Where a corporate official enters into a contract then, should the third party be unaware that the individual is contracting on behalf of a company, liability will attach to the individual pursuant to normal contractual principles. 52 In some instances the courts have held that the individual is jointly liable with the company on the basis that he contracted on behalf of himself and the company. 53 This situation often arises where the individual induces the third party to contract with the company on the understanding that the individual is associated with the company. In effect the individual guarantees the performance of the contract.

More commonly creditors will require express guarantees or indemnities from corporate officials.


51 The criminal law provides various crimes in relation to defrauding creditors. Where persons have been so convicted most jurisdictions empower the courts to order the felon to compensate those wronged, either at the discretion of the court or upon application by a creditor. It is not intended to canvass either these provisions, or other provisions or common law principles which are directed at fraud generally.

52 However as a general principle a director is not personally liable to a third party on a contract into which he has entered on behalf of his company: Ferguson v Wilson (1866) LR 2 Ch App 77.

Occasionally the courts have found the existence of an express agency relationship so rendering the controller liable. More often the courts have found that there is an implied agency relationship, thereby upholding one of the exceptions to the Salomon principle.

A director may also be liable on the ground of breach of warranty of authority, where he has acted beyond his own powers or the powers of the company, and this was not actually or constructively known by the other party. He will also be liable if he contracts on behalf of an illusory company, and also for ultra vires acts.

There are also instances where directors have been held liable to third parties for a company's wrongdoing where they expressly authorized the conduct complained of. The complicity of the company's agent can render him liable together with the company.

Torts law
Although the instances to date where corporate controllers have been held liable in tort for corporate obligations are rare, recent developments in the law of torts provide significant scope for the imposition of liability. The following torts have particular relevance:

(i) deceit,
(ii) conspiracy,
(iii) interference with contractual relations,
(iv) the general torts arising from intentional unlawful acts,
(v) misfeasance in a public office, and
(vi) negligence.

A difficult question of policy
Before examining these torts it would appear since C Evans & Son Ltd

54 See Gower (op. cit.) 132.
55 West London Commercial Bank Ltd v Kitson (1884) 13 QBD 360; Firbank's Executors v Humphreys (1886) 18 QBD 54.
56 Harrill v Davis 168 F 187 (1909).
Chapter 2
Creditors' Recovery Rights

v Spritebrand Ltd & Anor\textsuperscript{59} that a director who had authorized, directed and procured the commission by a company of a tortious act cannot be personally liable in tort unless it is established that he committed the acts in the knowledge that they were tortious or had acted recklessly without caring whether they were or not. Conversely a director is not automatically liable for the torts of his company no matter how small the company or how powerful his control over its affairs. Rather whether a director is personally liable in tort is a product of all the circumstances, in particular the role he played in relation to the alleged tortious acts.

Some doubt in this regard had been created by earlier English and Canadian authorities.\textsuperscript{60} Probably these cases should best be characterized as stating an element to be established in order to make out the specific torts at issue in each case or simply as an over-zealous attempt to protect the principle of limited liability from erosion via the medium of torts law. Certainly these cases highlight the difficult policy questions at issue. In the words of Le Dain J. in Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing Co Inc\textsuperscript{61}

"What is involved here is a very difficult question of policy. On the one hand, there is the principle that an incorporated company is separate and distinct in law from its shareholders, directors and officers, and it is in the interests of the commercial purposes served by the incorporated enterprise that they should as a general rule enjoy the benefit of the limited liability afforded by incorporation. On the other hand, there is the principle that everyone should answer for his tortious acts. The balancing of these two considerations is particularly difficult."

Thus, subject to implications arising from these background policy issues, torts law principles may apply to company directors in the same way as to any other persons. Therefore it will normally be necessary to show that either the company was the agent of the director or the director owed a personal duty of care.

4.2.1 Deceit

Prior to the introduction of the statutory remedy for corporate fraud, this remedy was provided by the tort of deceit. Some would argue that its

\textsuperscript{59} [1985] 2 All ER 415.
\textsuperscript{60} Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing Co Inc (1978) 89 DLR (3d) 195; White Horse Distillers Ltd v Gregson Associates Ltd [1984] RPC 61; Fairfax Dental Ltd v SJ Filhol Ltd (20 July 1984 Unreported).
\textsuperscript{61} (1978) 89 DLR (3d) 195 at 202.
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inadequacies stimulated the enactment of the statutory remedy, although there is also a view that the statutory remedy adds nothing to the law.

The tort of deceit requires proof of a subjective dishonest intention in circumstances where a false representation is made which induces the representee to act to his detriment.

Williams claims that litigants have overlooked the advantages enjoyed by this action over the statutory remedy. For example, it is available against all companies and not a limited category of insolvent or terminating companies, the plaintiff need not secure a conviction of the defendant before instituting civil proceedings as traditionally required by the Australian fraudulent trading provision, any moneys awarded by the court as damages accrue to the plaintiff and not the company, and the plaintiff is entitled to damages as of right and not as a matter of the court's discretion. Williams does however acknowledge the difficulties presented by the common law action.

In practice the action is normally only pursued where the company is insolvent, as only then is there a financial advantage in suing officers involved in the fraud rather than in suing the company in contract or in tort.

Ultimately however, the very fact that a need was perceived for the introduction of the statutory remedy during the 1930s, and that there has been little development of the tort of deceit in the 50 years since indicates the questionable utility of the tort in this context.

4.2.2 Conspiracy

The tort of conspiracy requires proof that two or more persons have combined together with the intention of injuring another and damage has in fact resulted to the other. It is a defence to show that the predominant purpose of the combination was the lawful protection or promotion of any lawful interests of the combiners. That is, if the common object or motive is "the protection or advancement of trading, professional or economic interests common to the defendants, there is no liability".

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63 R v Rollafson [1969] 2 All ER 833, 834.
64 Derry v Peek (1889) 14 App Cas 337(HL).
65 Williams, op. cit. 15-16.
66 Id, 15.
67 McKean v Fraser (1931) 46 CLR 343, 400 per Evatt J.; See generally Trindade and
It is conceivable that circumstances could arise where a company and/or its controllers could be said to be acting together with the intent of injuring creditors and that the subsequent insolvency of the company does in fact cause damage to the creditors. Arguably the defence would be unavailable to the controllers because the interests of the company are hardly being advanced in circumstances where it is rendered insolvent.

Except where group companies are concerned it is questionable whether the availability of this tort advances creditors' rights. It is likely that corporate controllers in circumstances where a conspiracy could be established would be liable on the ground of common law fraud or by virtue of the fraudulent, or more recently, reckless or wrongful trading provisions. Nevertheless there may be circumstances where these alternative causes of action cannot be established. In particular an application of the tort could be envisaged in the context of group companies where a subsidiary has been left to languish by the other group members. Even in such circumstances the need to establish that the conspirators had an intent to injure creditors may limit the usefulness of the tort although arguably this element imposes a lesser burden than the element of an intent to deceive which must be proved in order to make out fraud.

Furthermore there is some contention as to whether there can be a conspiracy between a company and its controller. The basis for this view is that "it would be artificial to take the view that the company, although it is clearly a separate legal entity, can be regarded as a separate person or a separate mind". On the other hand there is authority stating an alternative view and in Belmont Finance Corp Ltd v Williams Furniture Ltd, whilst the company was found not liable in conspiracy with its directors because it lacked knowledge, no issue was raised that it might lack capacity to conspire.

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68 Conceivably a conspiracy could arise where the conduct of one person constitutes both an individual's conduct and that of the company. This is discussed below.


70 R v ICR Haulage Ltd [1944] KB 551; [1944] 1 All ER 941 (CCA); R v Blamires Transport Services Ltd [1964] 1 QB 278; [1963] 3 All ER 170 (CA). Also the High Court has recently held that a managing director can be liable as an accessory to offences committed by a company: Hamilton v Whitehead (1989) 7 ACLC 34.

Conceivably any difficulty here might be avoided by reliance on the fact that a company may have no fewer than two shareholders and two directors and arguing that these two persons were the relevant conspirators. The difficulty with this argument is that unless they can both be shown to be playing an active part in the conduct and control of the company or at least in the specific matter giving rise to the action, then the tort would not be made out. The fact that one shareholder or director is merely a nominee providing the necessary consent as and when required and otherwise acquiescing in the other director's or shareholder's control of the company will not satisfy the requirements for a conspiracy.

4.2.3 Interference with contractual relations

This tort requires proof of conduct which either induces a breach of contract or interferes in some way with its performance. This conduct may take the form of a direct or indirect interference. Direct interference is in the nature of direct persuasion or inducement to breach a contract or by direct action such as action to prevent a party to a contract from performing his part of the contract. Except in the event of the first type of direct interference the traditional view is that the interference must be effected by or include an unlawful act.\(^\text{72}\)

Where an indirect interference is relied upon the breach of contract complained of must be the necessary consequence of the interference.\(^\text{73}\)

The tort also requires proof that the defendant knowingly induced or procured the breach. This can be established by showing that the defendant had knowledge of the existence of the contract and also had an intention to interfere with its performance. There is some authority to the effect that constructive knowledge of the contract, that is the knowledge of a reasonable man, will suffice. An intentional interference includes both deliberate and reckless interference. Should the defendant reasonably entertain a bona fide belief that he was not inducing a breach of contract he will not be liable.\(^\text{74}\)

It is a defence to the tort to establish that the interference was justified. A common justification is where the defendant interferes in order to protect his own existing contracts in circumstances where the contracts interfered with were inconsistent with these earlier contracts.

\(^{72}\) See Trindade and Cane, 178.
\(^{73}\) Id, 179.
\(^{74}\) Id, 179-181.
Where the controller of the company conducts the business of the company in such a way that it cannot pay its debts the controller could be said to have induced the company to breach its contracts. The interference could be said to be direct, by virtue of the fact that the controller in its capacity as the mind and will of the company has decided that the company will not pay a debt; or indirect, in that the company is prevented from paying the debt either by virtue of the fact that the company has been rendered insolvent or is simply unable to pay this particular debt by virtue of the conduct of the controller. Relevant conduct might be the manner in which the business of the company generally has been conducted, the payment of other debts in lieu of the debt in issue, the failure to provide sufficient capital to conduct the business or the drawing of funds from the company.

The requirement of an unlawful act
Although the requirement that the defendant have knowledge of the contract should normally be satisfied given that the defendant controls the company, proof of an intent to interfere with its performance may be more difficult. Furthermore if and where it is required to establish the existence of an unlawful act this too may limit the applicability of the tort. For example in *Airlines Airspaces Ltd v Handley Page Ltd*75 a receiver and manager was held entitled, in the absence of fraud or impropriety, to frustrate a contract entered into by the company by causing the subject matter to be transferred to a subsidiary incorporated for that purpose. The decision turned on the special position of a receiver and manager in respect of contracts between unsecured creditors and the company. It is arguable that a mere director would have been liable on these facts, such conduct being in breach of his duties to the company, and hence unlawful.

On the other hand, in *Einhorn v Westminster Investments Ltd*76 Disbery J. upheld the validity of a statement of claim alleging that directors, who had prevented a company from performing its contract by diverting its assets to an associated company, had committed the tort of inducing a breach of contract. His Honour did not require that the plaintiff prove interference by an unlawful act, the conduct of the directors being tantamount to fraud.

76 (1969) 6 DLR (3d) 71(Sask); Affirmed (1973) 73 WWR 161(CA). Also see Thermo King Corp v Provincial Bank of Canada (1981) 130 DLR (3d) 256 (Ont CA).
Similarly in *Esso Petroleum Ltd v Kingswood Motors (Addlestone) Ltd*\(^77\) an injunction was granted requiring a company to retransfer service station premises to a fellow subsidiary company, the defendant, in circumstances where the original transfer had had the effect of defeating a solus agreement between the defendant and the plaintiff. The Court considered that such an order was necessary in order to remedy the consequences of a conspiracy to induce a breach of contract. The holding and subsidiary companies, once they had control over the defendant company, procured a direct breach by it of its contractual obligations. This interference with the contractual relationship was both deliberate and direct.

The particular feature of these cases is that there was a direct interference with the contract so the courts were not concerned to establish an unlawful act, whilst at the same time the interfering conduct clearly evidenced an intent to interfere. This situation can be distinguished from where a company becomes unable to pay its obligations due to its insolvency. In such circumstances proof of an intent to interfere by an unlawful act would probably be required and may be difficult. In any event it is likely that if such an act can be established it would render the directors liable to impeachment under the fraudulent or reckless/wrongful trading provisions or constitute a breach of duty. For example had the defendant in the *Airspaces case* been a director he might have been liable for breach of his duty as a director. However, admittedly, this would only have entitled the company or a liquidator to proceed against him whereas the tortious action is available to the creditor.

Thus as with the tort of conspiracy there is probably little incentive for creditors to rely on this tort given the general availability of alternative actions. Only where these alternative remedies are inadequate or non-existent can reliance on this tort be justified. Again in chapter 7 the relevance of the tort in the context of group companies will be explored.

### 4.2.4 General torts arising from intentional unlawful acts

There is some authority in Australia, England and Canada for the existence of a tort of causing loss by interference with trade or business by unlawful means. It is uncertain whether it requires proof of an intent to inflict harm or merely proof of an intentional act which results in harm.\(^78\) The tort clearly encompasses the tort of interference

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77 [1973] 3 All ER 1057.
78 See generally Trindade and Cane (op. cit.), 194-196, Hazel Carty, "Unlawful..."
with contractual relations as well as the other economic torts. However, to the extent that its potential application is broader it may enhance the rights of creditors.

The tort has been applied in a number of contexts. One context has been the power of trade unions to affect proposed contractual arrangements or to affect the performance of a contract short of its breach. Another is in the context of the sale of illegal recordings of live performances where although no contracts are breached by this "bootlegging" the potential profits from contracts between musicians and recording companies are reduced.\(^79\) The cases in this latter category appear to accept that unlawful acts include those which are not independently actionable but only constitute the breach of a purely penal statute, but are conflicting on whether interference with contractual expectations or profit potential or with the economic advantages to be obtained from a contract satisfy the requirement of interference with trade.

The most important context for present purposes however is that of associated companies and the issue of instructions from one to another to the effect that the subsidiary should not enter into any further contracts with the plaintiff. This point will be further discussed in chapter 7.

What these cases demonstrate is that the tort of unlawful inducement of breach of contract may actually be broader in its application than traditionally viewed or merely a specific instance of a wider tort of unlawful interference with trade. Except to the extent that this wider tort might require a lower standard of unlawfulness it arguably adds little to the rights of a creditor of an insolvent company where the failure of the company to pay its debt clearly constitutes a breach of contract.

Furthermore there is Australian authority for the existence of a tort where a person causes loss to another as the inevitable consequence of his unlawful intentional and positive acts. It is clear that this tort does not require an intent to cause harm but merely an intentional unlawful act which in fact causes harm.\(^80\)

\(^79\) Ibid.

\(^80\) Beaudesert Shire Council v Smith (1966) 120 CLR 145. Discussed in Trindade and Cane at p.197.
Identifying the unlawful act

It is conceivable that circumstances may arise where these torts could provide a creditor with a cause of action. The major limitation is the need to establish the existence of an unlawful act by the company's controller together with a connection between that act and the loss to the creditor. There will normally be a variety of acts and events which could be particularised as giving rise to the creditor's loss or otherwise interfering with the business of the creditor. For example: (a) causing the company to contract with the creditor, (b) causing the company to be liquidated, (c) causing the company to incur other debts, or (d) causing the business of the company to be conducted in a particular way.

Probably the answer to determining what is the relevant act is to identify the main cause of the company's insolvency. Once this act is identified it is still necessary to establish that it was unlawful and it may also be necessary to establish that it was performed with an intent to inflict harm on the creditor. Should causing the company to enter into the contract be identified as the relevant act then proof that this was unlawful might cause further problems for the creditor because in some circumstances an unlawful contract is unenforceable.

It is submitted that this requirement that the act which caused the creditor's loss be unlawful is a major limitation on the applicability of these torts as where the act is shown to be unlawful then the creditor would probably have more appropriate alternative remedies. However there is some authority for the proposition that, at least in the context of the tort of unlawful interference with trade, "unlawful" means an act that the defendant is not at liberty to commit, for example, a breach of a penal statute, and is not restricted to independently actionable wrongs. This point is further explored in chapter 7. In any event there may also be occasions where the creditor's loss cannot be attributed to the acts of the controlling official, such as where the insolvency of the company arises due to external circumstances.

4.2.5 Misfeasance in a public office

Where a public officer does an act which to his knowledge amounts to an abuse of his office and he thereby causes harm to another person then an action in tort for misfeasance in a public office may be brought
against him at the suit of that person.\textsuperscript{83} It is conceivable that with some further development this tort might have an application to companies in their dealings with the public, especially creditors.

A public officer has been defined as a person who is paid out of public funds and who "owes duties to members of the public as to how the office shall be exercised".\textsuperscript{84} An actionable abuse arises where such an officer acts maliciously in the sense of having an intent to injure or where he acts with knowledge that what he is doing is in excess of his powers. A plaintiff must not only show damage but also that he is a member of the public to whom the holder of the office owed a duty not to commit the particular abuse complained of.

Certainly with respect to the largest corporations operating within Australia there is a case for arguing that their officials are public officers, being indirectly paid from public funds, being the funds generated by the extensive business of the company. In particular, with the trend towards privatisation of traditional public functions there is likely to be a further blurring of the concept of public officer with that of the corporate official.\textsuperscript{85} Furthermore, the privilege of limited liability could be said to carry with it certain community responsibilities, thereby establishing a case for extending the definition of public officers to encompass all company officials. This would lead to the proposition that there is a duty on all who shelter behind this privilege not to abuse it and when they do a creditor who suffers consequential damage may bring an action against them.

Over the last 125 years there have been various judicial references to the civic responsibilities of corporate officials and companies generally. The difficulty is determining when in fact such obligations have been breached. What conduct does amount to abuse of the corporate office? Fraud has long been regarded as such conduct and more recently recklessness. Further specific instances of unacceptable conduct have been recognized by the legislature.\textsuperscript{86}

Probably rather than providing an alternative cause of action this tort then provides the underlying rationale for the instances where the law has allowed creditors resort against corporate officials. The more specific causes of action such as fraudulent and reckless/wrongful trading simply particularise acts which the law considers as unlawful or as amounting to an abuse of office.

\textsuperscript{83} See generally Trindade and Cane, 198-199.
\textsuperscript{84} Tampion v Anderson [1973] VR 715, 720.
\textsuperscript{85} See Balkin & Davis, Law of Torts (1st ed), Butterworths Australia 1991 at 781.
\textsuperscript{86} See section 4.3 below.
4.2.6 Negligence

Company law traditionally has not recognized any causes of action for losses arising from nonfeasance. No conduct short of fraud or recklessness has given rise to liability. The general view is that the common law duty to creditors rather surprisingly derived from the duty of good faith rather than the duty of care, although it will be observed in chapter 3 that there is some authority for this duty having its origins in the tort of negligence. In any event to date that duty is yet to experience any developments in support of creditors' rights as opposed to those of shareholders.

With the recent recognition by the courts that an action can lie in negligence for pure economic loss it is conceivable that officials could be liable in negligence to creditors for losses incurred by them arising from corporate insolvency. In its present state of development the law of negligence requires that there exist between the plaintiff and defendant a special relationship on the basis of which the defendant ought to have the plaintiff particularly in mind as likely to suffer economic loss.\textsuperscript{87}

A dichotomy is made between ad hoc and continuing relationships. In the case of ad hoc relationships a distinction is drawn between statements and acts. Negligent mis-statements have been actionable for the last 30 years. The plaintiff must establish that he relied on a negligently made statement resulting in loss in circumstances where the maker knew that it would be used by a specific class of persons in a specific class of transactions. In the same way that an accountant might be liable to company investors for carelessly preparing an account, a director could conceivably be liable to creditors for careless statements inducing them to grant credit to the company.

More recently, liability has been held to lie for negligent acts causing economic loss. The leading case is the High Court decision in \textit{Caltex Oil (Australia) Pty Ltd v Dredge "Willemstad"}\textsuperscript{88}. The judgments in that decision appear to lay down three alternative principles. Their Honours are undecided as to whether foreseeability of loss to the particular

\textsuperscript{87} See generally Trindade & Cane, 296-305 and Balkin & Davis, 418-450. Of course, tortious liability may arise from the special circumstances of the directors' dealings involving the creditor. For example, see Kuwait Asia Bank EC v National Mutual Life Nominees Ltd [1990] BCLC 868 (discussed in Watts, "Company Law", [1990] NZ Recent Law Review 190) and National Mutual Life Nominees Ltd v Worn (1990) 5 NZCLC 66,384.

\textsuperscript{88} (1976) 136 CLR 529.
plaintiff is required, alternatively whether foreseeability of the specific economic loss is necessary or whether liability for all loss caused by breach of a duty should be imposed in the absence of public policy reasons limiting recovery.

There is some authority in support of the first view and other authority which rejects any attempt to extend the principle to foreseeability of loss to a class no matter how limited.\(^9\) Furthermore the principle has not been embraced in the United Kingdom where it is, broadly, a requirement that the loss be consequential on damage to the plaintiff's property.\(^9\)

The difficulty giving rise to this variety of opinion is that of constructing an appropriate definition of the relationship required to impose liability. Foreseeability of the particular plaintiff is arguably too narrow whilst foreseeability of a particular class creates its own difficulties as to how to define the parameters of the class and hence the rationale for the non-extension of the principle to the foreseeability of loss to members of a class. However should an appropriate matter arise for decision it is arguable that the class of corporate creditors might be a sufficiently identifiable class to overcome these concerns. In the ultimate however the decision in each case may well depend as much on the issue of public policy as on anything else.

Where continuing relationships are concerned no distinction is drawn between words or acts and the relationship solves all problems of proximity and indeterminacy. The issue in these cases is even more clearly identifiable as one of public policy.

Conflicting policy considerations at play
In this state of flux it is difficult to state with any authority the existence of a cause of action in negligence against corporate officials for loss suffered by creditors as a result of corporate insolvency. Certainly the category of "creditors" arguably satisfies the proximity test. The issue remains one of public policy.\(^9\) The availability of alternative causes of action together with the same community pressures which gave rise to the institutions of the corporate personality and limited liability may persuade a court to err on the side of discretion rather than innovation. The difficulty is that companies were designed as a vehicle for risk

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89 See Balkin & Davis, at 437-438.
90 Id, 439. See the recent decision in Murphy v Brentwood DC [1991] 1 AC 398.
91 McPherson argues that no duty of care in negligence exists nor should exist as no legal duty of care is capable of protecting a creditor half as well as his own judgment. "Duties of directors to shareholders and creditors", Legal Research Foundation Seminar, Auckland 1989, 1.
takings and the same public policy behind their introduction is unlikely to support the qualification inherent in the imposition of a duty of care. In any event the standard of care required would need to be very low to accommodate the taking of legitimate business risks.

It is submitted that if any developments are forthcoming then they will most likely be where a continuing relationship has been shown to exist, such as where a creditor had developed a longstanding relationship with the now insolvent company. With proximity not an issue, the policy of allowing such a creditor to claim against the assets of a careless director, where no express personal guarantees were obtained, might be embraced.

Notably in the South African decision of Ex Parte De Villiers and Another MNO: In Re Carbon Developments (Pty) Ltd (in liquidation) acknowledged the potential application of the principles of negligence in this context. In particular the Court observed that a corporate officer might be liable in negligence to a creditor in one of two circumstances. Firstly, where there was a negligent failure to perform the duty of causing the company to raise such capital to restore its solvency as a reasonable man could and would have raised or as a result of a negligent failure to perform the duty of causing the company to be wound up when a reasonable man would have done so and this caused the creditors foreseeable loss. Secondly, where an officer upon ordering goods on credit negligently misrepresented expressly or by implication from his conduct that the company was not insolvent thereby causing the creditor to contract resulting in loss. No authority was however, cited for these propositions. Furthermore, as discussed in chapter 8, whilst the South African judiciary has embraced some particularly strict principles in relation to the liability of directors of insolvent companies some recent reconsideration of these principles is evident.

92 A recent novel development has been the imposition of liability in negligence on a director in relation to the loss suffered by a person with whom the company had entered into a contract in circumstances where the services contracted to be performed by the company could only be rendered by the exercise of skill and care by the particular director. It was held that the circumstances were such as to impose a duty on the director towards that person to act with proper skill and care: Fairline Shipping Corporation v Adamson [1975] QB 180. See Diamond (1975) 38 Mod LR 198 who argues that this presupposes an independent tort which cannot be inferred from the company's tort. Cf. Pollnow v Garden Mews St Leonards Pty Ltd & Ors (1984) 9 ACLR 82, and also see Kuwait Asian Bank EC v National Mutual Life Nominees Ltd [1990] BCLC 868.

93 1992 (2) SA 95 (W).
Again, as with the intentional torts, the most likely scenario in which a cause of action in negligence might be relied upon is in the context of group companies. Where a holding company is carelessly conducting business through a subsidiary the absence of alternative causes of action might render attractive an action in negligence against either the holding company or its controllers.

4.3 The legislation

There are numerous instances in the various companies legislation where liability is imposed on corporate officials for corporate obligations, whether by the mechanism of piercing the corporate veil or otherwise. Furthermore other legislation often provides circumstances where the corporate identity will be ignored but seldom are such instances designed to sheet home to corporate officials the obligations of a company to its creditors. The major statutory bases of liability are the subject matter of this section.

4.3.1 Minimum shareholding provisions

Company legislation typically provides for a minimum number of members. Traditionally these provisions provide that should the company carry on business with less than the prescribed minimum number of members then after a specified period all persons who are members and who have knowledge of the deficiency will be liable for the future debts contracted by the company.\(^94\) These provisions do not operate to terminate the company although the company may be subsequently wound up on this ground.\(^95\) Their most significant feature is the relative rarity of their application.

4.3.2 Negotiable instruments

Another circumstance where personal liability may be imposed on corporate officials is where these officials have signed or authorised the signature on behalf of the company of any bill of exchange, promissory note, cheque or order for goods or money and the name of the company is not mentioned thereon in legible characters. In such circumstances personal liability will only arise should the amount due be not duly paid by the company.\(^96\)

\(^{94}\) See for example Corporations Law S.114 and S.186.

\(^{95}\) S.461.

\(^{96}\) S.219(7). For a recent example of the application of such a provision see Rafsanjan Pistachio Producers v Reiss [1990] BCLC 352, cf S.116 of the Companies Act 1955 (NZ) discussed by Watts in [1990] NZ Recent Law Review 190. The
These provisions are examples of a number of provisions designed to ensure that the name of the company appears on all business documents and letters and wherever it does business. Normally such provisions are enforced by penal sanctions rather than by civil liability. Nevertheless where the provisions provide for such liability it has been strictly enforced, particularly in the early days of the legislation.

It was observed earlier that one of the reasons for the legislative recognition of limited liability was in order to control this increasingly popular commercial phenomenon. In particular it was intended to protect third parties by ensuring that where they dealt with limited companies this fact was known to them. Accordingly the legislature has sought to ensure that the true name of the company is always used and in particular that the word "limited" appears where applicable. Hence the significance of these provisions.

4.3.3 Pre-incorporation contracts

Liability may also be imposed on corporate officials in relation to pre-incorporation contracts. This is particularly the case in the United Kingdom where the legislation does not provide for the subsequent ratification of such contracts by the company but rather imposes direct liability on the promoter in the absence of a clear contractual intention to the contrary.

Recently attempts have been made by creditors to rely on this provision where a contract has been entered into with a company trading under a false or misprinted name. These attempts have been unsuccessful drawing the comment that the courts will not readily permit misprints to be used as a basis to impose personal liability on corporate officials.


Pursuant to S.183 of the Corporations Law the company may subsequently ratify the contract although the promoter will remain liable on the contract effectively as a guarantor for the company (unless exemption from liability has been obtained from the other party).


S.117(8) of the Companies Act 1985 (UK) also imposes personal liability on corporate officials where a newly incorporated public limited company conducts business or borrows prior to complying with certain statutory particulars. No similar provision exists in Australia and the provision is of limited practical significance.102

4.3.4 The liability of directors of corporate trustees

S.233 of the Corporations Law provides that directors of a corporate trustee will be jointly and severally liable with the corporation for a debt incurred by it whilst they were directors in circumstances where the corporation was not entitled as trustee to be fully indemnified out of the trust assets with respect to the liability. Although this is a rather specific provision it does provide another example of circumstances where the privilege of limited liability will be rescinded. The provision owes its existence to the fact that a trustee may choose between paying trust expenses and then claiming on its indemnity or paying the expenses directly from trust funds. In certain circumstances where it adopts the former strategy it may be prevented from claiming on its indemnity where it has not properly incurred the expense in the performance of its trust obligations. For example, it may have acted in excess of its powers or in breach of its duty to execute the trust with reasonable diligence and care. Where the trustee is a two dollar company then it will be the creditors who will suffer in the event that the trustee has lost its entitlement to indemnity. Neither the common law nor the other statutory provisions could avail a creditor in such circumstances and accordingly S.233 was enacted.

General application of "who takes the benefits must bear the burdens" principle

In this context a common law principle which enables creditors to pursue beneficiaries of trading trusts for debts of the trust should be mentioned. It has been held that the trustee's right of indemnity extends to beneficiaries personally where the trustee is a bare trustee,103 where he accepted the trust at the request of the beneficiaries104 or where the beneficiaries created the trust.105 The importance of this is that by virtue of the doctrine of subrogation these rights may be transferred to creditors, thereby providing the creditor of

102 See Gower, 117-118.
103 Hardoon v Belilios [1901] AC 118.
105 Matthews v Ruggles - Brise [1911] 1 Ch 194.
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a trading trust with a direct remedy against the beneficiaries. This principle derives from the equitable maxim that those who take the benefits of a trust must also bear its burdens. The essential element is that the trust was established at the instigation of the beneficiaries. Given the equitable origins of company law the question which merits some discussion is whether this principle could be extended to a normal trading company arrangement.

Firstly no issue of indemnity or subrogation arises as the creditors' contracts will be with the company directly, the directors acting merely in a representative capacity when dealing with the creditors.

It is true that the average company can be characterized as having been created at the instigation of its shareholders, who in the case of small private companies will normally be the directors in any event. However to go further and argue that therefore the shareholders who ultimately share the benefits derived by the company should bear its burdens, in the sense of making good any deficiency on liquidation, is arguably to go too far and to run contrary to fundamental principles of company law. In effect this principle is already operational by virtue of the fact that shareholders risk their paid-up capital and will be required to satisfy any issued but uncalled capital should the company go into insolvent liquidation. Thus, the equitable maxim is given effect to but tempered to allow some scope for the doctrine of limited liability. In this way the competing principles are reconciled, a reconciliation which would be endangered if the principle supporting the cases referred to above were extended from trading trusts to trading companies.

4.3.5 Defaulting officer provisions

Companies legislation typically contains provisions designed to impose liability on defaulting or delinquent officers. Traditionally these provisions have imposed both a criminal sanction and a civil liability for the same conduct. From a creditor's perspective the criminal aspect is only relevant in so far as the criminal courts have interpreted the elements common to the cause of action and to the criminal offence and to the extent that a conviction may be of assistance or necessary in establishing a civil liability.

106 The limitations to this principle are discussed in Chalmers, Introduction to Trusts, The Law Book Co Ltd 1988 at p.203.
In the 1862 Act only one delinquent officer provision was enacted.\textsuperscript{107} This provision was known as the "misfeasance" provision. Although there was some initial doubt it was subsequently interpreted as providing a summary remedy for those who had suffered loss as a result of misfeasance or breach of trust by corporate officials. Gradually, with the enactment of new provisions providing causes of action designed to counter specific abuses, the application of the misfeasance provision fell into decline. However, with the derivation of a duty owed to creditors by corporate officials this provision has taken on a new significance. The development of this duty and of the misfeasance provision will be considered in chapters 3 and 4 respectively.

Most important of the provisions providing causes of action against corporate officials in specific situations are the fraudulent and reckless/wrongful trading provisions now to be found in most companies legislation. These provisions are directly aimed at imposing liability on corporate officials for unacceptable conduct which has resulted in loss to creditors. As Gower has stated with reference to the fraudulent trading provision:

"There is no doubt that in practice this section represents a potent weapon in the hands of creditors which exercises a restraining influence on over-sanguine directors ... Of all the exceptions to the rule in \textit{Salomons case} it is probably the most serious attempt which has yet been made to protect creditors ..."\textsuperscript{108}

This comment predated the enactment of the wrongful trading provision in the United Kingdom which is an even more serious attempt to protect creditors.

In chapters 5 and 6 the development of these provisions will be examined in detail, with the developments leading to the recent enactment of the Australian insolvent trading provision considered in chapter 10.

4.3.6 The liability of disqualified directors

Legislation exists in the United Kingdom\textsuperscript{109} imposing personal liability for corporate debts on a person who acts as a director of a company within twelve months of it going into insolvent liquidation and who

\begin{itemize}
\item \textsuperscript{107} S.165.
\item \textsuperscript{109} Also now see S.588Z of the Corporations Law, inserted by the \textit{Corporate Law Reform Act} 1992 with effect from 24 June 1993.
\end{itemize}
during the subsequent five years is concerned with a company trading under the same or similar name, or who in contravention of a disqualification order, has been involved in the management of a company.\textsuperscript{110} Such a person is jointly and severally liable with the company in respect of debts incurred whilst they were so involved. Liability is also imposed on undischarged bankrupts who become involved in the management of a company.

Personal liability is also imposed on persons involved in the management of a company who take instructions from persons whom they know to be subject to the application of these provisions.

4.3.7 S.1324 of the Corporations Law

Since 1980 the Australian company legislation has contained a provision authorising, amongst others, a person "whose interests have been, are or would be affected" by conduct contravening the companies law to apply for an injunction or other relief, such as damages.\textsuperscript{111}

This provision is clearly very broad and, on the face of it, has the potential of providing an avenue by which to pierce the corporate veil. This has been recognised by commentators\textsuperscript{112} but not, it would appear, potential applicants and the scope of the provision has remained untested.

Specifically in the context of a creditor, the viability of whose interest has been threatened by corporate conduct, the provision affords a potential avenue of redress against defaulting directors at, at least, three levels:

(i) if the conduct has involved the directors in a breach of the Corporations Law,

(ii) if the conduct has required the directors to take into account the interests of creditors and there is evidence that their interests have not been considered, and

(iii) if the conduct has involved a breach of the duty owed to


\textsuperscript{111} Initially S.574 of the Companies Code.

\textsuperscript{112} See Baxt, "Will S.574 of the Companies Code please stand up! (and will S.1323 of the Corporations Act follow suit)," (1989) 7 C&SLJ 388 and the articles there referred to at footnote 4.
Baxt has argued that the availability of a cause of action to creditors at the first and second levels is most unlikely but concedes that in the present state of flux in the law anything is possible. Whilst he would appear to acknowledge some scope for creditors to proceed at the third level much will depend on the scope of this duty which he argues would not be readily extended.\textsuperscript{113}

Trethowan has also canvassed that potential reliance on S.1324 at the second and third levels.\textsuperscript{114} Whilst conceding that a creditor has standing to proceed under S.1324 and that, furthermore, the provision authorises the awarding of damages irrespective of whether an injunction could properly be granted, she doubts whether the provision envisages any party other than the company affected as the appropriate beneficiary of any damages award.

Certainly in the current state of the law it would be anomalous if creditors were to be permitted by the courts to proceed under S.1324 at any level. The bulk of authority does not recognise any duty to individual creditors.\textsuperscript{115} Furthermore, to permit S.1324 to be interpreted broadly would raise the issue of its reconciliation with fundamental principles of corporate law as to the fiduciary responsibilities of directors.\textsuperscript{116}

In any event for creditors of insolvent companies wishing to pursue nonfeasance, as distinct from misfeasance, against company directors the provision possibly contains a limitation namely that "conduct" be at issue. However it might be argued in a given set of circumstances that if there was a failure to take a particular step or steps then the residual "conduct" of the directors might nevertheless satisfy the requirement that there be a breach of the \textit{Corporations Law}.

Ultimately the importance of this provision in the context of creditor's rights may be that if the common law duty is developed to extend to individual creditors then, given the inherent restrictions in the S.598 procedure,\textsuperscript{117} S.1324 might provide the basis for the enforcement of

\textsuperscript{113} Id, 398-400.
\textsuperscript{114} Trethowan, "Directors' personal liability to creditors for company debts", (1992) 20 ABLR 41, 56-59.
\textsuperscript{115} See chapter 3.
\textsuperscript{116} See the discussion in chapter 3 and, in particular, the cases referred to in footnote 3 of that chapter.
\textsuperscript{117} See chapter 4. In particular creditors have no automatic standing to proceed under S.598.
this duty.

4.3.8 Group company provisions

It was observed earlier that the demands and contingencies of modern commerce have witnessed the development of the group company concept. It was observed that the common law has sought to reconcile the various interests of external parties and group entities by application of agency and equitable principles.

Company legislation recognizes that a special relationship exists between group companies.118 Examples of this recognition include:

(i) the requirement that group accounts be filed,119

(ii) the prohibition on subsidiary companies holding shares in a parent company,120

(iii) restrictions on dealings between a company and directors of a related company, particularly in relation to the giving of loans,121

(iv) the prohibition on subsidiary companies providing financial assistance for the purchase of parent company shares,122 and

(v) the facilitation of schemes of arrangements involving the amalgamation of group companies.123

Obviously for these purposes the definition of "group company" is very important. The expression embraces the concepts of "holding" and "subsidiary" companies. These are dealt with in S.46 to S.50 of the Corporations Law and the essence is one of majority control or ownership. A similar approach has also been adopted in the United Kingdom where the definitions were recently altered to focus on control rather than ownership.124

Although these instances illustrate that the legislature acknowledges a

119 Corporations Law, S.295.
120 Corporations Law, S.185.
121 Corporations Law, S.243A-S.243ZI.
122 Corporations Law, S.205.
123 Corporations Law, S.410-S.415A, particularly S.411(1A) and S.413.
financial convergence between the interests of a subsidiary and of a parent company, only in recent times has legislation been proposed in Australia enabling creditors of a subsidiary some recourse against the resources of the group. These proposals have included provisions which operate to impose liability on companies for the debts of related insolvent companies and those which require the pooling of assets of related companies where they are being wound up. These developments are considered in chapter 7.

4.3.9 Commenda provisions

S.218(2) of the Uniform Companies Acts provided for a company to be formed on the basis that the directors would be subject to unlimited liability to contribute to the company for the payment of its debts upon a winding-up. Although this provision has not been retained in the current legislation it would no doubt be possible to provide for such liability in the articles.125

4.3.10 Trade Practices Act - misleading or deceptive conduct

It is conceivable that a debt might be incurred by a company in circumstances where a company official has engaged in misleading or deceptive conduct in breach of S.42 of the Trade Practices Act 1974 and is, accordingly, liable to the company's creditor in an ancillary capacity.126 Alternatively such an official might be primarily liable for such conduct under the corresponding provisions of the complementary State fair trading legislation.127

Clearly such a cause of action would require proof of conduct that is misleading or deceptive or calculated to mislead or deceive. It is arguable that a failure, during precontractual negotiations, to disclose to the creditor a company's precarious financial position could satisfy this requirement.

Trethowan has assembled the authorities on whether silence can amount to misleading or deceptive conduct.128 She concludes that, whilst the matter is not free from doubt, failure to inform a potential

125 Also see S.306 Companies Act 1985 (UK).
126 Under S. 75B.
128 "Directors' personal liability to creditors for company debts", (1992) 20 ABLR 41, 71-73.
creditor that the company may not be able to repay the debt may amount to a representation. Furthermore deeming provisions exist to the effect that such a representation would be deemed to be misleading in the absence of reasonable grounds for making it.\textsuperscript{129} The effect of this then would be to place the onus on the corporate official concerned to prove that reasonable grounds to expect that the debt would be paid did in fact exist.

It would appear, however, that this position would be reserved to proceedings under the State fair trading legislation as where a company official is proceeded against under the \textit{Trade Practices Act} there is authority to the effect that the official must be shown to have been aware of the company's financial position. That is, there is a mens rea requirement.\textsuperscript{130}

To the extent that the application of the consumer protection legislation in these circumstances might appear surprising, this suggests a potential barrier to the application of these provisions to insolvent companies. The legislation is directed at consumer protection and, accordingly, the courts may be hesitant, on policy grounds, to extend its application to debt recovery, particularly where the effect is to undermine corporate personality.

There are a number of cases in which the courts have examined the limits of the legislation.\textsuperscript{131} Whilst the better view would appear to be that the conduct at issue need not affect a "consumer" it must be of a trading and commercial character. Whilst this caveat clearly would have no application in the context under consideration this does illustrate that the courts are prepared to contemplate limits to the application of the provisions and it may be that on the policy grounds described above, the provisions may not be permitted to extend to debt recovery from corporate officials.

\textbf{4.3.11 Other statutory provisions}

There are many instances scattered throughout the statute books where corporate identity is pierced for various reasons. In some instances these provisions may have the effect of imposing a corporate obligation on the members or officials of the company.\textsuperscript{132} Apart from the

\begin{itemize}
\item \textsuperscript{129} S.51A, \textit{Trade Practices Act} (1975)(C/W).
\item \textsuperscript{130} Trethowan, op. cit. 76.
\item \textsuperscript{131} See Trethowan, op. cit. 73-76.
\item \textsuperscript{132} See Gower, 123-124. The voidable preference provisions may in some circumstances also provide creditors with a means of redress against corporate members or officials. Also see Equity and Commercial Relations Ch. 5, p.120, "Directors Duties and the
companies legislation the most notable circumstance in which this occurs is in the context of taxation.\textsuperscript{133}

\textit{Tax legislation}

There are a variety of situations where the tax laws look behind the corporate identity whether for the purpose of the recovery of a debt or unpaid tax or for other purposes. Examples provided by the Australian income tax laws are the treatment of dividends,\textsuperscript{134} group companies,\textsuperscript{135} loans and payments by companies to shareholders and their associates,\textsuperscript{136} and rolled over assets.\textsuperscript{137}

Of course any such provisions are relevant to only one creditor, namely the relevant taxing authority. Nevertheless, as will be explored in chapters 9 and 11, reference to this legislation may provide an insight into useful reform possibilities which can be applied in the context of a general creditor recovery regime. With this in mind it is appropriate to make reference to the most significant tax law principles in this regard, namely the anti-avoidance provisions.

\textit{Anti-avoidance provisions}

Arguably the most encompassing recognition of the intimate relationship between companies and their controllers is contained in the anti-avoidance mechanisms to be found in tax laws. It would appear that where the government by the agency of its revenue collecting authority is a creditor then special consideration is to be given to the enforcement and collection of the debt. These mechanisms may be either specific or general. Specific anti-avoidance provisions proliferate in the tax legislation. Such provisions are normally enacted in response to schemes that have come to light and are often precise and stringent in their application.\textsuperscript{138}

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\textsuperscript{133} This analysis will be restricted to a consideration of income taxation principles. Most taxation regimes contain provisions which look behind the corporate veil in certain circumstances.

\textsuperscript{134} In Australia dividends are taxed but shareholders receive a credit for the tax paid on the underlying company profits. In effect the company is treated as the agent of the shareholders, having paid tax in advance on their behalf.

\textsuperscript{135} Companies are entitled to a rebate on the tax paid on dividend income derived by them. Concessional tax treatment is also extended to enable group companies to transfer assets, tax losses and other tax concessions between them.

\textsuperscript{136} Provisions exist to restrict such payments because it is recognized that the close association between the parties could be used to reduce the incidence of taxation.

\textsuperscript{137} In Australia the relationship between companies and their controllers is recognized by virtue of provisions enabling assets to be transferred between companies or from an individual to a company without attracting any adverse taxation consequences.

\textsuperscript{138} Examples of schemes which have resulted in amendments to the Australian legislation in the nature of veil lifting provisions include dividend stripping schemes, bottom of the
The general anti-avoidance mechanisms are particularly savage in their treatment of the corporate form and the privilege of limited liability. The legislation does not hesitate to impose personal liability on corporate officials or members for corporate tax obligations. The purpose of such legislation is to prevent the avoidance of taxation liabilities and give effect to the true intent of the tax legislation. It would appear that the policy that all citizens should pay their dues takes precedence over the policy of promoting enterprise through the provision of limited liability.

The general anti-avoidance mechanisms in place in both the United Kingdom and Australia illustrate this proposition. In the United Kingdom one of the major anti-avoidance mechanisms was created by the judiciary in response to various capital transfer tax avoidance techniques. It is known as the doctrine of fiscal nullity. Pursuant to this doctrine a court is, for the purposes of taxation, to give effect to the substance of an arrangement rather than its form. That is, the court may look behind the formal legal arrangement and impose tax liability on the relevant taxpayer on the basis of the true economic effect of the arrangement. In other words, where the court concludes that a complex arrangement was established in order to minimise the incidence of taxation the aspects of the arrangement that have no economic effect or justification other than to facilitate the avoidance of taxation can be ignored. Clearly circumstances could arise where the application of this doctrine may result in a corporate identity being ignored and the taxation liability of the corporation assessed to its controllers.

A similar effect has been achieved in Australia by virtue of Part IVA of the Australian Income Tax Assessment Act 1936. These provisions provide the Federal Tax Commissioner with an extremely wide discretion to disregard or reconstruct features of an arrangement where the dominant purpose of the arrangement, objectively determined, is to provide the relevant taxpayer with a tax benefit. The powers of reconstruction appear to be extremely wide and unfettered. Again the application of these provisions may result in the existence of a corporation being disregarded for tax purposes and liability imposed upon its controllers.

harbour schemes and Curran schemes, all being arrangements whereby shareholders sought to avoid tax liabilities in relation to their corporate investments.

Although the United Kingdom doctrine and Australian provisions obviously cannot assist any creditors other than the relevant taxing authorities they do provide an illustration of one potential means of combating abuses of the corporate form and protecting creditors. Indeed the doctrine of fiscal nullity displays similarities to the business realities doctrine enunciated by Lord Denning in the DHN Food Distributors case.

Similarly it is arguable that the Australian provisions may provide a focus for future legislative development. For example, a legislative scheme could be envisaged whereby the court would be empowered to ignore the corporate form in favour of creditors where objectively determined it was established that a corporate business was conducted in such a manner as to enable certain unacceptable benefits to be obtained. Indeed the legislation to date is, arguably, merely illustrative of the various unacceptable benefits which such legislation might seek to prevent. Furthermore the objective factors which might be referred to in order to ascertain the intent of the scheme are already embodied in the current legislation or at least in the rules for the application of the legislation established by the courts. For example, one such factor might be whether the company is thinly capitalised, a factor which is, arguably, inherently recognised as a relevant consideration in most of the existing creditor recovery mechanisms.\(^\text{140}\)

The problem with the adoption of these tax law principles in the company law arena is that different considerations and policies have shaped the tax principles. The public benefit in promoting the corporate form and the privilege of limited liability together with the need to weigh up the respective rights of corporate management and investors against those of third parties, in particular creditors, are not relevant considerations when deriving taxation principles. On the other hand, the policy of ensuring that each citizen pays his share of public dues and that the government has sufficient revenue with which to function are factors which are taken into account but have no place in the company law arena.

This is well illustrated by the DHN Food Distributors principle, a major criticism of which is that its limits are too imprecisely defined. Thus, whilst clearly of relevance, the significance of tax law principles to the future development of creditors' rights ought not be overstated.

\(^\text{140}\) See chapter 9, section 6.
5. Conclusion

This chapter has traced the origins of the relationship between incorporation and limited liability together with the origins of their abuse. It was observed that because of the deficiencies of the original companies legislation and the unwillingness of the courts to depart from a literal interpretation of the legislation, abuse of the privilege of limited liability was allowed to flourish at the expense of creditors. Creditors were expected to protect themselves or, as a last resort, to rely on the limited exceptions to the corporate identity principle established at common law.

No common thread
It was observed that, over time, creditors were provided with other legislative and common law avenues of recovery from corporate controllers. These various avenues were identified, namely the common law causes of action and exceptions to the corporate identity principle, contractual and tortious causes of action, and legislative provisions. It was observed that neither the common law exceptions nor the legislative provisions revealed any common thread. The most that could be said was that the judiciary tended to embrace the exceptions where the justice demanded it, whilst the legislature had become increasingly aware of the need to extend the potential liability of corporate controllers. Developments in torts law provided some scope for the imposition of liability on corporate officials although the real significance of these developments was likely to be in the context of group companies where the legislature has been slow to react and the common law exceptions have proved inadequate.

This lack of coherency or central theme in the avenues providing recourse to the controllers of companies is undesirable. Each category of exception to the limited liability and incorporation principles has developed, typically in response to a particular malaise, without regard to the over-all balance between the need to promote entrepreneurial behaviour and the need to provide creditors with a recovery regime. Whilst, over time, the position of creditors would appear to have strengthened there is every possibility that the independent development of each of these ad hoc categories could, if it has not already done so, result in the stimulation of entrepreneurial behaviour being excessively stifled.

If we are to establish a coherent creditor recovery regime based on a central theme then what is this theme and how should it find legislative expression? In particular do the primary categories of creditor redress provide any insight in to the answers to these questions? Should these
categories feature in such a regime, and if so, what reforms, if any, are required to them?

It is proposed in chapters 3 to 8 to consider the major avenues for recovery available to creditors in more detail with a view to formulating a framework for future development in chapter 9. The Government's recent reforms will be identified in chapter 10, with these reforms analysed, from the perspective of the chapter 9 conclusions, in chapter 11.
1. Introduction

   2.1 What is meant by acting in the best "interests" of the company?
   2.2 A duty owed to creditors
   2.3 Cause of action for individual creditors?

3. The Position in the United Kingdom
   3.1 Judicial support for a duty to creditors
   3.2 Some support for the traditional view

4. Legislative Recognition of the need to take into account the Interests of Creditors

5. Arguments Against a Duty to Creditors
   5.1 Practical difficulties with the duty
   5.2 Conceptual difficulties with the duty

6. Possible Bases of Reconciliation with Traditional Principles
   6.1 A flexible definition of membership and the transfer of risk
   6.2 The schizoid company

7. Conclusion
CHAPTER 3

THE COMMON LAW FIDUCIARY DUTY TO CREDITORS

"... when these ghosts of the past stand in the path of justice clanking their medieval chains the proper course for the judge is to pass through them undeterred".

Lord Atkin, 
*United Australia Ltd v Barclays Bank Ltd [1941] AC 1*, 29.

1. Introduction

It was observed in chapter 2 that the protection of creditors of limited liability companies was initially entrusted to the disclosure requirements of the legislation together with the common law remedies against corporate controllers. Whilst these common law remedies extended to fraud, the remedies for breach of trust and misfeasance were typically not available to creditors. Such remedies resided in the company and where there was an assimilation between management and the shareholders then in the absence of a liquidator being appointed, it was unlikely that these remedies would be enforced against corporate management to the advantage of the creditors.1

The inadequacies of the legislative response to the provision of a creditor recovery regime has ensured that the common law remedies have retained their importance. Recently the judiciary responded to these inadequacies with the derivation of a duty owed by company directors to creditors. This duty has its origins in the fiduciary responsibilities of directors to their company. The duty to creditors is perceived as arising only at such time as the company becomes insolvent at which time the interests of the company become immeshed with those of its creditors. Consistent with this rationalisation the duty is not owed directly to the creditors but is owed to the insolvent company.

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1 Even when a liquidator was appointed there remained the issue of whether the breach of trust or misfeasance was actionable where the company had ratified the directors' conduct. Furthermore not all conduct damaging to creditors was actionable by the company. This is discussed further in chapter 4.
The extent of the development of this duty is examined in this chapter. It will be observed that, notwithstanding the restrictive nature of this development, criticism directed at its incompatibility with traditional jurisprudence has been most vehement. Whilst a reconciliation with traditional analysis can be supported if the interests underlying a company are viewed as liable to change upon the insolvency of the company, many of these criticisms remain unanswered.

In these circumstances it will be argued that this judicial creation ought not to feature in a creditor recovery regime. On the other hand, this development serves to emphasize the significance for creditors' interests of the event of insolvency and highlights this as a central consideration in defining a creditor recovery regime. There is a need to recognise the change in the interests underlying a company upon insolvency or, stated differently, the risk transfer that occurs in a limited liability company.

Furthermore the fact that the cases supporting the existence of the duty all feature closely held companies may suggest that it is in this context that the legislative recovery regime is most inadequate and that, possibly, different considerations apply to these companies than apply to other types of companies.

The criticisms of the duty also emphasise that the categories of creditors differ thereby supporting the view that creditors are not a homogeneous group. This is a relevant consideration in determining whether a collective regime or one which permits individual creditors a cause of action ought be established. The inadequacies of the judicial response to resolving this issue in relation to the common law duty serves to emphasise the need to determine the issue one way or the other in respect to future legislative reforms.

Other considerations relevant to the reform agenda highlighted by the common law developments include a recognition that the development of a creditor recovery regime must have regard to the need to maintain the integrity of the law and be reconcilable and consistent with both underlying principles and the manner in which these find expression. Reforms must also have regard to the importance of ensuring a balance between the promotion of entrepreneurial activity and the protection of creditors.
2. **Australasian Origins of the Duty**

2.1 **What is meant by acting in the best "interests" of the company?**

The equitable origins of company law place company directors in a fiduciary relationship with their company. Thus they are regarded as owing a duty to their company to act in good faith. In other words to "act honestly for the benefit of the company they represent".2

From an early date creditors of companies seized on these equitable notions to argue the existence of a trust relationship between them and company directors. The basis for this argument was the special position of directors, namely that the only way the company could act was through its directors. Such an argument persuaded one member of the English Court of Appeal in *Wilson v Lord Bury and Others*3 but the majority rejected any notion that directors were under other liabilities to dealers with a company than normal servants of the company. Nevertheless the split decision in this case was an early sign of the underlying tension that was to shape future development.

This development was to hinge on the interpretation of what was in the best interests of a company and on the meaning of the term "company" itself. Was not the placating of creditors in the best interests of the company or might it not be said that debt participants were as much part of the company as equity participants?

*Duty owed to members only*

The initial judicial response was restrictive. The duty was owed to the company, meaning the members or corporators4, and to them alone. No duty was owed to employees, customers, creditors or even the nation. In fact, should directors consider the interests of these other parties then they were liable to impeachment for breach of their duties. This point is graphically illustrated by the decision in *Dodge v Ford Motor Co*5. In a commendable spirit of altruism Henry Ford determined to utilise surplus company funds to reduce prices in order to make the motor car accessible to all. In his words:

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5 (1919) 170 NW 668.
"My ambition is to employ still more men, to spread the benefits of this industrial system to the greatest possible number to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back into the business."  

This ambition was apparently not shared by all the shareholders, two of whom sought to force a dividend distribution from the company. In an affirmation of the strict approach the Court found that Ford's behaviour was an illegitimate exercise of management powers. It was not for directors to conduct the affairs of the company to benefit anyone other than the shareholders.

Forty years later this view was still prevalent. In *Parke v Daily News Ltd* a board of directors were reprimanded for giving undue weight to the welfare of the employees of the company. This was not a proper management concern.

Similarly the position of creditors was not the concern of directors.

Then in 1974 *Mason J.*, in an often cited passage from his judgment in *Walker v Wimborne*, stated:

"...it should be emphasised that the directors of a company in discharging their duty to the company must take account of the interests of its shareholders and its creditors. Any failure by the directors to take into account the interests of the creditors will have adverse consequences for the company as well as for them."  

*Walker v Wimborne* concerned a misfeasance summons issued by a liquidator against directors of a group of companies who had adopted the practice of moving funds between the companies as exigencies demanded. Read in this context his Honour's comments are a condemnation of this practice. However much more has been made of this passage.

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6 Ibid.
7 [1962] Ch 927.
8 Contrast Cmnd 5391, paras 55 to 59.
9 (1976) 137 CLR 7.
2.2 A duty owed to creditors

The last decade has witnessed a gradual revolution in the law as to the requirements to satisfy directors' fiduciary duties. Since the judgment of Mason J. in *Walker v Wimborne* it has been recognised that in some circumstances the performance of duties by directors will require them to take into account the interests of creditors. Recent cases have expanded on this proposition and in particular examined the circumstances where the interests of creditors become relevant. The result has been the formulation of a duty owed by directors to creditors.12

*Landmark decision - Nicholson & Others v Permakraft (NZ) Ltd (in Liq)*

With the exception of a number of minor incursions into the subject the judiciary did not at first place much significance on the judgment of Mason J. However in a landmark decision in 1985 the New Zealand Court of Appeal in *Nicholson & Others v Permakraft (NZ) Ltd (in Liq)* examined what authority there was and concluded that directors are required to take into account the interests of creditors where:

"... the company is insolvent or near insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency".15

The Court was of the view that where a company is in a situation of marginal commercial solvency creditors were to be seen as beneficially interested in the company. This duty did not extend to future new creditors but where continuing creditors were concerned, if at the time

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10 Some would call it a "silent and paradoxical revolution". See the casenote by Dawson [1984] NZULR 68 at p.77.
12 It has been argued that this formulation of a duty derives from a misconception of the comments made by Mason J. His Honour was not enunciating a separate duty to creditors but simply recognising that sometimes the best interests of the company require paying attention to the interests of creditors. See Heydon, "Directors' Duties and the Company's Interests", in Finn (ed), Equity and Commercial Relationships, Chapter 5, at p 120, Law Book Co North Ryde NSW 1987. Sometimes the decision is referred to as authority for this more narrow proposition, for example see ANZ Executors & Trustees Co Ltd v Qintex Australia Ltd (1990) 8 ACLR 980.
14 (1965) 3 ACLC 453.
of the payment in question the directors "should have appreciated" or "ought to have known" that the payment was likely to cause loss to these creditors or threaten the continued existence of the company, then the payment constituted a misfeasance by the directors.

It is clear from the judgments handed down in the Nicholson case that in deciding when the duty to take into account the interests of creditors arises a distinction must be drawn between solvent and insolvent companies. However the Court noted that in the intermediate situation of near insolvency or doubtful solvency greater difficulties of legal principle arise. As the evidence before the Court indicated that the company was solvent at the relevant time the Court was able to avoid deciding this difficult question.

Cooke J. gives some indication as to the possible source of the duty being in the tort of negligence. However this presents conceptual difficulties because it is the director's primary role to take risks, not to take care. On the other hand, whilst it can be conceded that there are conceptual difficulties with sourcing the duty in negligence, tort principles may provide a more adequate basis from which to regulate the extension of liability in this context than general equitable principles and would overcome problems of locus standi for a creditor before winding-up. This uncertainty as to the exact source of the duty foreshadows the nature of the criticisms that have been levied at it.

16 Per Cooke J. at p. 460.
17 Ibid.
19 Farrar, "The Obligations of a Company's Directors to its Creditors", an unpublished paper, Christchurch New Zealand, 1987 at p.11. Also see (1989) 4 Canta LR 12 at 19-20 and 31 and [1985] Jnl of Bus L 413 at p.416. But contrast Prentice, "Creditor's interests and Director's Duties", (1990) 10 Oxford J Legal Stud 265 at 275. Worthington also criticises the theoretical foundation of the duty, but from a new perspective. She distinguishes the duty to act bona fide and in the interests of the company from the duty to act for proper purposes. Whilst the former duty is owned to the company the latter is arguably owned to a wider group, including creditors. She argues that creditors' interests are therefore protected by virtue of this latter duty and they may have transactions, in breach of this duty, avoided: "Directors' duties, creditors' rights and shareholder intervention", (1991) 18 MULR 121.
Australian endorsement - Kinsela & Another v Russell Kinsela Pty Ltd (in liq)
This decision was subsequently endorsed by the New South Wales Court of Appeal in Kinsela & Another v Russell Kinsela Pty Ltd (in liq).20 At issue was whether a liquidator could set aside a lease taken out by the directors from the company at a reduced rental when the company was in the state of imminent collapse. It was clear from the facts that the purpose of the lease was to put assets beyond the reach of company creditors.21 The Court in the course of unanimously upholding the liquidator's claim again emphasised the solvency/insolvency dichotomy. On the facts before them the company was clearly insolvent at the time of the transaction and so it was unnecessary to formulate a general test of the degree of financial instability which would impose upon directors an obligation to consider the interests of creditors. However, Street C.J., who gave the judgment of the Court conceded that:
"the duty arises when a company is insolvent in as much as it is the creditors' money which is at risk in contrast to the shareholders' proprietary interests".22

His Honour noted the danger inherent in attempting to state any wide ranging principles given the varying nature of companies and the business they conduct. However subsequently the South Australian Court of Appeal encountered in Grove v Flavel23 facts which required them to delineate the degree of insolvency required to give rise to the duty.

Insolvency requirement explored - Grove v Flavel
The defendant who was a director of seven companies had been charged with seven breaches of the duty not to make improper use of information namely that a particular company was experiencing liquidity problems. The evidence was that the defendant armed with this knowledge had effected a "round robin" of cheques between the

21 Hill (1986) 60 ALJ 525 at 527 queries the interaction of this "purpose" factor with the insolvency criterion. It is likely that the application of this purpose factor might involve considerable difficulties given that directors are required by this duty to balance the interest of shareholders and creditors. The difficulties in determining whether improper purposes were taken into account was considered in Whitehouse v Carlton Hotel Pty Ltd (1987) 61 ALJR 216.
22 At page 223. Herzberg (1987) 5 C&SLJ 157 argues that the Kinsela case illustrates a new approach to tackling voidable preferences which significantly extends the scope to recover such preferences and improves the position of creditors. To the extent that it effects an extension to directors' duties he would like to see these duties extended even further (p.161).
23 (1986) 4 ACLC 654.
company concerned, himself and certain debtor and creditor companies which he controlled. The result was that the debt to the defendant was reduced and the director and companies which were previously debtors of the troubled company became debtors of another company which had previously been a creditor of the troubled company. That is the troubled company was effectively extracted from the arrangement leaving certain debtor and creditor companies in a direct relationship.

The issue before the Full Court was whether by reference to the defendant's duties as a director there was an "improper use of information".

The Court concluded that there was an "improper use" if there was conduct inconsistent with the proper discharge of the duties of the officer concerned. There had been conduct by the defendant which was to the possible detriment of the creditors of the company. The difficulty was however that there was no evidence that the company was insolvent at the time of the transactions and so it was arguable that there was no duty to take into account the interests of creditors.

Jacobs J., who gave the judgment of the Court, examined the earlier authorities. His Honour noted that the company concerned in Walker v Wimbome was in fact insolvent at the time of the impugned transactions but otherwise there was nothing in the judgment of Mason J. to suggest that it is insolvency that gives rise to the duty.

His Honour also noted that the decision in Ring v Sutton was a case where the challenged transaction was entered into at the time the company was solvent. However his Honour rejected this case as authority for the proposition contended by the liquidator that there is a duty owed to creditors independently of insolvency or financial instability. Rather his Honour viewed this case as an application of the general principle that the duty is to act in the interests of the company as a whole.

It is submitted that this aspect of the judgment is tenuous relying as it does upon a vague and inconclusive passage in the judgment of the New South Wales Court of Appeal in Ring v Sutton. It is, with respect,

24 (1976) 137 CLR 7.
26 The passage is quoted at p. 654 of the judgment of Jacobs J. It reads: "None of the three transactions was for the benefit of the company, their terms as to interest were detrimental to the company and were arrived at for the benefit of the respondent and the respondent was able to procure the terms because of his position as director."
clear that their Honours were addressing the aspect of the directors' duty to creditors. Their Honours quoted from the relevant passages in the judgment of Mason J. in Walker v Wimbome. Furthermore the following passage can be found in the judgment of Hope J.A., who gave the leading judgment:

"The present case is one that concerns the interests of creditors and it has not been nor could it be suggested that they approved or affirmed the terms of the loan contracts." 27

This passage was in response to the argument that the shareholders had consented to the loan agreements and therefore the liquidator could not complain. The fact that the Court rejected this argument gives further weight to the view that the breach of duty at issue was a breach of duty owed to creditors and therefore the conduct of the shareholders was irrelevant. 28

In any event to the extent to which Ring v Sutton is authority for the proposition that a duty to creditors is owed by directors of a solvent company it is inconsistent with the narrower duty propounded by the authorities referred to above.

Jacobs J. also referred to the judgment of Wallace J. in Wright v Frisina 29 which he cites as authority for the proposition that a director may be in breach of his duty even though he knows only that the company is facing financial difficulties.

Finally, his Honour referred to the Nicholson case 30 and the Kinsela case 31 noting that the solvency/insolvency distinction was not rigidly applied especially by Cooke J. in the former case whose judgment was cited with approval by Street C.J. in the latter case. In the event his Honour concluded that not only does the duty to creditors arise when the company is known to be insolvent but also arises where the director has "knowledge of a real risk of insolvency". 32 Whether there is such a real and perceived risk of insolvency must depend upon the facts of the particular case.

His Honour noted that the effect of the conduct at issue was to involve a disposition of the assets of the company in the form of debtors. This

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27 At page 548.
28 Also see the note in (1982) 56 ALJ 189.
29 (1983) 1 ACLC 716.
30 (1985) 3 ACLC 453.
32 At 663.
conduct constituted a possible detriment to creditors. Accordingly, notwithstanding that the company was not shown to have been insolvent, the conduct amounted to an improper use of information. In the words of his Honour:

"A director of a company X limited who, upon acquiring information which leads him to believe that the company faces a risk of liquidation - whether voluntary and because it cannot pay its debts as they fall due or at the suit of the creditors - which is a real and not a remote risk, thereupon acts to protect himself and other companies of which he is a director from the consequences of such liquidation to the possible detriment of the creditors of X limited, is acting "improperly". 33

Clearly this case effected an extension of the duty owed to creditors. On the authority of this case a liquidator has a cause of action against a director who entered into a transaction at a time when he perceived that the company was in financial difficulties and a creditor of the company suffers loss as a result of the transaction. 34

Duty to present and future creditors - Jeffree v NCSC
This decision was endorsed by the Western Australian Full Court in Jeffree v National Companies & Securities Commission 35 in circumstances where a business had been transferred to another company for the purpose of avoiding a prospective liability. The importance of this decision is the recognition that the duty owed by directors extends to both present and future (or contingent) creditors.

Such a rationalisation of the duty had been suggested in a United Kingdom decision which had been criticised as going too far and placing a too onerous duty on directors. 36 Similar criticisms have been levied against this decision. 37

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33 At 662-663.
34 Applied in McNamara v Flavel (1988) 6 ACLC 802.
36 Winkworth v Edward Baron Development Co Ltd [1987] 1 All ER 114. See the discussion below and the commentators there referred to.
37 For example see: Baxt, "A Senior Australian Court gives the "thumbs up" to the Winkworth principle - directors owe a duty to creditors both present and future", (1989) 7 C&SLJ 344, and the commentators he refers to. Also see Baxt (1989) 63 ALJ 846 and (1990) 64 ALJ 345.
2.3 Cause of action for individual creditors?

There is some support for the proposition that this duty provides individual creditors with a cause of action. Cooke J. stated in the Nicholson case:

"The foregoing principles relate to actions by the company against directors, whether or not in truth brought by the liquidator. It does not exclude the possibility of an action by a particular creditor against the directors or the company for breach of a particular duty of care arising on ordinary negligence principles. ... But that is territory which need not be explored in the present case".38

The territory was also not explored in the Kinsela39 or Grove40 cases.

Further scope to argue that individual creditors have a cause of action is provided by the NSW Supreme Court decision of Young J. in Hooker Investments Pty Ltd v. Email Ltd & Ors41. His Honour was required to rule on whether a statement of claim should be struck out. The matter concerned proceedings by a shareholder against directors for a breach of duty arising from a share issue. Young J., after stating the traditional view that normally the company is the proper plaintiff in such circumstances, noted that there was some support for the alternative view that a duty is owed by directors in these circumstances to individual shareholders or creditors. Alternatively it may be that there are a series of duties, some owed to the company, some owed to the shareholders and some owed to the creditors and that it is possible to sue in respect of each type of breach.

His Honour considered various authorities, including the Kinsela42 and Nicholson43 cases and Coleman v Myers44, and concluded that in the light of these decisions and in view of the way that the law of fiduciary duty is moving he was not able to say that it was unarguably clear that a shareholder himself has no personal cause of action in respect of a breach of duty by a director.

Thus both this decision and the judgment of Cooke J. in the Nicholson case provide some support for the existence of a personal cause of

38 Supra, 460.
41 (1986) 10 ACLR 443.
43 (1985) 3 ACLC 453.
action for creditors.\textsuperscript{45}

There must be some doubt as to whether it would be desirable to provide individual creditors with a cause of action to enforce this duty, whether in a derivative form or otherwise, given the onerous responsibilities and duties already imposed on directors by legislation, in particular the reckless and fraudulent trading provisions contained in S.592 and S.593 of the \textit{Corporations Law}. On the other hand, it would be anomalous for a duty to be owed to creditors, which could not be waived without their consent, yet they would be unable to individually enforce it.

Probably the greatest objection to providing individual creditors with a cause of action is that it would enable them to subvert the statutory scheme of distribution. Although a similar comment can be made in relation to S.592 and S.593 arguably as they were conceived by parliament they are reconciled with, and indeed elements of, the statutory scheme of distribution. The same cannot be said for the common law duty to creditors.

Similar observations are ventured by \textit{Sealy} who also observes that such a duty would run counter to established insolvency policy considerations, namely that the priority is for the company to be salvaged as a going-concern.\textsuperscript{46} Typically, however, the arguments advanced against a duty to individual creditors mirror the arguments against a duty to creditors generally, detailed below. In particular, it has been suggested that the duty would require that some recognised standard of conduct by directors be recognised as otherwise honest business decisions which result in insolvency might attract personal liability and the courts would be required to arbitrate on commercial decisions.\textsuperscript{47} Furthermore the existence of the duty would create uncertainty and lead to conflicts of interest.\textsuperscript{48} More specifically, other commentators have referred to the multiplicity of actions, problems of double recovery and the expense of providing individual creditors with a cause of action, whilst acknowledging that enforcement of the duty by creditors would make it most efficient and effective.\textsuperscript{49}

\textsuperscript{45} Hill argues that it is but a short step to hold that creditors have individual rights of action and it is odd that to date is has not been so held given that directors have a duty to consider their interests and a breach of that duty cannot be waived without their consent: (1986) 60 ALJ 525 at 527.


\textsuperscript{47} Trethowan, "Directors' personal liability to creditors for company debts", (1992) 20 ABLR 41, 59.

\textsuperscript{48} Id, 53-56.

Chapter 3
Duty to Creditors

It is of note that the Companies and Securities Law Review Committee has recommended the establishment of a derivative action which would permit creditors, amongst others, to seek the leave of the court to enforce the duties of corporate officials.\textsuperscript{50} If enacted this would provide individual creditors with an avenue to enforce this duty albeit with leave and by way of derivative action. Notably the criteria for granting leave is generous.\textsuperscript{51} Furthermore the court would be empowered to order the corporation to indemnify or pay the applicant's costs and also to direct that any proceeds from a successful action be paid to any creditor of the corporation or a related corporation.

Whilst this would clearly appear to promote a major advance in creditors' recovery rights, rather surprisingly the proposal is expressed to be predicated on the need to protect the interests of the company and not those of creditors.\textsuperscript{52} It is suggested that the width of this provision is such that the Committee may not have been sufficiently focused on the principles they were attempting to express and may have been over-reacting to the corporate excesses of the 1980's. Certainly to assert that the provision is solely concerned with the interests of the company and not those of creditors appears inconsistent with the tenor of the provision in relation to creditors' rights. Notably the Companies and Securities Advisory Committee rejected the extension of the action to encompass creditors as potential applicants.\textsuperscript{53}

Whilst this specific reform is problematical it is argued that the suggestion of a derivative type action by creditors is worthy of consideration in the limited circumstances of the defaulting officer provisions. This issue of whether creditors should have a direct cause of action against corporate management, whether derivative in nature or otherwise, is explored in detail in chapter 11 where it is concluded, in the context of the legislative remedy, in favour of such a development. Whilst the conclusion is drawn below against the further development of this common law duty, in the event that the preferred regime were not adopted and the common law duty was retained as an element of the creditor recovery regime, for the reasons advanced in section 2 of chapter 11, primarily the disparate nature of corporate interests, it is argued that there are grounds for providing individual creditors with a

\textsuperscript{50} Enforcement of the duties of directors and officers of a company by means of a statutory derivative action, Report No 12, November 1990.

\textsuperscript{51} Essentially that the corporation is unlikely to take proceedings but that it is in its best interests.


cause of action. Possibly, to accommodate the opposing arguments, which have much force in the context of the common law duty, this action ought be more readily identifiable as necessarily derivative in nature.

3. The Position in the United Kingdom

3.1 Judicial support for a duty to creditors

Initially the existence of a duty to creditors was resisted by the United Kingdom judiciary and the traditional view that directors are only accountable to shareholders endorsed.

*Initial support - Re Horsley and Weight Ltd*

The first English case to consider the matter was *Re Horsley and Weight Ltd*. The liquidator had argued that a payment of a pension to a director was in breach of the duty owed to creditors to preserve the company's capital fund. In the course of rejecting this argument Buckley L.J. also rejected any notion of a duty to creditors. However the other members of the Court have often been cited as authority recognising the existence of the duty. Templeman L.J. stated:

"If the company had been doubtfully solvent at the date of the grant to the knowledge of the directors the grant would have been both a misfeasance and a fraud on the creditors for which the directors would remain liable".55

Although it is arguable that in this passage his Lordship acknowledges misfeasance in the form of breach of a duty to creditors it is also arguable that the passage refers to a misfeasance [vis-a-vis the company] and a fraud on the creditors. There has never been any doubt that directors are liable for fraud on creditors.

In any event his Lordship found no evidence of fraud or misfeasance given that the company's business was solvent at the time of the transaction. Furthermore there was nothing to suggest that the likelihood of loss to creditors should have been appreciated by the directors.

54 [1982] Ch 442.
55 At 455.
Cumming-Bruce L.J. concurred with Templeman L.J. and together these judgments were, for many years, the strongest English authority for the proposition that a duty is owed to creditors. Some other supporting authority was provided by a passage from the judgment of Diplock L.J. in Lonrho Ltd v Shell Petroleum Co Ltd\(^6\) where his Lordship stated that the interests of the company "are not exclusively those of its shareholders but may include those of its creditors". His Lordship does not refer to any authority for this proposition and indeed the passage arises by way of a side remark only incidentally related to the issues raised by the case.

Leading authority - Winkworth v Edward Baron Development Co Ltd and Others

The leading authority in support of this duty is the judgment of Templeman L.J. in the House of Lords decision in Winkworth v Edward Baron Development Co Ltd and Others\(^7\) in which his Lordship took the opportunity to re-affirm his view that a duty is owed to creditors. At issue was a claim by a director that a company held property on trust for that director. In the course of dismissing this claim his Lordship referred to the fact that equity would only intervene to uphold a constructive trust where it was conscionable in all the circumstances. On the facts the enforcement of a constructive trust in favour of the director would defeat the claims of creditors. In the circumstances this would be unconscionable because:

"... a company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of a company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors."\(^8\)

His Lordship noted that the directors had committed acts which constituted a breach of their duty to the company and its creditors. However these breaches did not become of any significance until the company became insolvent.\(^9\)

\(^{56}\) [1980] 1 WLR 627 at 634.
\(^{57}\) [1987] 1 All ER 114.
\(^{58}\) At 118.
\(^{59}\) However it is arguable that his Lordship is not restricting the duty to the insolvency
Although these comments would appear to be a forceful and unambiguous affirmation of the existence of a duty to creditors it is submitted that they constitute only persuasive and far from decisive authority. The decision was not founded on the existence of this duty but rather on the general principle that in all the circumstances equity should not intervene. The finding that the director had breached this duty to creditors constituted a neat way of categorising her conduct, conduct which would arguably not have been considered equitable regardless of whether there could be identified a specific duty which the director had breached. Furthermore no consideration of the authorities was undertaken nor was any supporting authority cited.

Nevertheless the other four members of the Court concurred with the judgment of Templeman L.J. This may suggest a judicial reconsideration of the existence of the duty although, on the other hand, it could be argued that for the reasons stated above, namely that the reference to this duty was only for the purpose of categorising the director's conduct, that their Lordships considered the slight overindulgence in judicial creativity by their learned friend to be too insignificant to warrant qualification.  

Certainly it is arguable that these comments go too far and if they are taken literally it would mean that a company could not engage in any activities that did not result in a profit to the company. Furthermore they extend too far the capital maintenance rules and the suggestion that directors owe duties to future creditors creates practical difficulties. Possibly they are better regarded as loosely expressed (and possibly obiter) dicta addressed to the particular problems of capital maintenance and misfeasance in a winding-up.

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60 However in Hilton International Limited (in liq) v Hilton & Anor (1988) 4 NZCLC 64721 this decision was relied on in support of the proposition that directors, when declaring a dividend, owe a duty to its creditors of all kinds likely to be affected.

61 See Baxt (1987) 5 C&SLJ 247 at 248. Requiring directors to take into account the interests of potential creditors would seem particularly onerous.

62 See Farrar "The Obligations of a Company's Directors to its Creditors", an unpublished paper Christchurch New Zealand, 1987, at p.5. Also see (1989) 4 Canta LR 12 at 14. He rationalises the remarks as using the alter ego theory (in the guise of the corporate conscience) to pierce the corporate veil in favour of creditors in a way which is unprecedented.
Subsequent decisions

Liquidator of West Mercia Safety Ltd v Dodd

In any event, subsequently the English Court of Appeal in Liquidator of West Mercia Safety Ltd v Dodd\(^63\) confirmed that, at least in the case of insolvent companies, directors are under a duty to take creditors' interests into account when disposing of company property. In this case a director had transferred company funds to pay off the overdraft of another company which he had personally guaranteed. Rather than rely on the preference provisions the liquidator sought a declaration\(^64\) that the director was liable for breach of trust and misfeasance in transferring the money.

The Court held that there was a clear fraudulent preference\(^65\) of the overdrawn company and it therefore followed that the director had breached his duty to the company because he had disregarded the interests of the general creditors of the insolvent, or near insolvent, company. The traditional position that no duty was owed to creditors was to be confined to circumstances of a solvent company.

Brady & Anor v Brady & Anor

This decision was affirmed in Brady & Anor v Brady & Anor\(^66\), the Court of Appeal holding that in the case of an insolvent or near insolvent company the interests of the company are in reality the interests of the creditors. This view was not disturbed on appeal.\(^67\)

3.2 Some support for the traditional view

There is some authority in support of the traditional view, although what authority there is, is either implied authority, authority which mentions the issue in passing or authority which lays down principles conceptually inconsistent with the existence of a duty to creditors.

Multinational Gas

The strongest English authority discounting the duty to creditors is that of Multinational Gas and Petro Chemical Co v Multinational Gas and Petro Chemical Services Ltd and Others\(^68\). The complicated facts of that case basically gave rise to the issue of whether the shareholders

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\(^{63\) (1988) 4 BCC 30.\n
\(^{64\) Under the equivalent of S.594 of the Corporations Law.\n
\(^{65\) For a consideration of the relationship between the position established by this case and the fraudulent preference provisions see the casenote by Herzberg (1989) 7 C&SLJ 72.\n
\(^{67\) [1988] 2 All ER 617.\n
\(^{68\) [1983] 2 All ER 563.\n
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of a company could ratify the conduct of directors who had entered the company into improvident contracts. The liquidator had alleged that the directors were in breach of duty by virtue of entering into the high risk contracts, notwithstanding that at the time the company was solvent. The directors alleged that the shareholders had lawfully ratified these contracts and accordingly they could not be impeached by the liquidator.

The majority of the Court of Appeal found the conduct of the directors was ratifiable. Dillon L.J. stated:

"An individual trader who is solvent is free to make stupid but honest commercial decisions in the conduct of his own business. He owes no duty of care to future creditors. ... A company ... likewise owes no duty of care to future creditors. The directors indeed stand in a fiduciary relationship to the company as they are appointed to manage the affairs of the company and they owe fiduciary duties to the company though not to the creditors, present or future ..."

His Lordship had been referred to Re Horsley & Weight Ltd by the liquidator as authority for the proposition that shareholders cannot ratify conduct of directors amounting to misfeasance. Dillon L.J. noted that Templeman L.J. in that case had drawn a distinction between negligence and gross negligence amounting to misfeasance. In his view what Templeman L.J. had in mind by the term misfeasance was in fact recklessness. Thus the case was only authority for the proposition that in the event of recklessness shareholders could not absolve delinquent directors. On the facts before his Lordship there was nothing in the nature of recklessness proved. Furthermore his Lordship noted that the comments of Templeman L.J. concerned a situation where the directors were also the shareholders. Again that was not the case on the facts before his Lordship.

It is arguable, however, that both these bases of rejecting the dicta contained in the judgment of Templeman L.J. are not to the point. Whether shareholders can ratify the conduct of directors does not depend on some spurious distinction between misfeasance and negligence. Rather it depends upon whether the duty at issue is one owed to shareholders or one owed to creditors. This was recognised in the Australian decision in the Kinsela case. The New South Wales Court of Appeal, having found that the impugned conduct took place in the context of insolvency and therefore amounted to a breach of duty

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69 At 585.
70 [1982] Ch 442.
owed to creditors, concluded that the shareholders could not authorise this breach by ratification.

Once it is recognised that the duty is owed to shareholders or creditors depending upon the financial solvency of the company, then the question of whether shareholders can ratify can be easily decided. Therefore it becomes unnecessary to draw the distinction between ratifiable negligent acts and unratifiable acts of misfeasance or to examine the body of shareholders and only allow them to ratify where they are independent from the directors of the company.

The other member of the majority, Lawton L.J., similarly identified the company with the shareholders thereby implying that the directors are only liable to the shareholders and not creditors. By ratifying the conduct of the directors the shareholders had made that conduct their own. As shareholders owe no duty to creditors then no breach arose. His Lordship stated that this was so notwithstanding the dicta contained in Re Horsley & Weight Ltd. In any event that dicta referred to the inability to ratify conduct amounting to misfeasance which conduct probably does not include that which would give rise to an ordinary claim for damages.

Again it is submitted that his Lordship, by failing to recognise that a duty to creditors arises where the company is insolvent, has found it necessary to draw this spurious distinction between misfeasance actions and ordinary claims for damages. Furthermore had his Lordship recognised this duty he would not have needed to reduce the analysis to a question of whether shareholders owe duties to creditors. It is submitted that the relationship between shareholders and creditors is vastly removed from the relationship between directors and creditors. To reduce the issue to a consideration of the relationship between shareholders and creditors is to entirely avoid the issue.

The dissenting judge May L.J. similarly did not recognise a duty to creditors and as a result was forced to go to the other extreme by stating that in no circumstances would ratification by shareholders

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72 In Aveling Barford Limited v Perion Limited (1988 A No 5742; 17 April 1989) shareholders were held unable to ratify a breach essentially because creditors' interests were at stake. Whilst the company was solvent at the time of the breach it did not have sufficient distributable profits to make a distribution of equivalent value to the property lost as a result of the breach. It has been argued that this case is persuasive authority for an extension of the circumstances in which the duty to creditors arises to a company in financial difficulties approaching insolvency: Rose, "Corporate Gifts & Creditors' Rights", (1991) 11 Co Law 91 at 95.

73 The ratification issue resulting from an acceptance of the traditional view has been recognised by a number of commentators, for example Hill (1986) 60 ALJ 525 at 527.

74 [1982] Ch 442.
absolve directors from actions for breach of duty brought by a liquidator. With respect to the dicta contained in *Re Horsley & Weight Ltd* his Lordship expressed difficulties distinguishing between gross and ordinary negligence. However, he considered that the dicta did not rule out claims by a company against its directors based on negligence in the circumstances of the instant case. Again the difficulties encountered by his Lordship would not have arisen if the conduct of directors was properly dichotomised into a breach of duty to shareholders or a breach of duty to creditors. Furthermore it would have been unnecessary to go to the lengths of stating that shareholders can never ratify negligent conduct by directors.

Notwithstanding the reservations expressed concerning features of this decision it clearly is authority for the traditional view that the interests of creditors have no relevance to the performance of duties by directors. However, the difficulties encountered by their Lordships in their judgments could have been overcome had they recognised that in some circumstances a duty to creditors arises.

*Rolled Steel Products*

In *Rolled Steel Products (Holdings) Ltd v British Steel Corporation and Others*,75 in the course of dismissing the defendant director's attempt to raise the defence of ratification, Slade L.J. made some obiter references to the power of shareholders to ratify the conduct of directors. His Lordship stated:

"... the clear general principle is that any act that falls within the corporate capacity of a company will bind it if it is done with the unanimous consents of all the shareholders or is subsequently ratified by such consents. ... This last mentioned principle is certainly not an unqualified one. In particular, it will not enable the shareholders of a company to bind the company itself to a transaction which constitutes a fraud on its creditors ... but none of the authorities which have been cited to us have convinced me that a transaction which (i) falls within the letter of the expressed or implied powers of a company conferred by its memorandum and (ii) does not involve a fraud on its creditors and (iii) is assented to by all the shareholders will not bind a fully solvent company merely because the intention of the directors, or the shareholders, is to effect a purpose not authorised by the memorandum. The recent decision of this Court in the Multinational case seems to me to point to a contrary conclusion (see also A-G's Reference (No. 2 of 1982) [1984] 2 All E.R. 216 at 223 ...). However none of these matters relating to ratification in my opinion call for

75 [1985] 2 WLR 908.
decision on this appeal."\textsuperscript{76}

This is a clear statement of the traditional position. It is difficult to envisage how the decisions in the \textit{Multinational case}\textsuperscript{77} and the \textit{Attorney-General's Reference} might point to a contrary conclusion. In the latter case it was held that the shareholders could not ratify dishonest or illegal conduct by directors. This decision does not represent a departure from the traditional position. The conduct of the directors in that case could be clearly characterised as fraud on the creditors. The companies concerned were in debt to the sum of 7 million pounds at the relevant time representing a deficiency as regards creditors of over 2.5 million pounds. Nevertheless the directors lived an extravagant life using the companies' funds for their private purpose. In as much as the Court upheld charges of stealing from the company against the directors their conduct also amounted to fraud against the creditors.

It is interesting to note that the above quotation from the judgment of \textit{Slade L.J.} is cited with approval by \textit{Street C.J.} in the \textit{Kinsela case}.\textsuperscript{78} His Honour refers to this passage as authority for the proposition that the principle of validation of directors' conduct by ratification is not an unqualified one. Furthermore his Honour used this passage to illustrate that the general principles of ratification are restricted to \textit{solvent} companies, thereby enabling him to hold that in the case of insolvent companies different considerations apply.

This analysis by \textit{Street C.J.} illustrates the inherent limitation of the English authorities which affirm the traditional position. All these authorities are confined to statements of principle in the context of solvent companies. In none of these cases has the company concerned been insolvent at the time of the impugned transactions. Thus the position in the United Kingdom would now appear to be that a duty of care is owed to creditors by directors of an insolvent or near insolvent company.

\textsuperscript{76} At 947-948.
\textsuperscript{77} [1983] 2 All ER 563.
\textsuperscript{78} (1986) 4 ACLC 215.
4. **Legislative Recognition of the need to take into account the Interests of Creditors**

Whilst the judiciary has clearly recognised that directors' fiduciary duties include a duty to consider the interests of creditors which is, in fact, manifested in the form of a duty to creditors, there has been little legislative recognition that directors owe duties to, or even need to take into account the interests of, persons other than the body of shareholders. The main exceptions are considered below.

**United Kingdom**

Since 1980\(^9\) the *Companies Act* has included a provision to the effect that directors are required to have regard in the performance of their functions to the interests of the company's employees. Certain implications may be drawn from the fact that neither this provision, or the original draft provisions, contain any reference to a requirement to take into account the interests of creditors. It is arguable that the interests of creditors are excluded from consideration by implication and that directors who take into account the interests of creditors are in fact in breach of their duties to the company.

**New Zealand**

The New Zealand *Companies Act* contains a similar section which permits provision to be made for the welfare of the employees when a business ceases, whether or not it is in the best interests of the company.\(^8\) Again no reference is made to creditors.\(^1\)

**Ghana**

The only legislation in which creditors' interests have been recognized in this way, albeit only to a limited extent, would appear to be the Ghanan *Companies Code 1963* which requires that the interests of creditors be taken into account in the performance of the directors' fiduciary duties. S.203(3) provides that:

"In considering whether a particular transaction or course of action is in the best interest of the company as a whole, a director, when appointed by or as a representative of a special class of members, employees, or creditors, may give special, but not exclusive, consideration to the

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79 S.46 of the Companies Act (1980). The provision was first proposed in the 1973 Companies Bill and again later in the 1978 Bill on the recommendation of a number of reports; Cmd 6706, Ch. 8 para 38 and Cmd 7037 para 5. It now appears as S.309 of the Companies Act (1985).

80 S.15A(1)(g) and S.15A(2) of the Companies Act (1955).

81 However see the recommendations of the New Zealand Law Reform Commission discussed in chapter 8, section 3.5., although note that the subsequent Companies Bill has not enthusiastically embraced these proposals.
interests of that class."[ My emphasis.]

This absence of legislative endorsement of a duty to creditors, or even of the need to take into account the interests of creditors, foreshadows the concern at the desirability of the common law development. It is proposed to now turn to a consideration of the various practical and conceptual difficulties that have been identified as inherent in the common law duty. It will be observed that a fundamental concern is the incompatibility of the duty with traditional jurisprudence. Possible bases of reconciling the existence of the duty with this jurisprudence will be explored.

5. Arguments Against a Duty to Creditors

It has been argued that if judicial sentiments of the kind endorsing a duty to creditors had prevailed over the past century and a half, the limited liability company would never have got off the ground. 82 Certainly, given the balance struck in the companies legislation between promoting enterprise and the protection of creditors, arguably this judicial creativity flies in the face of the intention of parliament. 83 On the other hand, it can be argued that the duty is clearly desirable from the standpoint of raising commercial morality, imposing minimum standards and recognising current ideals that directors should take into account the wider public interest.

Whatever view is adopted it is clear that the duty presents many conceptual and practical problems. These raise the issue of whether the duty should be retained as an element of the company law of the future. It is therefore appropriate to consider these problems and whether they are capable of resolution.

5.1 Practical difficulties with the duty

Uncertainty associated with duty

Probably the most identified problem is that it is uncertain when the duty to take into account the interests of creditors will arise. Accordingly a director of a company in financial difficulties cannot enter into a transaction confident that it will be valid and effective, if it is likely to leave the creditors lamenting should the company subsequently go into liquidation.

To the extent that the issue of directors' duties to creditors is presently the subject of judicial development this criticism is valid. However, there is nothing new in such criticisms. Whenever the judiciary embarks upon new developments a degree of uncertainty must eventuate. This is the price of a dynamic legal system which recognises current social attitudes and attempts to reflect them in the law.

A related criticism is that company directors are not always aware that a company is in financial difficulties, and may only discover this upon preparation of the financial accounts. Accordingly, they may be unaware that a duty to creditors has crystallised. On the other hand, it can be argued that directors have a duty to be acquainted with their company's financial health.

Duty requires a difficult balancing act

It has also been argued that the duty to take into account the interests of creditors requires a difficult balancing act by directors and, presumably, a difficult review process for the judiciary. The Bullock Report attempts to answer this objection by arguing that directors have managed to balance these interests so they should be required to balance them. However this argument avoids the issue. It is one thing


86 It is argued that the accountability of directors would be compromised because they could justify their decisions as the result of the balancing exercise. See Watts, "Company Law", [1990] NZ Recent Law Review 190 at 194. Discussed further below.

87 Cmd 6706, Chapter 8, paragraph 39.
to say that directors do balance the interests of various classes. How well they balance these interests is an entirely different consideration. The increase in reported decisions in this context may well be evidence that the balancing act is creating difficulties. On the other hand, it is conceded that an argument to the effect that a duty is difficult to perform and so therefore need not be performed is hardly convincing.

5.2 Conceptual difficulties with the duty

*Novel meaning of the term "company"*

The duty to creditors embraces a novel meaning of the term "company". The traditional view is that the company is equated to the shareholders. The new view characterises the company as an entity separate from its shareholders. The powers of this entity are vested in the directors who are required to exercise these powers in accordance with a wide range of considerations. Therefore according to this new view it is conceptually permissible to impose on directors an obligation to consider the interests of various parties including creditors.\(^{88}\)

This divergence from the traditional view gives rise to the ratification issue. The principles of ratification are based on the identification of the company with the shareholders. The new movement has altered this underlying theory thereby giving rise to difficult questions as to the shareholders' power to ratify a breach of duty owed to creditors.\(^{89}\)

It has been argued that the metaphor of the company as a separate legal person has, thus, been pushed too far. Putting corporate personality in its correct perspective it is apparent that the shareholders and not the creditors have conferred powers on directors and so it should be to the shareholders that duties are owed. However the curious result of a breach of this duty is that it cannot be forgiven without the consent of the creditors yet they cannot enforce the duty except to the extent that the company acts on its own motion or through a liquidator.\(^{90}\)

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89 See Dawson, ibid, and also see (1982) 56 ALJ 189 at 190 and (1984) 2 C&SLJ 127. Grantham concedes the need for creditor protection but questions whether this radical change in what is meant by "the company" is appropriate: "The judicial extension of directors' duties to creditors" [1981] Jnl of Bus L 1.
90 See Heydon (op. cit.). In his view the answer to this conceptual malaise is that no independent duty is owed to creditors. Mason J. in Walker v Wimborne was simply recognising that, in the exercise of their duties to a company, directors may properly have regard to the interests of outsiders such as employees and creditors. (Also see McPherson, "Duties of directors to shareholders & creditors", Legal Research Foundation Seminar, Auckland 1989, 1) Recent cases have, by recognising an independent duty to creditors, moved from enforcing a duty to consider to imposing a
Chapter 3
Duty to Creditors

These conceptual criticisms can be summarised in the form of two questions:

(i) If directors owe this duty to the company how can it be denied that a fully informed general meeting can excuse a breach of the duty? and,

(ii) If on the other hand directors owe a duty to creditors why it is that the creditors are not entitled to sue in equity to enjoin breach of that duty? 91

Certainly the existence of a duty to creditors appears contrary to principle and to long-established authority. Further the theory that a general meeting cannot excuse a breach of duty confers on outsiders (i.e. creditors) the right to interfere in the internal workings of the company. It would also place a creditor of a company in a more advantageous position than the creditor of a natural person. 92

It is sought to address this conceptual difficulty in section 6 below.

No homogeneous class of creditors

Another problem with the cause of action for breach of the duty is deriving an appropriate remedy which will properly assist the relevant creditors. There is no true "class" of creditors but simply a number of competing entities, which in turn have an existing, future and continuing face. The duty is a too simply formulated concept to deal with all the various interests at issue. This issue is further explored in chapter 11 in the context of the legislative remedies. 93

91 See Renard commenting on Heydon's article: Renard, "Commentary on Ch 5" in Finn (ed), Equity and Commercial Relations, at p 137, Law Book Co North Ryde NSW 1987.


93 See Sealy, op. cit., 12.
Problems with a duty arising upon insolvency

A further deficiency is the place of the concept of "insolvency" in the application of the duty. Arguably the standards required of directors should not differ depending on the financial status of the company. The concept only gives rise to definitional issues and to difficult arguments where a company's financial position fluctuates such that it moves in and out of that state.

This has been recognised by Sealy who has argued that as directors' decisions are taken with reference to the company as an ongoing business they should be judged by that broad standard, not by technicalities and coincidences of this kind.94 He believes that the common law can only accommodate a limited duty if it is to remain inherently consistent. On the other hand legislation can be used to impose further liabilities on directors undeterred by any such constraints, with the judicial acknowledgment of a possible wider basis for directors' liability being a signal that legislative change is overdue. There is much strength in these comments.

Difficult enforcement task required of the judiciary

It is difficult to reconcile the duty towards creditors with the notion of a company as a vehicle to facilitate risk taking. To accommodate creditors' interests the judiciary must be prepared to throw down the shackles of the business judgment rule and enter the boardroom to examine the purpose of executive decisions. What the courts must ensure is that the risks embraced by the company fall within the range of legitimate business risks.95 Furthermore the courts must be more readily prepared to examine the exercise of shareholders' powers, especially their power of ratification, as they are no longer the only interest groups involved.

Sealy believes that in the exercise of these principles the courts should give effect to a number of policy considerations, namely that:

(i) the action is a class action for the benefit of creditors generally. Any other policy would create impossible conflicts, especially for the liquidator, and would undermine the object of insolvency law,

94 Op. cit., 12-13 and see footnote 60 where Sealy identifies some of the various characterizations of "insolvency" used in the caselaw.
95 See Sealy, op. cit.. Baxt argues that this is what has been occurring in these cases and that perhaps this flexible and creative approach by the judiciary is preferable to rigid and stultifying legislation: (1986) 4 C&SLJ 197 at 199.
(ii) the priority must always be the salvation of the enterprise as a going concern. Hence compromise may be necessary and any pre-occupation with the interests of existing creditors would undermine this policy and promote short-term remedies at the expense of long-term prospects, and

(iii) any extravagant imposition of personal liability on directors may result in people with the necessary experience and ability being reluctant to fill non-executive directorships.96

These considerations illustrate a justifiable concern that the duty has been developed without proper regard to the underlying policy behind the corporations jurisprudence. Whilst the first point has been discussed previously and, indeed, it is argued that there is a merit in permitting individual actions, the second and third considerations are particularly poignant. It will be seen that recent developments in strengthening the position of creditors have, arguably, both discouraged the acceptance of directorships and promoted an environment which does not encourage attempts to trade out of insolvency.

Ultimately Sealy echoes the response by Berle97 to Dodd's proposal98 that wider interests be recognised by corporate management, namely that it is unworkable. The concept of "duty" ceases to be justiciable. A concession in favour of a duty to take account of creditors' interests in a situation of doubtful solvency is only achievable if the judiciary is prepared to adopt a more interventionist role than has been traditional and to review directors' commercial and policy decisions. Any attempt to go further and establish the duty as owed to creditors clashes with established principles of company law and the underlying policy of insolvency law.99

Other difficulties
Other difficulties associated with this duty include:100

(i) the procedural problems arising from the lack of nexus between the company to whom the duty is owed and the creditors of the

97 "For Whom Corporate Managers are Trustees" (1932) 45 Harv LR 1365.
98 "For Whom are Corporate Managers Trustees?" (1932) 45 Harv LR 1145 written in response to A.A. Berle Jnr "Corporate Powers as Powers in Trust" (1932) 45 Harv LR 1049. Ultimately Dodd came to share Berle's view: (1942) 9 U Chic L Rev 538, at 546-547.
100 See generally Wishart, "Models & theories of director's duties to creditors" (1991) 14 NZULR 323.
company, being the persons protected by the duty,

(ii) the lack of any general definition as to what is and is not ratifiable and as to at what time a breach of the duty becomes non-ratifiable,

(iii) the lack of identification as to whether all creditors are protected by the duty or only a class of them. Wishart suggests that the confusion here reflects an attempt by the courts to avoid overgeneralisation by tying any statement of the duty into the nature of the transactions at issue in a particular case. However any categorisation between types of creditors is flawed as no such categorisation attaches to the distribution of the proceeds of any action,101

(v) the lack of guidance as to what is required of directors to satisfy the duty, particular as the duty may vary in stringency with the degree of solvency of the company, and

(vi) the lack of reconciliation of this common law duty with the statutory provisions.

There is much to be said for these criticisms of the common law duty. It may be that the judiciary has embarked upon a course consistent with current commercial sentiments without proper regard for theoretical cohesion or general considerations. On the other hand, as has been foreshadowed, possibly a reconciliation with traditional principles can be maintained.

6. Possible Bases of Reconciliation with Traditional Principles

6.1 A flexible definition of membership and the transfer of risk

Perhaps the true importance of this development is the recognition that at the instance of insolvency there is a shift in the interests that are at stake. In other words there is a transfer in risk. This is recognised by Wishart who supports the need for this duty in order to protect creditors from uncompensated risks. He argues that the need for this protection only arises where management and control of a company is not well separated, that is in the case of small tightly controlled companies.

Wishart identifies the various models of the company in order to identify whether this duty can be rationalised. He acknowledges that the

101 Ibid.
traditional and modern legal models of the company are inadequate in their explanations of the effect of the shifting of risk between creditors and shareholders and hence are incapable of dealing with uncompensated transfers of risk. Thus there is no guidance of authority or principle for the judiciary.

However he argues that, with some adaptation, the traditional theory of the company as the collective shareholders can assimilate this recent development. This requires that the distinction between shareholders and creditors be recognised as, in reality, no more than terminology as the capacities are the same in substance. On this basis, if the model views the company as the collective members then a mechanism to protect one group against uncompensated transfers of risk can be accommodated. Thus Wishart requires that the judiciary make the concept of membership explicit. If creditors are not members then uncompensated transfers ought to be precisely identified and proscribed. On the other hand if the creditors are members uncompensated transfers can be dealt with as fraud on the minority under a regime of managerial liability.

In this way Wishart concludes that the existing principles of company law are adequate to the task of accommodating the development of the directors' duty to creditors. However, he would see it as preferable to regulate the prohibition of uncompensated transfers of risk perceiving the alternative of a flexible definition of membership as less desirable.

It is argued below that a recognition that at the instance of insolvency the interests of the company and those of its creditors are to be assimilated, or stated differently, that the underlying corporate interests become the creditors, is the preferred basis of reconciliation of the duty with traditional concepts. Whilst this has obvious similarities with Wishart's analysis it avoids the need to acknowledge creditors as members of a solvent company. Furthermore, like Wishart, it will be argued that more appropriate mechanisms to regulate this risk transfer can and ought be implemented.

**Insight into alternative regulatory mechanisms and reform considerations**

An insight into the nature of these preferred mechanisms is provided by Wishart's suggestion that the debate is wrongly directed when it conceives the problem as one of mismanagement. In reality the problem is one of creditors bearing risks which they have not agreed to take. The transferors of that risk are the shareholders.
In the course of his analysis of the various models of the company Wishart acknowledges the draft Companies Act recommended by the New Zealand Law Reform Commission\(^\text{102}\) pursuant to which no duty was to be owed by directors to creditors and the interests of creditors were to be subordinated to the best interests of the company and the benefit of existing shareholders.\(^\text{103}\) A creditor recovery regime was to be provided in the form of standing to sue for a proposed breach of the company's constitution or the Act. In addition management was to owe a duty to the company not to take unreasonable risks with the solvency of the company. This solvency test was designed to prevent management taking the company into situations where either the funds were insufficient to meet liabilities or where the cash flow was inadequate. This proposal will be considered further in chapter 8 where it will be argued that, whilst probably too radical for legislative endorsement,\(^\text{104}\) it provides an insight into the theoretical basis for any resultant legislation.

An analysis of the cases supporting the existence of a duty to creditors reveals some factual similarities. The companies have been closely controlled proprietary companies, exhibiting an assimilation of ownership and management, and in financial difficulties at the time of the impugned transactions. The transactions all had the effect of placing company assets out of the reach of unsecured creditors. In each case the liquidation claw back provisions have been inadequate to deal with the transaction explaining why the courts have had recourse to establishing this new principle in an effort to supply the defect in the law. This also explains why these decisions leave so many critical issues unresolved as the courts have concerned themselves with reaching the correct result in the case before them, hampered by the conflicting conceptual and jurisdictional problems.\(^\text{105}\)

The fact that the companies have all been small closely held companies suggests that, from the reform perspective, different considerations apply to small closely held companies than to other companies.\(^\text{106}\)


\(^{103}\) Id, para 218.

\(^{104}\) The subsequent Companies Bill 1990 was ambivalent in its approach to directors' duties and retreated from the position adopted in the draft Act. The duty not to take unreasonable risks with the solvency of the company was replaced with a prohibition on reckless trading. The bill was referred to the Justice and Law Reform Select Committee and is yet to pass through Parliament. See the discussion in chapter 8.

\(^{105}\) See Trethowan, "Directors' personal liability to creditors for company debts", (1992) 20 ABLR 41, 50-51.

\(^{106}\) This is also expressly supported by Wishart's analysis (op. cit.).
6.2 The schizoid company

In virtually all the major judgments supporting the new movement reservations are expressed by the judiciary as to the desirability of stating a wide ranging principle without a thorough examination of the varying considerations. Accordingly their Honours have been cautious not to be overly enthusiastic in their support for the interests of creditors. Thus the duty to take into account the interests of creditors is restricted to the insolvency context. The fundamental principle that directors of a continuing company owe no duty to creditors remains unchallenged. It is only in the context of insolvency that the rights of shareholders give way to those of creditors. At this stage in the company's existence the directors become in effect trustees for the interests of creditors because it is the creditors' investment that is at stake. Where the company is insolvent in the sense that the company is trading with the creditors' money then the company undertakes a significant metamorphosis. The interests of shareholders are relegated to those of the creditors. This is the price of obtaining limited liability. It is only fair that shareholders pay this price. If it has the effect of placing a creditor of a company in a more advantageous position than a creditor of a natural person then so be it. The existence of limited liability has always meant that such a creditor is in a less secure position. It would seem justifiable on equitable grounds that the creditor receives some advantage to offset against this detriment.

Thus although it is conceptually correct that the interests of the company and shareholders are to be assimilated in the case of a continuing company, in the case of a company of doubtful solvency different considerations apply. The trusteeship remains the same but different beneficiaries are nominated. It is appropriate that at this stage extra weight be given to the interests of these new beneficiaries in the directors' process of decision. This also explains why a general meeting cannot excuse a breach. In the insolvency context it is to the creditors that the directors must look for exoneration.

107 For example see the judgment of Richardson J. in Nicholsons case (supra) and that of Street C.J. in the Kinsela case (supra), especially at page 223. Hill (op. cit.) argues that a further factor curbing the application of these principles is the traditional self-restraint and reluctance of the courts to interfere with, and pronounce upon, commercial decisions of directors.

108 There is a view that these decisions have in fact narrowed the position stated in Walker v Wimborne (supra) which did not distinguish between insolvent and solvent companies: see the note by Hill in (1986) 60 ALJ 525 at 527.

This is, indeed, inherently recognised by the obligations imposed on company officers by the companies legislation designed to protect the interests of creditors. Most of these obligations crystallise when a company becomes insolvent or approaches insolvency. Thus the legislation recognises a special relationship between creditors and the officers of insolvent corporations.\textsuperscript{110} It is also a principle applied in certain United States jurisdictions.\textsuperscript{111}

Given that the duty is of recent origin and is still undergoing refinement and acceptance this assists to explain why to date the courts have not had cause to consider whether to grant creditors an independent cause of action. The lack of an independent cause of action presents no conceptual difficulties in any event. To date actions for breach of this duty have been brought by the liquidator acting for the collective good of the creditors. In a similar way proceedings against a director for breach of his duties to the company per se must be brought on behalf of the company. Traditional directors' duties are owed to the company as a whole and not to individual shareholders. Similarly this duty is owed to the creditors as a whole and not to individual creditors. Thus the positions are the same except that a creditor has no concept of a derivative action on which to rely.

In the restricted circumstances of insolvency, or near insolvency, the interests of creditors should be taken into account. It is the interests of creditors only however, not those of employees, customers, the public or the nation at large. There is no question of directors exercising their powers for the public good. To suggest that they are required to do so is to falsely present and extend the principles laid down in the recent cases beyond the scope envisaged by their authors.

\textsuperscript{110} To the extent that certain requirements designed for the protection of creditors are imposed on solvent companies by the Corporations Law a fiduciary relationship between creditors and officers of solvent companies is recognised by the legislation. The officers of the company are in effect the trustees of the rights granted to creditors by these provisions. This aspect provides some scope to argue that directors are trustees for creditors' rights even where a solvent company is concerned. Cf. Baxt An Introduction to Company Law (4th edition) Law Book Co Ltd (1987), p.183; Baxt, (1986) 69 ALJ 102 at 104.

\textsuperscript{111} The rule applied in a number of American States is that "upon the insolvency of the ordinary private corporation a quasi trust relationship arises between its directors and creditors" (Whitfield v Kern 192 A 48 (1937); and see 19 Corpus Juris Secundum, Corporations, para 837). The Supreme Court of the United States has approved of this principle. (Pepper v Litton 308 US 295 (1939)). Possibly the American doctrine of "unjust enrichment," currently gaining acceptance in Australia, also provides some justification for this view.
A company does have a legal personality separate from shareholders. Normally, however, the company's personality and that of its shareholders will be identical. In some situations a second personality will be discernible. A personality characterised by the interests of creditors. In truth companies are best perceived as schizoid.

7. Conclusion

It was observed in this chapter that traditionally directors have been regarded as owing a duty to their company to act in good faith. This has been characterised as a duty to act in the best interests of the shareholders of the company. Recent authority has supported the extension of this principle to encompass a duty to the creditors of the company, at least where the company is insolvent or of doubtful solvency.

This development has been criticised by most commentators who favour a re-affirmation of the traditional, conceptually attractive, position. It was argued, however, that many of these criticisms ignore the element of insolvency generally required by the supporting authorities as a pre-requisite for the existence of the duty. Proper regard to this feature allows these new developments to be rationalised with the traditional view.

However, although these developments can be reconciled with traditional principles, practical and conceptual difficulties remain, mainly arising from the overly simple nature of the duty given the complexities involved and the uncertainty arising from the fact of its novel and recent origins. In particular, the duty poses substantial practical difficulties both for directors who must satisfy it and for the judiciary who must enforce it. Whether such a simply expressed principle is workable, particularly given the varying classes of creditors, must be doubtful. Furthermore, to the extent that it generates uncertainty for corporate management, there is a potential for the principle to have an adverse impact on business and the economy.

On the other hand, the fact that the judiciary has considered it appropriate to establish the duty suggests that a need exists for the extension, in some circumstances, of liability to corporate officials for debts owed to creditors. Ultimately, it must be questioned whether developments of this significance should be left to the domain of the judiciary or whether this is more appropriately an area for legislative reform after consideration of all the ramifications.
Whilst it is, therefore, argued that the recovery mechanism afforded to creditors by this common law duty could be more appropriately provided in another guise this development assists in identifying underlying themes which must be addressed in any reform agenda. Firstly it identifies the insolvency of a company as the critical determinant of when creditors' interests become paramount. Secondly there is a recognition that there is a change in underlying interests, in effect the risks associated with the enterprise are transferred to the creditors, at the instance of insolvency. Thirdly the common feature of the cases supporting the development of the duty, namely that the companies at issue exhibited an assimilation of managerial and shareholder interests, suggests that the means of creditor protection and recovery may need to vary with the specifics of the corporate arrangement. Fourthly the criticisms of the common law development, that it is theoretically inconsistent with traditional jurisprudence, does not mesh with the existing legislative provisions directed at fraudulent and reckless trading and places a too greater onus on corporate management illustrates that a coherent and integrated approach to the development of a creditor recovery regime is required. Finally the uncertainty as to whether individual creditors have a cause of action for breach of the duty illustrates the need to resolve whether a creditor recovery regime ought be collective or otherwise. These considerations will be further examined in chapters 9 and 11.
1. **Introduction**

2. **Legislative Origins of S.598**
   2.1 United Kingdom developments
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3. **Procedural Provision only or Cause of Action?**

4. **The Features of the S.598 Proceedings and the Duty to Creditors**
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4.8.2 Set-offs, cross claims and third party proceedings

5. Conclusion
CHAPTER 4

THE FIRST DEFAULTING OFFICER PROVISION
- THE MISFEASANCE PROVISION

"The Conscience of the company, as well as its management, is confided to its directors".

Lord Templeman,
Winkworth v Edward Baron Development Co Ltd [1987] 1 All ER 114 at 118.

1. Introduction

Prior to the enactment of the fraudulent trading provision the obligations of corporate officials to corporate creditors was the domain of the common law. The companies legislation did, however, provide a summary procedure designed to expedite such actions. With the introduction of the fraudulent and reckless trading provisions this summary procedure lost its significance.

In chapter 3 it was observed that the judiciary has recently advanced the proposition that in particular circumstances directors owe a duty to creditors. The courts have drawn a distinction between a solvent and an insolvent company. The duty to creditors only arises where the company is insolvent or where the officer concerned has "knowledge of a real risk of insolvency". It has been argued that there are no conceptual difficulties in the proposition that a duty to creditors is owed by the directors of an insolvent company. Although the interests of a company and its shareholders are normally to be assimilated, in the case of a company of doubtful solvency different considerations apply. Even though the trusteeship remains the same it could be said that different beneficiaries are nominated. In other words, in an insolvent company the directors are trustees for the creditors.

The recent development of this common law duty has provided the summary procedure with renewed importance as it provides the mechanism by which the duty is to be enforced. The development of

2 See chapter 3.
3 For example, it was relied upon by the liquidator in Kinsela & Anor v Russell Kinsela Pty Ltd (In Liquidation) (1986) 4 NSWLR 722; (1986) 4 ACLC 215.
the provision establishing this procedure, commonly known as the "misfeasance provision"\(^4\), will be examined in this chapter. Furthermore, the features of the current Australian provision will be explored in the context of their suitability for the enforcement of the duty owed to creditors.

The current Australian misfeasance provision is contained in S.598 of the *Corporations Law*, repeating S.542 of the *Companies Code*. The operative section is sub-section 2 which reads as follows:

"(2) Subject to sub-section (3), where, on application by the Commission or a prescribed person, the Court is satisfied that -

(i) a person is guilty of fraud, negligence, default, breach of trust or breach of duty in relation to a corporation; and

(ii) the corporation has suffered, or is likely to suffer, loss or damage as a result of the fraud, negligence, default, breach of trust or breach of duty,

the Court may make such order or orders as it thinks appropriate against or in relation to the person (including either or both of the orders specified in sub-section (4)) and may so make an order against or in relation to a person notwithstanding that the person may have committed an offence in respect of the matter to which the order relates".\(^5\)

The other four subsections specify who has locus standi, codify the rights of the defendant, specify the types of orders that may be made under the provision, and provide that applications pursuant to the section will not bar the institution of other proceedings, in particular criminal proceedings.

The purpose of this provision is, today,\(^6\) recognised as to provide a summary recovery procedure predicated on the need to realise the assets of a company and, as far as possible, to meet the claims of creditors expeditiously in order that a liquidation is conducted in an

\(^4\) The phrase "misfeasance provision" is the colloquialism by which the provision contained in the various companies legislation empowering the court to impose personal liability on delinquent officers has become known. This provision applies to a variety of forms of delinquency of which misfeasance has occupied most of the courts' time.

\(^5\) Cosmetic changes to this provision effected by the Corporate Law Reform Act 1992 are noted in chapter 10, section 6.3.

\(^6\) As discussed below, this has not always been appreciated and at one time the judiciary flirted with giving the provision a much greater significance.
orderly and effective manner.\textsuperscript{7}

**Significance of provision**

It will be argued that the provision is significant for a number of reasons. Firstly it was initially interpreted as providing a general cause of action against misbehaving directors. Whilst this interpretation was subsequently displaced the concept provides an interesting reform possibility.

Secondly, to the extent that the provision provides a summary procedure by which to enforce various causes of action against defaulting corporate management, it is a focal element in the creditor recovery mechanism provided by the common law duty.\textsuperscript{8} Indeed to the extent that the impact of this duty is directly related to the ability of liquidators and creditors to enforce it, the provision provides an important element of the rights of creditors against defaulting corporate officers. Thus the adequacy of the provision from the perspective of the support it provides for the enforcement of this duty will be explored. Whilst it will be argued that the provision is generally adequate for this purpose there must be some doubt as to the appropriateness of the summary procedure in the difficult cases which typically arise in the enforcement of the common law duty. This serves to cast further doubt on the desirability of the common law duty as an element of a creditor recovery regime.

2. **Legislative Origins of S.598**

2.1 **United Kingdom developments**

The provision has its origins in the *Joint Stock Companies (Winding Up) Acts* of 1844 and 1848. The stated purpose of this legislation was to address the need for legislation to facilitate the winding up of the affairs of companies unable to meet their pecuniary engagements.\textsuperscript{9} Accordingly it was surprising that absent from these Acts were provisions dealing with civil proceedings against defaulting officers by parties who had incurred losses by virtue of their dealings with insolvent companies. If such a party wished to pursue an action

\textsuperscript{7} Per the Companies and Securities Law Review Committee, Enforcement of the duties of directions and officers of a company by means of a statutory derivative action, Report No 12 (November 1990), at paragraph 272.

\textsuperscript{8} This provision is complemented by other provisions, for example those imposing a duty of co-operation with the liquidator and those empowering the liquidator to investigate dealings and conduct: see Oditah, "Misfeasance proceedings against company directors", [1992] LMCLQ 207.

\textsuperscript{9} 7 & 8 Vict C.111 and 11 & 12 Vict C.45.
against the directors then it was necessary to utilise the normal court proceedings and commence the action by way of a bill. Normally such proceedings would be instigated by the liquidator or by the company members suing on behalf of the company. Thus the action had to be finalised before the liquidation of the company could be concluded with the result that the existence of these proceedings with their attendant pre-trial procedures and delays could significantly delay the liquidation.

These considerations probably induced the enactment in the *Companies Act 1862* (UK) of S.165, the first misfeasance provision. This was, at the time, the only provision directed at defaulting officers.

The section was amended by the *Companies (Winding Up) Act 1890*. These amendments included a number of extensions to the application of the provisions. They were, together with some subsequent minor amendments, consolidated by the *Companies (Consolidation) Act 1908*. The resultant provision, S.215, was to remain on the statute books substantially unaltered until 1985. In that year the current United Kingdom provision was enacted, namely S.212 of the *Insolvency Act 1986*.

This provision makes some changes including the adoption of certain recommendations by the *Jenkins Committee* made 23 years previously. That Committee had noted that the existing provision did not encompass proceedings for actionable negligence nor did it empower a court to make orders in respect to a receiver of a company. Both of these matters have been addressed.

Further changes include the addition of the requirement that an applicant obtain the leave of the court before proceeding against the liquidator or administrator of a company. Also a contributory must now obtain the leave of the court before making an application.

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10 "165. Where, in the course of the winding-up of any company under this Act, it appears that any past or present director, manager, official or other liquidator, or any officer of such company, has misapplied or retained in his own hands or become liable or accountable for any monies of the company, or been guilty of any misfeasance or breach of trust in relation to the company, the Court may, on the application of any liquidator, or of any creditor or contributory of the company, notwithstanding that the offence is one for which the offender is criminally responsible, examine into the conduct of such director, manager, or other officer, and compel him to repay any monies so misapplied or retained, or for which he has become liable or accountable, together with interest after such rate as the Court thinks just, or to contribute such sums of money to the assets of the company by way of compensation in respect of such misapplication, retainer, misfeasance, or breach of trust, as the court thinks just."

11 Cmnd. 1749.

12 ss (4).

13 ss (5).
although the section provides that an application, can be made by a contributory notwithstanding that he will not benefit from any order made, thereby reversing an established principle.\footnote{Traditionally a contributory did not have locus standi unless he had a direct pecuniary interest in the success of the application: Bentinck v Fenn (1887) 12 App Cas 652; Gibson's Executor v Gibson [1978] S C 197 at 203-204; Re B Johnson & Co (Builders) Ltd [1955] Ch 634 at 786.}

\section*{2.2 Australian developments}

In Australia, the misfeasance provision also dates from the 1860's first appearing in Queensland in 1863 and being subsequently enacted by all the other States.\footnote{Qld. S.166 (1863), Vic. S.149 (1864), S.A. S.151 (1864), Tas. S.200 (1869), N.S.W. S.216 (1874), W.A. S.181 (1893).} Its legislative development paralleled that of the United Kingdom provision until the implementation of the co-operative legislation where it appeared as S.305 of the \textit{Uniform Companies Acts (1961-1962)}.\footnote{"(1) If in the course of the winding up of a company it appears that a person who has taken part in the formation or promotion of the company or any past or present liquidator or officer has misapplied or retained or become liable or accountable for any money or property of the company or been guilty of any misfeasance or breach of trust in relation to the company, the Court may, on the application of the liquidator or of any creditor or contributory, examine into the conduct of that person liquidator, or officer and compel him to repay or restore the money or property or any part thereof with interest at such rate as the Court thinks just or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance, or breach of trust as the Court thinks just." Ss.(2) is considered below. Ss.(3) provided that the section applied notwithstanding that the offender was also criminally liable. The section is based on S.227 of the Companies Act 1958 (Vic.) with Ss. (2) being taken from S.308 of the Companies Act 1936 (N.S.W.).}

Although the \textit{Uniform Companies Acts} contained many of the Jenkins Committee recommendations, surprisingly the misfeasance provision was not extended to encompass negligence proceedings. However, in 1966, Victoria enacted the \textit{Companies (Defaulting Officers) Act} which effected a number of major reforms to the defaulting officer provisions resulting in the replacement of S.305 with S.367B. These reforms included the restriction of locus standi to the Attorney General or any person authorised by him and the relaxation of the requirement that the company be in the course of being wound up. The provision was now to apply to companies which fell within the terms of S.367C, that is, to companies in various forms of financial difficulties. This category included companies which had ceased to carry on business or were unable to pay their debts, the provision specifying circumstances in which these requirements would be deemed satisfied. In particular a company would be deemed unable to pay its debts where execution

\[\text{Page 103}\]
proceedings were returned unsatisfied in whole or in part.\textsuperscript{17}

During the 1970's this provision was the subject of various amendments, the most significant being the adoption by all States, except Tasmania, of the \textit{Jenkins Committee} recommendation\textsuperscript{18} that the provision be extended to provide a summary procedure for negligence actions. This was effected by replacing the word "misfeasance" with "negligence, default, breach of duty".\textsuperscript{19}

This initiative was also coupled with the extension of the category of persons having automatic locus standi by the introduction of the concept of a "prescribed person". Those prescribed included liquidators, contributories and official managers but not creditors.\textsuperscript{20} Thus there was a partial return to the position that existed under and prior to the \textit{Uniform Companies Acts}.

It is difficult to discern the precise legislative policy underlying the repeal of the traditional misfeasance provision in S.305 and its replacement with S.367B, particularly the change in the standing of creditors.\textsuperscript{21} The extension of the category of persons with \textit{locus standi} did remove an inconsistency which existed between the misfeasance provision and fraudulent and reckless trading provisions. Under the latter, liquidators and similar officers had always had automatic locus standi and the provisions specifically allowed contributories or creditors locus standi provided they had the consent of the Commission. Arguably, all of these parties could have been authorised by the Commission to commence proceedings under S.367B prior to the amendments, but nevertheless prima facie an anomaly existed. Unfortunately, in relation to creditors the anomaly was maintained.

\begin{itemize}
\item \textsuperscript{17} No. 7501. Identical amendments were enacted in West Australia (No. 98/1969), Queensland (No. 8/1971) and South Australia (No. 52 1971/72). The amendments were also enacted in New South Wales (No. 61/1971) but with the inclusion of a subsection empowering the court to award costs against any person making an application without reasonable cause. In all States, reference to the Attorney General (or crown law officer) was subsequently replaced by reference to the Corporate Affairs Commission (Qld No. 71/1975; W.A. No. 100/1975; Vic. No. 8787; S.A. No. 54/1979; N.S.W. No. 61/1971).
\item \textsuperscript{18} Supra.
\item \textsuperscript{19} Effected by the second set of amendments referred to in footnote 12. In N.S.W. the amendment was effected by No. 20/1973. Cf. S. 212(1) of the Insolvency Act 1986 (UK) The W.A. amendment was incomplete: contrast S.367B (1)(b) and (1)(d).
\item \textsuperscript{20} Ibid.
\item \textsuperscript{21} O'Donovan and McPherson - The Law of Company Liquidation (3rd edition), Law Book Co Ltd 1987, p.362.
\end{itemize}
2.3 The features of S.598

The *Companies Code* replaced S.367B with S.542, which was copied to the *Corporations Law* as S.598. Changes initiated by this provision included:

(i) The removal of the requirement that the company concerned be insolvent or experiencing financial difficulties.

(ii) The separation of the power to conduct an examination, if it previously existed, from the provisions relating to awarding compensation orders and its enactment as a separate provision. A similar amendment would seem to have been envisaged by the New South Wales legislature in 1973 but subsequent amendments in New South Wales ignored this innovation.23

(iii) The abolition of the requirement that the persons against whom the court may make orders are to have "taken part in the formation, promotion, administration, management or winding-up" of the company.

(iv) The extension of the relevant acts of default to include fraud together with the deletion of the alternative of establishing the retention or misapplication of company money or property or other accountability.

(v) The legislative acknowledgment of a requirement that the company have suffered or be likely to suffer loss or damage.

(vi) The specification of the types of orders that the court may award. These include injunctive type orders and it would seem that the court's discretion has been extended beyond that provided by S.367B. On the other hand S.367B empowered the court to award interest, whereas S.598 is silent on this point.

(vii) The deletion of the provisions as to unfair or unjust payments or transfers to officers and as to awards of costs against applicants.

(viii) The specification that the onus of proof required is that the court be "satisfied" as to the elements contained in the provision. This would seem to add nothing because the ambiguous phrases, "If ... it appears ..." and "Where it appears to the (applicant) ..."

22 See below.
contained in the earlier provisions has always been interpreted as requiring the court to be satisfied on the balance of probabilities.\textsuperscript{24}

(ix) The removal of automatic locus standi being granted to contributories.

2.4 The relevance of the section

It is apparent from the development described above that the legislature has over the past century and a quarter gradually extended the scope of this provision. It is, therefore, initially surprising to note that notwithstanding this enlargement of the provision, the most significant feature of the case law in recent times is the rarity with which it has been relied upon. A feature of the law reports of the Chancery and Equity division of the late nineteenth century is the number of misfeasance provision cases reported. Today they are unusual indeed,\textsuperscript{25} the reason probably being the availability of the reckless and fraudulent trading provisions.

The absence of these latter provisions well into the twentieth century\textsuperscript{26} reflected the fact that the misfeasance provision was seen as the panacea for all the ills arising from directors' malfeasance. As it was the only provision dealing with defaulting officers there were many attempts by applicants to stretch its application. Generally these attempts were resisted by the courts. However, they illustrated a need which, had the provision been held to cater for, would have obviated the need for the subsequent enactment of the reckless and fraudulent trading provisions. It is arguable that had the courts accepted that, in the insolvency context, a trustee relationship exists between the directors and creditors, then an adequate creditor recovery regime would have existed without the need for legislative intervention.

\textsuperscript{24} For a discussion of the problems presented by this terminology see Wren v Lyndon [1972] ALC 40-050; and also see Re Boyagarra Pty Ltd (in liq.); Evans v Dean & Ors 7 ACLR 612 at 613.

\textsuperscript{25} A reversal in this trend may be expected with the development of the duty owed to creditors.

\textsuperscript{26} The first fraudulent trading provision was S.75 of the Companies Act 1928 (UK), first appearing in Australia as S.275 Companies Act 1938 (Vic.). The first reckless trading provisions was S.303(3) of the Uniform Companies Acts (1961-62).
3. Procedural Provision only or Cause of Action?

Probably the most significant debate over the scope of the provision concerned whether the provision merely provided a summary procedure whereby actions against officers based on an existing cause of action could be speedily brought or whether it provided a new statutory cause of action for default. This issue was first considered by Jessels M.R. in *In re Canadian Land Reclaiming and Colonizing Company; sub nom Coventry and Dixons case* in 1880. The Master of the Rolls upheld a summons by a liquidator against two persons who had knowingly acted as directors without holding the appropriate share qualification. His Lordship considered this to be "as plain a case of misfeasance or misconduct as you can possibly state" and had no hesitation in finding them liable under the misfeasance provision.

The English Court of Appeal overturned this decision on the basis that the provision did not create any new liability and for the section to apply the liquidator had to show something which would have constituted a cause of action by the company. James L.J. explained his divergence from the view of the Master of the Rolls on the basis that Jessels M.R. was not "construing the Act but legislating for the purpose of putting a stop to a proceeding which is no doubt wrong ... ". Similarly, in the words of Bramwell J., the directors had only committed "misfeasance in the abstract" whereas what was required was actionable misfeasance.

The English Court of Appeal had cause to reconsider this decision in *In re Anglo-French Co-Operative Society; Ex parte Pelly* in 1882. In this case the summons was upheld on the basis that there was clearly a misapplication of company funds amounting to a breach of trust, and thus *Coventry and Dixons case* could be distinguished. Nevertheless, it is interesting to note that of the three members of the Court of Appeal, Cotton L.J. expressed approval of the principle established in that case, Jessels M.R. was silent on the issue, and Brett L.J. delivered a stinging attack on the decision stating that he was "extremely sorry" for the restrictive interpretation placed on the provision by that case because he had:

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27 (1880) 14 Ch D 660, 668.
28 Id, 664.
29 (1880) 14 Ch D 668.
30 Id, 669.
31 Id, 672.
32 (1882) 2 Ch D 492, 499.
"always thought that that section was the most salutary section in the whole of the Act and one intended to meet ... in the very widest terms, transactions which have become a perfect scandal in the getting up of companies in this country."

Nevertheless, his Lordship felt himself bound by the earlier authority.

**New amendments, old arguments**

Whilst this appeared to settle the issue to the effect that the provision was merely a procedural section the issue recently resurfaced in Australia in another guise.

Whilst it is arguable that the summary procedure provided by the misfeasance provision is not appropriate as a vehicle by which to conduct negligence proceedings the Jenkins Committee nevertheless recommended that the provision be amended to include negligence, and subsequently legislative changes were effected by most jurisdictions. The Australian amendments gave rise to some difficult questions as to the effective commencement date of the amendment.

An analysis of the earlier caselaw, together with the Jenkins Committee recommendation, renders the purpose of these amendments plain, viz. to bring within the scope of the summary proceedings claims founded in negligence. However, in Kimberley Mineral Holdings (In Liquidation) v Triguboff it was argued that the amendment created new liabilities and accordingly should be

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33 Id, 505.
34 The interpretation of the misfeasance provision as not giving rise to an independent cause of action is indicative of nineteenth century formalism and has parallels in the interpretation of other legislation. For example the provisions of the English Judicature Act 1873 dealing with the jurisdiction of the courts to grant interlocutory injunctions were interpreted as merely confirming the pre-existing jurisdiction of the courts and not extending that jurisdiction. See especially North London Railway Co v Great Northern Railway Co (1883) 11 QB D 30 where the Court maintained the necessity for there to be an existing cause of action before injunctive relief could be entertained taking the view that the Act dealt only with procedure, not jurisdiction. Again Jessel M.R. took a more liberal view opining that the jurisdiction of granting injunctions was practically unlimited: Beddow v Beddow (1878) 9 Ch D 89 at 93. Generally see Tilbury, Civil Remedies, Butterworths Sydney 1990 at pp 303-305 and the authorities and references he cites there.
35 Also see In re City Equitable Fire Insurance Company Limited [1925] 1 Ch D 407; Because the provision is procedural only then the limitation period for the purposes of the Statute of Limitations commences from the date the cause of action arose and not from the date of the winding-up. (In re JE Hurdley & Son Ltd (in Lig) [1941] NZLR 686, 711; Re Maney & Sons De Laxe Service Station Ltd [1969] NZLR 116 and Official Assignee v Fuller [1981] 2 NZLR 110.)
36 Oditah, Op. cit. 212 and see the discussion in section 4.1.2 below.
37 See section 4.1.2 below.
construed prospectively as applying only to such events as occurred after it came into operation and not retrospectively as would have been the case if the provision remained procedural. The essence of the argument was that company officers are now to be liable *inter alia* for negligence whereas previously they were liable only for misfeasance or breach of trust.

*Needham J.* rejected the proposition that by using the word negligence the legislature was creating a new subject matter of liability. This could not be inferred from the section and in fact there were indications to the contrary.39

This decision was followed by the Full Court of South Australia in *Re Claridge House Ltd (in liq); Mount v Tomlinson & Anor; Small v Burton.*40 It had been argued in that case that the amendment had been effected to overrule the decision in *Re B Johnson & Co (Builders) Ltd* which held *inter alia* that a case of common law negligence was not within the section. It was submitted that accordingly the word "negligence" in S.367B meant common law negligence such that the section should be treated as dealing with the substantive law. This interpretation of negligence was rejected in favour of a construction that it meant negligent acts of a director of the company for which he has always been liable.

These decisions are in accordance with the purpose behind the amendment as explained by the *Jenkins Committee*. Although the intention of the amendments was to displace the decision in *Re B Johnson & Co (Builders) Ltd* the effect of that is not to bring all common law negligence actions within the scope of the provision but only such negligence actions as the substantive law allows against directors.41

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39 Furthermore, in his Honour's view, the proposition that negligence was, prior to the enactment of the amendment, unknown in the relationship of a company and its directors was false. Directors who breached the standard of care immortalised by Romer J. in *In re City Equitable Fire Insurance Company* committed acts properly characterised as negligence which have long been the subject of a liability to the company.


41 Some would argue that the interpretation of the term 'negligence' by the courts in Triguboffs and Tomlinsons cases was too narrow: Baxt 54 ALJ 229 at 231. O'Donovan states that the result of these cases is that the amendment did not affect the principle that mere negligence did not suffice to attract liability unless the act or omission was one, which independently of the misfeasance provision, would constitute a breach of duty (op. cit., 362). Also see Oditah (op. cit., 212-213) who also doubts whether the amendment has the effect of including 'mere negligence' within the purview of the provision.
Thus again this was an attempt to give the misfeasance provision an effect on the substantive law. This time, however, the argument was advanced by directors in an effort to defend claims against them rather than by those seeking redress.\textsuperscript{42}

Thus it is now beyond doubt that the provision does not affect the substantive law but provides a summary procedure, the significance of which is that a matter can be resolved speedily without recourse to pleadings and pre-trial procedure but with the simple expedience of an application for directions if necessary. It will be observed below that this has given rise to the argument that the procedure is only available in simple cases, and to considerable discussion as to the procedure which should be adopted and as to the availability or otherwise of third party proceedings and set offs.

The need for this summary procedure is to prevent liquidations from being unduly delayed whilst the liquidator pursues an action against defaulting officers. It has been recently illustrated that no such action is available once the liquidation has concluded,\textsuperscript{43} and in any event a liquidation could not be settled until outstanding actions against company officers are resolved.

The significance of the interpretation of the provision rejected in \textit{Coventry and Dixons case} cannot be understated. Had the view of Jesse Is M.R. prevailed then the provision would have constituted a statutory cause of action against defaulting officers and the pressures on the legislature which gave rise to the enactment of the reckless and fraudulent trading provisions during the twentieth century may not have eventuated. Creditors would have been able to proceed against company officers for misfeasance or breach of duty even in the absence of a direct duty being owed to them. Further, this cause of action would have been vested in them individually, a state of affairs which the recently developed directors' duty to creditors is yet to acknowledge. It would seem that this interpretation could have prevailed had his Honour, in his capacity as Master of the Rolls, simply constituted the Appeal Court differently.\textsuperscript{44}

The finding that the provision is procedural only presented a great blow to opponents of the limited company concept who perceived the

\textsuperscript{42} This probably illustrates the shift in the balance that had taken place during the preceding century as evidenced by the legislative amendments effected by Parliament and the more stringent approach to directors' duties demonstrated by the judiciary.

\textsuperscript{43} Re Claridge House Ltd (in Liq); Mount v Tomlinson & Anor (1980) 6 ACLR 81.

\textsuperscript{44} Had the Court of Appeal comprised of Jessel M.R. and Brett L.J. their interpretation of the provision would have prevailed.
companies legislation as the "Rogues' charter". Now the avenue for some control over abuses of the corporate form had been severely curtailed. However, if the general law duties of company officials to the public, contributories and creditors in particular, could be extended, then together with a liberal interpretation of the requirements to be satisfied in order for the misfeasance provision procedure to be available, such developments could provide the necessary control over defaulting officers.

Indeed, developments in directors' duties were forthcoming.45 However, the focus of this duty was restricted to misconduct or negligence, vis-a-vis contributories. Directors were seen as owing no duties to creditors. They could loosely be characterized as trustees of the property of contributories, as was observed in chapter 3, but it was not until very recently that they were recognized as trustees of the property of creditors, albeit in the limited context of a near insolvent company.

Thus the general law has been slow to recognize any obligations on the part of directors towards creditors. Now that a duty has been recognised the question arises as to whether the current misfeasance provision is an adequate vehicle by which to enforce the duty. In order to examine this question it is proposed to analyse the elements required to be satisfied for the section to apply together with any other restrictions or special considerations associated with it.

4. The Features of the S.598 Proceedings and the Duty to Creditors

4.1 What causes of action may be brought by misfeasance summons?

4.1.1 Clear application to duty to creditors

The courts, having established that the provision was procedural only, rendered it necessary for an applicant to show a cause of action in order for the provision to be applicable. The provision traditionally required proof of a cause of action amounting to:

(i) a misapplication or retention or liability or accountability of or for any money or property of the company, or

45 The seminal authority is In re City Equitable Fire Insurance Company Limited [1925] 1 Ch 407.
(ii) a misfeasance or breach of trust.

There have been no reported decisions dealing solely with this first category and rather its relevance has generally been as an aid to the interpretation of the second category. In any event, the first category does not appear in S.598.

The second category has, on the other hand, given rise to considerable judicial comment, in particular as to the meaning of the term "misfeasance". As observed above the word "misfeasance" has been replaced with the words "negligence, default, breach of duty". The significance of this shall be discussed shortly.

As to the term "breach of trust", it too has received little judicial attention except as an aid in the interpretation of the word "misfeasance". In S.212 of the Insolvency Act 1986 (UK) the phrase "breach of trust" has been replaced by "breach of any fiduciary or other duty". The terms "trust" and "fiduciary" would seem interchangeable and the reference to "other duty" would seem to be intended to bring proceedings for negligence within the ambit of the provision.

S.598 has also added the category of fraud. This was arguably covered by the provision in any respect although there are no reported decisions dealing with the issue.

Clearly proceedings for breach of the duty to creditors are within the jurisdiction of the provision as currently defined. It is, however, proposed to briefly explore whether this would have been the case under the traditional form of the provision and also to consider the potential scope of the current Australian provision.

4.1.2 "Misfeasance" defined

In chapter 3 some contention as to the source of the duty to creditors

46 See the discussion in section 2.2.
47 Cf. S.423(1) of the South African Companies Act which uses the expression "breach of faith or trust".
48 Murphy J., of the Victorian Supreme Court, gave some indication as to what is meant by the term when he stated in Re Insurance Associates[1974] ACLC 40-124: "It does seem therefore to me that directors act in breach of trust qua property and moneys of the company which is in their hands or under their control if they apply such property or money in a manner which is beyond the powers of the company."
49 Although see Southern Cross Commodities Pty Ltd (in liq) v Ewing (1987) 5 ACLC 1110; "Whilst [S.367B] provides a remedy at law, it speaks in the language of equity ... it contemplates ... liabilities in equity ... [and] that transactions caught by it may well be fraudulent". (p.1124).
was identified. Whilst the prevailing view would appear to be that its source is in the fiduciary duties owed by company directors to their companies there is an opposing view that it is sourced in torts law principles, in particular the tort of negligence.

Whilst it would appear, from the analysis below, that proceedings for breach of this duty could readily have been brought under the traditional misfeasance provision given the prevalent view of the source of the action, if, on the other hand, the action in properly sourced in negligence the application of the provision is more problematical. Ultimately the issue is one as to the meaning of the term "misfeasance".

"Misfeasance" can be defined as the improper performance of a lawful act.\(^{50}\) Thus, its scope is very broad and soon after the enactment of the first misfeasance provision the courts were required to define the term with greater precision. In *Coventry and Dixons case* the Court held that the word in the section meant misfeasance in the nature of a breach of trust, resulting in some actual loss to the company. This was soon taken to be the settled position.\(^{51}\)

Why the courts decided to restrict the interpretation of the term in such a manner is not initially apparent until it is recognised that in many of these early cases the courts were forging a general statement of liability for directors. If there was no cause of action apparent upon an application under the misfeasance provision, then it was unnecessary to define the term. However, many of the earlier decisions either ignored the fact that the misfeasance provision did not provide a cause of action or confused the two steps, viz. (i) determining whether the claim was one for misfeasance and (ii) determining whether a cause of action existed. Hence the term misfeasance became restricted to a misfeasance in the nature of a breach of trust because this was effectively the limitation placed upon a company's cause of action for wrongdoing against directors.\(^{52}\)

This may also serve to explain why the draftsman initially restricted the provision to actions in the nature of misfeasance (assuming that the narrow interpretation of this term is correct) and did not include negligence within the category of wrongful acts to which the provision

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51 The judgment of Lord MacNaghten in *Bentinck v Fenn* (1887) 12 App Cas 652 at 669 is often cited as stating the settled position.

52 Apart from fraud, the main causes of action enjoyed by creditors were for ultra vires acts or for breach of warranty of authority; Halsbury (4th edition) p.301-302. See chapter 2.
applied. It may be that the draftsman of 1862 simply could not envisage proceedings for negligence being brought against directors.

Application to negligence proceedings

Early caselaw

The cause of action against directors was initially allied to the assimilation of the position of the director with that of a trustee. Soon the courts began to emphasize the points of distinction between the two capacities\(^{53}\) and gradually a cause of action in negligence against directors was forged. This gave rise to the issue of whether the court had jurisdiction to hear negligence proceedings on an application under the misfeasance provision.

The early caselaw discloses a dispute as to whether all negligence actions were comprehended by the provision or only those involving gross negligence in the nature of a breach of trust. For example, in In re Railway and General Light Improvement Company; sub nom Marzettis case\(^{54}\) Brett L.J. refused to accept a distinction between negligence and gross negligence. Any degree of negligence was actionable under the misfeasance provision.\(^{55}\) A purported rationalization of the decisions as to the scope of the misfeasance provision was attempted in In re Kingston Cotton Mill Company (No. 2).\(^{56}\) In that case the English Court of Appeal held that the critical test of

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53 In particular, directors are required to risk company property, whereas trustees are under an obligation to keep trust property safe. See Re International Vending Machines Pty Limited and the Companies Act [1962] NSW R 1408 at 1419-1420.

54 (1879-80) 28 WR 541.

55 Marzettis case was followed in In re Faure Electric Accumulator Company (1889) 40 Ch D 141. The important point for present purposes is that the Court in that case considered that it had jurisdiction to consider a cause of action founded in gross negligence under a misfeasance summons. Also see Lord Hatherley in Overend & Gurney Company v Gibb (1870) 5 Law Rep H L 487 and Kekewich J. in In re the Liverpool Household Stores Association (Limited) (1890) 59 L J Ch 616, but cf. Brett L.J. in Marzettis case (1879-80) 28 WR 541. There are also some observations in the judgment of Romer J. in In re City Equitable Fire Insurance Company which could be interpreted as implying that negligence proceedings could be pursued upon a misfeasance summons. Further support for this view is also apparent from the judgment of Vaughan-Williams J. in In re New Mashonaland Exploration Company [1892] 3 Ch 577 at 585 in which his Lordship stated that whilst it has been held that directors are not within the section unless they have been guilty of a misfeasance in the nature of a breach of trust clearly if directors are guilty of such negligence that it could not be said that in doing what they did they attempted to perform their duty as directors, then such directors are guilty of misfeasance.

56 [1896] 2 Ch 279; This case was interpreted by Evershed M.R. in In re B Johnson & Co [1955] Ch 634 as not deciding that any breach of duty which did not involve a misapplication of assets was outside the section but rather, the converse, namely that where there has been a breach of duty which did in fact result in a misapplication of company property, then such a transaction was within the ambit of the section. Also see Selangor United Rubber Estates Ltd v Cradock & ors [1967] 1 WLR 1168 at 1173-1174.
whether the section would apply was whether there had been a misapplication of company assets. This was justified by reference to the object of the provision which was to enable the liquidator to recover any assets of the company improperly dealt with by an officer.

Notwithstanding these observations, Maugham J. in *In re Etic Limited*,57 after analyzing many the earlier decisions, stated that the provision was limited to cases where there had been something in the nature of breach of duty which included a misfeasance or a breach of trust in the strict sense. The provision did not authorise a summons grounded on misfeasance in the nature of negligence. This decision was affirmed in the latest English case on the subject of *Re B Johnson & Co Builders Limited*.58

**Australian cases**
The seminal Australian case on the issue is the High Court Decision in *Couve v J Pierre Couve Limited (In Liquidation) and Another*59 where the Court held that a fraudulent preference amounted to a misfeasance. The High Court expressly followed the English decisions in *Coventry and Dixons case, Bentinck v Fenn and In re Etic Limited*, preferring the narrow meaning of the term "misfeasance".

The views expressed in *Couves case* and *In Re B Johnson & Co (Builders) Limited* have been consistently applied in subsequent Australian cases. For example, the Full Court of New South Wales affirmed these authorities in *Hurstville Finance Pty Ltd (In Liquidation) v Franklin and Another*60 as did the High Court in *Walker v Wimbourne and Others*61 where the Court circumvented the requirement by characterizing the section as requiring a breach of duty but then taking an expansive view of the duty to act in the best interests of the

57 [1928] Ch 861.
58 [1955] Ch 634. Sir R. Evershed M.R. stated: "There is no such distinct wrongful act known to law as misfeasance ... it is not every kind of wrongful act so done that is comprehended by the section. At one end of the scale it may, I think, be taken as prima facie clear that a wrongful act involving misapplication of property in the hands of the person charged would be covered by its terms. At the other end of the scale a claim based exclusively on common law negligence, an ordinary claim for damages for negligence simply, would not be covered by the section. Nor is such a claim brought within the section by the mere expedient of adding epithets to the negligence charged calling it 'gross' or 'deliberate'. Nor by that expedient without more can what in truth is mere negligence be converted into something else, namely, breach of trust. In between the two extremes I have mentioned, there is obviously a large range of conduct which may (or may not) be within the section. I shall follow others in not attempting any precise definition of what does or does not fall within it."
59 (1933) 49 CLR 486; also see *Re Yorke (Stationers) Pty Ltd (in liquidation) [1965]* NSWLR 446.
60 (1968) 70 SR (NSW) 350 at 361.
61 (1976) 50 ALJR 446; also see *Re Boyagarra et al (1982-83) 7 ACLR 612.*
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The Misfeasance Provision

company.\textsuperscript{62}

\textbf{Application to nonfeasance}

Whether the misfeasance provision authorises a summons to be issued grounded in negligence also arose in a series of decisions in which nonfeasance amounting to negligence was alleged.\textsuperscript{63}

The first case on point was the 1878 decision of Jessels M.R. in \textit{In re Forest of Dean Coal Mining Company}\textsuperscript{64} where his Lordship rejected a summons issued against a director for failing to take steps to recover money incorrectly paid by the company. His Lordship held that he did not believe that the section authorised the court to inquire whether a man had or had not properly exercised his discretion in such a case as was before him. Rather the section only applied to what his Lordship termed fairly plain and ordinary cases of misconduct and was not intended to go beyond what was the settled law on the subject before the statute was passed. Whilst the contexts are clearly different, this decision by his Lordship is somewhat surprising given the approach he adopted and views expressed two years later in \textit{Coventry and Dixons case}.\textsuperscript{65}

The decision was followed by Fry L.J. in \textit{In re Wedgwood Coal and Iron Company}\textsuperscript{66} where his Lordship made the observation that the legislature plainly did not refer to cases of mere nonfeasance excepting those where there had been, in fact, a breach of trust.\textsuperscript{67}

\textsuperscript{62} Also see Re Tropic Isle Limited (supra) where the Full Court of Queensland held that mere imprudent investment amounting to common law negligence without more could not be pursued upon a misfeasance summons. On the other hand in \textit{In re Australasian Venezolana Pty Ltd; Olsson v Vogel; Olsson v Best [1962] 4 FLR 60} Eggleston J. of the Supreme Court of the A.C.T. would seem to have been prepared to make orders pursuant to a misfeasance summons against a director charged with negligence had the liquidator proved that certain monies paid away were irrecoverable. No consideration of the authorities was undertaken and the case is dwarfed by the weight of authority cited above.

\textsuperscript{63} Marzettis case (1879-80) 28 WR 541 and the Mashonaland Exploration case [1892] 3 Ch 577 would support the proposition that the provision encompasses nonfeasance whereas the authorities against the extension of the provision to cover negligence must by implication deny the application of the provision to nonfeasance.

\textsuperscript{64} (1878) 10 Ch 450.

\textsuperscript{65} See the discussion in section 3 above.

\textsuperscript{66} (1882) 47 LT 612; followed in \textit{In re The Liverpool Household Stores Association (Limited)} (1890) 59 LJ Ch 616.

\textsuperscript{67} Thus in \textit{In re Cardiff Savings Bank [1892]} 2 Ch 100 it was argued that the failure to attend meetings by a president of a bank amounted to a breach of his duties which ought to have been performed at those meetings and so there was nonfeasance amounting to a breach of trust. The argument was rejected on the basis that there was no evidence to indicate that the president knew that the duties of the proper management of the bank were not being fulfilled. Thus, for nonfeasance to amount to a breach of trust it would seem that knowledge of the default must be brought home to the officer concerned.
Thus, if the duty is properly sourced in common law negligence there must be some doubt as to whether actions against directors for failing to take into account the interests of creditors could have been brought under the misfeasance provision as it was traditionally drafted. On the other hand, it could be argued that such actions are in the nature of a breach of trust and so within the exceptional category of negligence proceedings that could have been brought by misfeasance summons. In any event, as stated previously, such proceedings are clearly within the category of the causes of action contemplated by the current Australian misfeasance provision. In fact this provision is cast particularly broadly and it is to a consideration of the width of its application that it is now proposed to turn.

4.1.3 Jurisdiction of current provision - application to any "default"

Until recently there have been very few cases under S.598 and its immediate predecessor probably due to the availability of the alternative, and arguably, more extensive statutory causes of action, such as those contained in the reckless and fraudulent trading provisions. As previously observed, with the recent development of a duty of care owned by directors to creditors the provision is again gaining popularity.

Another possible avenue for extension in the application of the provision was opened by the decision in Re Indopal Pty Ltd where the Court adopted a very wide interpretation of the word "default". The case involved, inter alia, an application by the liquidator under the misfeasance provision seeking orders that directors submit a report as to the affairs of the company as required by the legislation. The Court held that the failure to submit the report amounted to a "default" within the meaning of S.598. Furthermore, the company was likely to suffer loss as a result of such default by reason that in the absence of a proper report as to the affairs of the company the liquidator would probably have to seek an order for an examination of one or more of

68 The Senate Standing Committee on Legal and Constitutional Affairs observed in their Report on the social and fiduciary duties and obligations of company directors (November 1989) that the fiduciary duty continued to attract litigation notwithstanding the availability of the statutory remedies. This was attributed to the broader and more flexible nature of this duty and to the attraction of equitable remedies over those available under the legislation (paras 5.58 to 5.62). This prognosis is supported by the decisions in Wright v Frisina (1983) 7 ACLR 532 and Re Buchanan Enterprises Pty Ltd (No. 3) (1983) 7 ACLR 532 where, in each case, directors were found liable on a summons issued under S.367B alleging a breach of the duty to creditors.

69 (1987) 5 ACLC 278.
the officers of the company in order to obtain the information which should have been provided by the report. Such an examination would involve considerable expense for the company.

Thus it would appear that the word "default" in S.598 encompasses any failure to comply with the Corporations Law. This is a vast extension from the earlier requirement of misfeasance amounting to a breach of trust. Now any breach of duty, however insignificant, will suffice.

4.2 The requirement of loss

In addition to proving the requisite wrongful conduct by the respondent it is also necessary, pursuant to S.598(2)(b), to prove that the company has suffered or is likely to suffer loss or damage as a result of this conduct.

Requirement originally a judicial gloss

Whilst this loss element was not, until recently, an express requirement of the provision, nevertheless the courts have traditionally required the applicant to show loss probably because the provision authorises orders of a compensatory nature and in order to make such orders the court requires evidence of loss.

There are many obiter pronouncements in the early decisions dealing with the provision referring to the need to show loss but the seminal authority is the case of Bentinck v Fenn. In that case a summons against a director for failing to disclose an interest in an asset purchased on the company's behalf at a price far exceeding its value was dismissed on the basis, inter alia, that no evidence that the alleged breach of duty resulted in loss to the assets of the company had been adduced.

This decision was expressly approved by Kekewich J. in In re the Liverpool Household Stores Association (Ltd) where his Lordship neatly summarised the position as follows:

"... the complainant is bound to prove a loss occasioned by the acts complained of, loss to himself if he be a creditor or a contributory, loss to the company, and, through the company, to the creditors or contributories if he be the liquidator." 

70 Supra.
71 (1890) 59 LJ Ch 616.
The requirement had been adopted in numerous Australian decisions.\textsuperscript{72}

\textit{When is a loss incurred?}

Whilst circumstances where company funds have been dissipated without the acquisition of any asset of equivalent value have readily satisfied this loss requirement, circumstances where an asset of some form has been acquired or where the "loss" is in the nature of foregone profit have proved more problematic.

Circumstances where it has been argued that no loss had been incurred because the company had simply exchanged one asset for another are illustrated by the case of \textit{Re Insurance Associates}.\textsuperscript{73} The respondent to the summons had arranged a loan from his company to a third person to enable that person to purchase from the respondent shares in the company at an exorbitant price. The respondent argued that the company had not suffered a loss because the company now owned a book debt, albeit illegally created, and the asset represented by this book debt was equal to the cash advanced.

\textit{Murphy J.} rejected this argument holding that it was necessary to look at the real money or property position of the company, not simply at book entries. It was fallacious to equate a tangible asset represented by cash in the bank with an asset represented by an unsecured loan for a like amount.

Whilst this decision is consistent with a line of authority\textsuperscript{74} the recent decision in \textit{Re Derek Randall Enterprises Ltd}\textsuperscript{75} must be taken as inconsistent with it. In that case it was held that a company suffered no loss when a director who had received a secret commission paid this money into a blocked account to secure a guarantee that he had given in respect of the company's overdraft. The English Court of Appeal was concerned to avoid double recovery attendant on ordering payment to the company of the secret profit. However it is clear that what the company "received" by way of the payment into the blocked account

\textsuperscript{72} For example, \textit{In re Inland Motors Limited} (1931) 34 WALR 104 discussed in a casenote in the ALJ (1932) at p. 347; \textit{In re JE Hurdley & Son Limited (In Liquidation)} [1941] NZLR 686; \textit{Re Tropic Isle Limited} [1967] Qd R 193.

\textsuperscript{73} Supra.

\textsuperscript{74} \textit{Re Canadian Oil Works Corp; Hays case} (1875) LR 10 Ch App 593; \textit{Re Caerphilly Colliery Co; Pearsons case} (1877) 5 Ch D 336; \textit{Re West Jewell Tin Mining Co; Westons case} (1879) 10 Ch D 579; \textit{Re North Australian Territory Co; Archers case} (1892) 1 Ch 322; \textit{Ex parte Pelly} (supra); \textit{Re Country Marine Insurance Co; Rances case} (1870) LR 6 Ch App 104 and \textit{Re Carriage Co-operative Supply Assn} (1884) 27 Ch D 322.

\textsuperscript{75} [1990] BCC 749.
was not the same as the payment of money representing the commission. Notably the decision has been the subject of critical comment.\textsuperscript{76}

An example of a profits foregone case is provided by \textit{In re North Australian Territory Co: sub nom Archers case,}\textsuperscript{77} where a director who had derived a secret profit from an agreement with a promoter argued that the company had suffered no loss from his alleged breach of duty. The English Court of Appeal disagreed on the basis that the failure by the director to account to the company for the profit amounted to a loss to the company. The fact that the company had been kept out of that which it had a right to receive allowed the Court to distinguish \textit{Bentinck v Fenn} and hold the director liable.

\textit{Reasonable commercial decisions not to be reopened}

It would appear that whether the company has properly incurred a loss is a commercial decision in which the courts are hesitant to become involved.

In \textit{Wilson v Gilbert & Another}\textsuperscript{78} a branch manager of an insurance company had committed misfeasance by issuing guarantee bonds contrary to his instructions. The company had been required to pay out on a number of these bonds or had acknowledged its liability to pay. The High Court upheld a summons against the branch manager upon finding that the bonds were binding on the company and thereby constituted a loss.

However, Barwick C.J., McTiernan and Owen JJ. concurring, indicated that even if the bonds were not binding it could not be said that the company had suffered no loss simply because had it disputed liability and fought the case against it upon the bonds to the final Court of Appeal it would have been held not to have been liable. In their Honours' opinion it might be that a decision to ratify the manager's acts in executing the bonds might in all the circumstances be reasonable and the resultant liability a consequence of the misfeasance.

Thus their Honours would seem to be upholding a business judgment test in that it is not for the court to decide whether the loss was properly incurred or not, at least on the facts before it. No doubt it is possible to envisage the boundaries of this principle, and hence their Honours' reference to the standard of reasonableness. It might be that the point of inquiry is not "has loss been suffered?" but rather "has loss been

\textsuperscript{76} Oditah, op. cit. 222-26.
\textsuperscript{77} [1892] 1 Ch 322.
\textsuperscript{78} (1965-66) 39 ALJR 348.
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suffered and if so was it reasonably incurred?".

**Requirement now stated and applied liberally**

As observed earlier, S.598 expressly codifies the need to prove loss. The provision, however, liberalises the requirement by providing that prospective loss is sufficient. Thus, in *Re Indopal Pty Ltd* 79 anticipated legal expenses if the orders applied for pursuant to S.598 were not granted, satisfied the loss requirement.

This case is also extraordinary in that the only anticipated loss to the company was legal expenses. This liberal application of the requirement was necessary because as the provision now authorises injunctive type orders it may well be that no loss save for legal expenses to enforce an obligation (by alternative means to using S.598) could in many circumstances be anticipated where injunctive type orders are sought.

Thus it would appear that, whilst some difficulties have arisen, the loss requirement has typically been applied from a realistic commercial standpoint. 80 Furthermore, it has seldom presented a limitation on the availability of the misfeasance procedure and it would appear that there is even less likelihood of it providing any such limitation given the liberal codification of the loss requirement contained in S.598.

4.3 Locus standi

**Legislative history**

S.165 authorised proceedings to be commenced by the liquidator, a creditor or contributory of the company. With the addition of the official receiver this is still the position in the United Kingdom today. 81

In Australia, however, the legislature has often altered the category of potential applicants. The Uniform Companies legislation restated the original position but in the 1966 Victorian amendments locus standi was restricted to the Attorney General or any person authorised by him. 82 During the 1970's the concept of a prescribed person was introduced. Such persons included a liquidator, a contributory, an official manager or a person authorised by the Corporate Affairs Commission.

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79 (1987) 5 ACLC 278.
80 Some would call it a broad view: Oditah, op. cit. 213.
81 S.212(3) Insolvency Act 1986; Ss.(5) requires a contributory to obtain the leave of the court before commencing proceedings. Cf. In re B Johnson & Co (Builders) Ltd [1955] 2 All ER 775.
82 The reference to the Attorney General was subsequently replaced by a reference to the Corporate Affairs Commission.
Commission. A notable exclusion from the grant of automatic *locus standi* was creditors. This position has been adopted by S.598 which also excludes contributories as automatic applicants.\(^{83}\)

These recent exclusions in Australia are surprising but it is to be observed that such parties may still be eligible if they can persuade the Australian Securities Commission to authorize proceedings.\(^{84}\) Certainly one of the most striking features of the original misfeasance provision was that it authorised a creditor to commence proceedings under it. There are few reported decisions of creditors wishing to utilise this provision\(^{85}\) probably because there were few causes of action available to creditors against directors.\(^{86}\)

It has not been until the recent development of the duty owed by directors to creditors that the significance of creditors having locus standi becomes apparent. On the other hand, whilst there is considerable authority to the effect that a liquidator may bring proceedings for breach, there is little authority in support of the existence of cause of action available to individual creditors.\(^{87}\) Furthermore there is authority to the effect that rights personal to a creditor, or indeed a contributory, cannot be enforced under the misfeasance provision.\(^{88}\)

**Particular circumstances**

It was established in *In re National Funds Assurance Company*\(^ {89}\) that a liquidator had locus standi to bring an application under the misfeasance provision in his own right and it was unnecessary to consider whether he brought such an application in his capacity as the

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83 The concept of "prescribed person" is now incorporated into a new concept of "eligible applicant" introduced by the Corporate Law Reform Act (1992) discussed in chapter 10.

84 S.598(1) includes within the definition of a "prescribed person", persons authorized by the Commission. The amendments to the provision effected by the Corporate Law Reform Act (1992), has not altered this aspect.

85 In *In re British Guardian Life Assurance Company* (1880) 14 Ch D 335 a policy holder of an insurance company was held to have locus standi in the sense that he may be a creditor. Also see *Hermann v Charny* [1976] 1 NSWLR 261.

86 The section would appear to confer on creditors the power to institute proceedings for wrongs done to the company but, not surprisingly, this power was seldom exercised; *Re Exchange Banking Co* (1882) 21 Ch D 519; *Re Oxford Benefit and Investment Society* (1886) 35 Ch D 502. Also see above.

87 See *Nicholson & Ors v Permakraft (N.Z.) Ltd (in Liq.)* (1985) 3 ACLC 453 per Cooke J. at p.460, and *Hooker Investments Pty Ltd v Email Ltd & Ors* 10 ACLR 443.

88 *Re Hill's Waterfall Estate Co* [1896] 1 Ch 947; Contrast, however, the wording of S.598 with the earlier provisions. Arguably the court has power to direct awards in favour of individual creditors although the requirement in subsection (2) that the misfeasance be "in relation to a corporation" and that "the corporation has suffered ... loss or damage" would imply that any award is to be in favour of the corporation.

89 (1878) 10 Ch D 118, 124
representative of the company or of the creditors. Furthermore, in *Couve v Pierre Couve Ltd (In Liquidation) and Another* the High Court rejected an argument that because the general body of creditors would obtain no advantage from misfeasance proceedings, the liquidator being actuated by a desire to benefit a secured creditor, the proceedings must fail. The Court emphasised that the motive of the liquidator in bringing proceedings was irrelevant.

It has been held that a contributory does not have locus standi unless he has a direct pecuniary interest in the success of the application.\(^{90}\) Obviously this requirement could not meaningfully be extended to liquidators. However, it is possible to envisage circumstances where a creditor, should he have a cause of action in the nature of a representative action, could be met with a defence relying upon an extension of this principle, viz, where the debt owed to a secured creditor by the company exceeded the fullest possible return to the company from the applicant unsecured creditor's claim.

It would appear from the judgment of *Fullager J.* in *Re 67 Budd Street Pty Ltd and Ors; The Commonwealth of Australia v O'Reilly*\(^{91}\) that no action or prosecution may proceed against company officers once the winding up of the company has been completed because, at least in a formal sense, such proceedings are brought for the benefit of the company on the authority of *Coxon v Gors*\(^{92}\). This would only normally be an issue where the Australian Securities Commission has commenced proceedings and in this context the decision in *Re Klintworth Homes Pty Ltd*\(^{93}\) may assist the Commission, although that case was expressly disapproved of by *Fullager J.* Alternatively the Commission may succeed in obtaining orders avoiding a dissolution as the Federal Commissioner for Taxation was able to do in the *Re 67 Budd Street Pty Ltd case*.

Thus it would appear that recent developments in Australia may have fettered a creditor's standing to commence misfeasance proceedings.\(^{94}\) However, given the present state of development of the directors' duty to creditors in not providing a personal cause of action to creditors this

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90 Supra.
92 (1891) 2 Ch 73.
94 The Companies and Securities Law Review Committee would have recommended the amendment of this provision "to make it clear that the recovery procedure is available to a ... creditor" but given their recommendation that creditors have standing to apply for leave to commence a derivative action this amendment was considered unnecessary. See Enforcement of the duties of directors and officers of a company by means of a statutory derivative action, Report No 12 (November 1990) at paragraphs 266 to 275 and Discussion paper No 11 (July 1990).
does not present an immediate problem. As long as liquidators continue to enjoy the relatively unrestricted right to commence misfeasance proceedings, the current Australian provision provides an adequate procedural device given the available causes of action.

### 4.4 Potential respondents

S.598 authorizes the court to make orders against any person who has been found to be delinquent towards the company.

This would appear to have been an innovation which, on the face of it, may have enlarged the purview of the provision. Notably all previous misfeasance provisions, including the current United Kingdom provision, required that some connection between the respondent and the company be established. However, at least in Australia in recent years, the wide terms in which this requirement was expressed rendered it easily satisfied. For example, in *O'Toole v Mitcham* the Court held that the description of potential respondents specified in S.367B included, but was not restricted to, the previous categories. The change in language indicated, in the view of the Court, that so far from intending to confine the section to the earlier categories, parliament intended to broaden the category of persons affected. Accordingly, the argument that S.367B(1) was restricted in operation to officers or former officers of the company and so did not encompass a liquidator appointed by the court or creditors was rejected.

A few decisions based on the early provisions had found some exclusions. Liberal interpretations, even of the restrictive S.165, were,

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95 Initially S.165 of the Companies Act 1862 envisaged two categories of respondents: (i) any past or present director, manager, official or other liquidator; and (ii) any officer. In 1890 a third category was added: (iii) any person who has taken part in the formation or promotion of the company. (S.10 Companies (Winding Up) Act 1890 (UK)). These categories have been adopted by all subsequent United Kingdom misfeasance provisions, although S.212(4) Insolvency Act 1986 (UK) requires that the leave of the court be obtained before proceedings are brought against a person who has acted as liquidator or administrator of the company and had his release. In Australia the three categories were referred to in the original misfeasance provisions, but were reduced to two in the 1958 Victorian legislation, the blueprint for the Uniform Companies Acts. The 1966 Victorian amendments, adopted in turn by all the States, except Tasmania, witnessed the reduction of the requirement to the following terms: "any person who has taken part in the formation, promotion, administration, management or winding up".

96 Contrast the interpretation of S.423(1) of the South African Companies Act. A judicial manager has been held not to be an "officer" for the purposes of the provision: Rennie No v Holzman 1989 (3) SA 706.

97 [1978] ACLR 30-053; 3 ACLC 646.

98 In Re B Johnson & Co (Builders) Ltd it was held that a receiver manager appointed pursuant to a debenture trust deed was not a manager within the terms of the first
however, the norm. For example in In re Morvah Consols Tin Mining Co: sub nom McKays case\textsuperscript{99} it was held that it was only necessary that the respondent had been an officer at the time when the wrongful act was begun to be committed and he need not still be an officer upon its completion.\textsuperscript{100}

For the purposes of proceedings based on breach of the duty to creditors the scope of potential respondents would appear to always have been sufficient as the duty has, to date, been limited in its application to directors and any conceivable extension is likely to be restricted to the general category of corporate management. This is now beyond doubt given that S.598 is simply expressed to apply to any person.\textsuperscript{101}

4.5 Other legislative qualifications on the application of the provision

S.165 was included in the winding up section of the Companies Act 1862 and its application was expressly restricted to companies in the course of being wound up. This restriction has been continued through to S.212 of the Insolvency Act 1986.

Similarly, in Australia, until the Victorian amendments of 1966, it was necessary to prove that the company was in the course of being wound up. In the 1966 legislation, the concept of "a company to which this section applies" originated. This phrase was defined in S.374E. Again the fundamental criterion was that the company be terminating or in financial difficulties. Nevertheless, the category of potential companies

category (see fn 92) because he was not concerned to manage for the benefit of the company but was concerned to realise the debenture holders’ security. The powers of management endowed on a receiver were considered only incidental to and solely for the purposes of his receivership. Furthermore, in both Feltom’s Executors case Law Rep 1 Eq 219 and In re British Guardian Life Assurance Co (1880) 14 Ch D 335 it was held that the executors of a deceased director could not be proceeded against under the misfeasance provision as originally worded. However, in Re Boyagarra Pty Ltd (In Liquidation): Evans v Dean and others it was held that the wider terminology adopted in S.367B was sufficient to enable an estate to be proceeded against.

\textsuperscript{99} (1868) 2 Ch D 1.

\textsuperscript{100} The 1890 amendment would have caught such an officer, but by virtue of a slight change in terminology in the 1908 Consolidating Act, which was carried through until the enactment of the Insolvency Act, this decision took on more significance. The 1908 terminology was adopted in Australia, but since the enactment of the 1958 Victorian provision the legislation has expressly applied to any past officers. (The 1890 provision caught "... any past or present director, manager, liquidator, or other officer ...". S.215(1) of the Companies (Consolidation) Act 1908 changed this terminology to "... any past or present director, manager or liquidator, or any officer ... ". Arguably the 1908 provision would not catch past officers other than those particularized.)

\textsuperscript{101} See Oditah, op. cit. 216.
was substantially broadened by the inclusion of those companies which had ceased to carry on business or were unable to pay their debts. The section also provided for circumstances in which a company would be deemed to satisfy either of these requirements. In particular, S.374E(2)(b) provided that it would be deemed to be unable to pay its debts if execution or other process issued on a judgment decree or order of any court in favour of a creditor of the company was returned unsatisfied in whole or in part.

This major legislative limitation is completely abandoned in S.598 which applies to "any company". Given that the duty to creditors in its present form only arises in an insolvency context, the existence or otherwise of this limitation on the application of the misfeasance provision is of little significance.

4.6 Judicial qualifications on the application of the provision - simple cases only?

The judiciary also flirted with the issue of whether a gloss should be placed on the availability of the summary procedure provided by the misfeasance provision. This issue arose as a result of the lack of pre-trial procedures in summary proceedings resulting in the inability of the respondent to discover the case against him and of the parties to define the points at issue prior to the hearing. This was to be contrasted with the procedure available upon the issue of a bill where pleadings, discovery, interrogatories and directions summons would ensure that the parties could define the issues in dispute and thoroughly prepare their cases prior to the hearing.

Misfeasance summons procedure limited to simple cases

In a number of very early decisions the courts resolved this problem by limiting the application of the misfeasance summons procedure to simple cases. In In re Royal Hotel Co of Great Yarmouth102 Lord Romilly M.R. disposed of an application under S.165 by stating that unless the case against a director or officer be clearly and distinctly made out and there is no question of law to be determined, then the section had no application. His Lordship considered it too dangerous to attempt to proceed under this section where there was really a question to be tried. He justified this conclusion from an examination of the procedure which would be adopted upon a misfeasance hearing which he argued was unsuitable for complicated cases.

102 (1867) 4 Law Rep Eq 244.
His Lordship also relied on the earlier decision in *In re the Bank of Gibraltar and Malta*\(^{103}\) which acknowledged that the court had a discretion as to the cases in which it would put in force the powers conferred by the section.

In the following year his Lordship took the opportunity to restate his view in *In re the Brighton Brewery Co: sub nom Hunts case*.\(^{104}\) He stated the principle regulating the discretion of the court in the following terms:

"... [the court] must call directors and officers to account in all cases of a simple character and not in cases where from the peculiar nature of the facts and questions which arise justice can only be fairly done by bill and answer. I admit that this leaves the matter very much at large as it must be solely from a consideration of the peculiar facts of each case that the Court can act."

**Court to exercise discretion to issue directions**

The issue came for the consideration of the English Court of Appeal in *In re Mercantile Trading Co: sub nom Stringers case*\(^{105}\) in 1869. Selwyn L.J. observed that the issue had been adjudicated upon more or less ever since the passing of the first winding up Act in 1848 where the power was expressed in a very much less stringent and comprehensive form than under the 1862 Act. The reason for the tightening of these provisions could be traced to observations made by Turner L.J. who considered that such proceedings were, if not unlawful, at all events, inexpedient.

His Lordship then observed that the provision was expressed in such a way as to give the court discretion to make directions as to the conduct of proceedings so as to ensure that the respondents had full knowledge of the case to be brought against them and the fullest opportunity to defend themselves. Accordingly, they could not be said to be in any way disadvantaged from their position had a bill been filed. His Lordship stated that it would be doing something entirely inconsistent with the provisions of the Act, so general as they were, if he were to introduce any such qualification as that purported to be laid down in the *Royal Hotel Co of Great Yarmouth case*. Should such a qualification be introduced then the person charged would be induced to endeavour to make out that there was some question to be tried or that the matter was not so straight forward as it was represented to be and there would be very few cases in which such an attempt might not

\(^{103}\) (1868-69) 1 Law Rep Ch Ap 69

\(^{104}\) (1868) 37 LJ Ch 278 at 279.

\(^{105}\) (1867) 4 Law Rep Ch Ap 475. Also see Rances case (1870) 6 Ch App 104.
be made without some reasonable hope of success. The result would be to occasion the necessity for a double mode of proceedings and unnecessary expense and delay.

Giffard L.J. concurred adding that the provision was introduced in order to prevent the doubling up of proceedings and effect a complete winding up, and accordingly it would be rare for circumstances to arise in which the jurisdiction ought not to be exercised. If a narrow construction were placed upon the Act it would only be to the disadvantage of the public.

Misfeasance provision cases characterized by difficult procedural issues

Nevertheless, and probably as a result of this conclusion, the decisions under the misfeasance provisions have been characterized by difficult procedural issues. It would seem that complicated cases do not lend themselves readily to a summary jurisdiction but are best dealt with according to the tried and tested pre-trial procedures available under the bill or writ system.

Such considerations gave rise to the issue in the United Kingdom of a practice note in 1921 requiring every summons to be brought before the registrar before the filing of supporting affidavits. Should the registrar find the summons to be really in the nature of a witness action likely to involve issues of fact which ought to be tried by oral evidence, no affidavits were to be filed. Where there was any kind of complication, each party was to be required to deliver points of claim and of defence in the nature of pleadings so that the parties and the court should know what issues were to be tried.

In In re Vestal Hosiery Co Lawrence J. scathingly attacked the procedure often adopted by counsel whereby voluminous affidavits were filed and nobody except counsel concerned knew what issues they would raise. In his Lordship's view, a view which he stated was shared by his fellow brethren, this was nothing worse than a scandal on the procedure of the courts and one which lead to probable injustice, certainly waste of time and increased costs.

These comments and the issue of the practice note were a direct result of the decision not to impose a gloss on the types of proceedings which could be brought by misfeasance summons. As will be observed

106 Supra, 494.
108 [1922] 91 LJ Ch 627; also see the observations made by Astbury J. reported in the Practice Note (Supra) and those of Neville J. in Re AT Carter & Co (unreported).
in section 4.8, a further result of this broad application of the
misfeasance provision has been the necessity for the court to consider
a number of procedural questions, such as whether set-offs, cross
claims and third party proceedings should be entertained on an
application by way of misfeasance summons, and to convene
directions hearings. In the result complicated cases typically have
given rise to the summary procedure ultimately, after directions
hearings, being characterised by procedures typical of the bill or writ
system. Accordingly it must be doubted whether applications under this
provision are an appropriate mechanism by which to commence such
cases.

4.7 The powers of the court

4.7.1 Generally

Where the requirements of the section were proved to the satisfaction
of the court\(^{109}\) then S.165 empowered the court to examine into the
conduct of the respondent and compel him to repay any monies (or
property)\(^ {110}\) improperly retained together with interest or to compensate
the company\(^ {111}\) to the extent the court thought just. These powers are
more or less repeated by S.212(3) of the \textit{Insolvency Act 1986}. They
were also adopted by the Australian legislation, the wording used
remaining virtually identical to that used in S.165 until the enactment of
the 1966 Victorian amendments. In these amendments rather than
empower the court to make contribution orders in favour of the
company by way of compensation the court was empowered to order
that the respondent pay to the company "such sum by way of damages ...
... as the court thinks just".\(^ {112}\)

This trend towards broadening the statement of the courts' powers has
been continued in S.598 which empowers the court to may make such
orders as it thinks "appropriate" in relation to the respondent and to

\(^{109}\) (1922) 91 LJ Ch 627.

\(^{110}\) S.165 (UK 1862) only referred to wrongful conduct in respect to monies of the
cOMPANY and hence restricted the courts' powers to the making of orders as to the
payment of monies. S.10 (UK 1890) added a reference to property of the company.
S.215 (UK 1908) extended the courts' powers to making orders for the repayment or
restoration of money or property wrongfully obtained, "or any part thereof".

\(^{111}\) Any property or money recovered by means of the proceedings must be returned to
the company; Thomas Franklin & Sons Pty Ltd v Cameron (1935) 36 SR (NSW) 286 at
300; Re Asiatic Electric Co Pty Ltd (1970) 92 WN (NSW) 361.

\(^{112}\) This phrase was interpreted in Kimberley Mineral Holdings (in Liq) v Triguboff as
empowering the court to grant equitable relief and not envisaging common law
damages. The expression was considered to be a most inapt description of damages
at common law.
make the orders irrespective of the fact that the person may have committed an offence. Some guidance as to the type of orders that could be made is provided in subsection 4.113.

Of potential significance, from an individual creditor's perspective, the court is not restricted by S.598 to directing awards solely in favour of the company. Rather the court has an unfettered power to specify the beneficiary of any award, in contrast to earlier versions of the provision. Of course, on the current state of the authorities, a breach of the duty to creditors is not actionable by an individual creditor either in a personal or a representative capacity.

4.7.2 The power of examination

S.598 contains no reference to the power of the court to examine respondents. However, S.598(3), by codifying the basic rights of a respondent to a summons, would appear to require that the court should conduct adversarial proceedings prior to making any orders. This provision is the only fetter placed on the court's discretion. It states that the court has no power to make any orders unless the respondent is given the opportunity to exercise his rights there specified.

Some doubt as to the exact procedure to adopt upon a misfeasance summons and, in particular, as to the status of the power of examination contained in the provision had been generated as a result of earlier amendments which enacted a specific power to conduct an examination, contained in S.367A, and changes to the misfeasance provision which appeared to have the effect of restricting the courts' powers under that section to the awarding of compensation orders after an examination held pursuant to the terms of the misfeasance provision only. However, subsequent amendments had the effect of making the powers to examine and make orders disjunctive. That is, the courts were empowered to examine into the conduct of the respondent or to make compensation orders or to do both.

The nature of this examination power and, in particular, its relationship with the general examination power contained in S.367A, a predecessor to S.597, has been considered in two Australian cases. In Noble v Susta it was held that an application for examination

113 Discussed below.
114 First effected in the 1966 Victorian amendments.
116 3 ACLR 391.
pursuant to S.367B of a person already examined under S.367A was not an abuse of process as the two sections were not alternatives but rather, complementary. The classes of persons to whom the sections applied were not the same, although overlapping, and the conduct called in question by S.367A exhibited a more general kind of default than that called in question by S.367B. Furthermore, the purpose of obtaining an order under s.367A was to have the conduct and dealings of company officers examined, the notes from the examination being admissible in subsequent legal proceedings, not necessarily confined to proceedings under S.367B. The purpose of an examination under S.367B was to obtain an order for the payment of money and thus the purview of such an examination was dictated by the orders sought. This right of recovery given by S.367B contrasted significantly with the absence of any right given by S.367A.

In Re Marra Developments Ltd and the Companies Act (No 4)\(^{117}\) the issue before the Court was whether S.367B empowered the applicant to act as inquisitor or whether the applicant had to establish in the ordinary course of adversarial proceedings his entitlement to the relief sought. Needham J. held that the applicant had to satisfy the court that the respondent was guilty of one of the descriptions of conduct set out in the provision and in examining the conduct of the respondent the applicant was not to act as an inquisitor. This was in contrast to the procedure upon an examination under S.367A which was inquisitorial as evidenced by the fact that the section contained detailed provisions as to how the examination was to be conducted. In other words, S.367B did not provide for examinations in the abstract as did S.367A, but rather the reference to the courts' power to examine was simply a reference to the need for normal adversarial proceedings in order to determine whether the orders should be granted.

Thus the power to examine contained in the earlier forms of the misfeasance provision added nothing to the powers of the court, but simply left it beyond doubt that the courts should only make the orders sought after first presiding over adversarial proceedings and that this was so notwithstanding the disjunctive format of the power to examine and the power to make orders\(^ {118}\) and dicta expressed in certain English cases\(^ {119}\). As stated above, this position would appear to be expressly

\(^{117}\) 4 ACLR 889. Also see Wright v Frisina (1983) 1 ACLC 716.

\(^{118}\) For a similar conclusion see O'Donovan (op. cit.) at p.348: "The principal purpose of this section appears to be to extend traditional procedures beyond the field of winding up; cf. Re John Sanderson & Co Pty Ltd (1985) 1 ACLR 79 at 84".

\(^{119}\) There is some dicta to the effect that the section created a separate power of inquiry contrary to the Australian conclusion. In In re the Bank of Gibraltar and Malta the Court posed the question before it as to whether it should exercise the summary jurisdiction which the statute gave it by sending the case into chambers with a view to
endorsed in S.598.

4.7.3 The power to make orders

S.598 confers a very general power on the courts to make such orders as thought appropriate. In sub-section 4 the Act seeks to provide the courts with some guidance by stating that the courts may make orders directing a person to pay money or transfer property to the company or pay to the company an amount corresponding to any loss suffered. However, the section makes it clear that the courts' discretion is not restricted to these types of orders. Furthermore, whilst two unique Australian sub-sections defining aspects of the powers of the court to make orders have appeared in past provisions, neither of these two provisions appear in S.598.

investigating the conduct of the company officers. In the result the Court decided against this course and rather gave leave to the petitioners to file a bill in the name of the company on the basis that the matter would be much better resolved by the issue of a bill than by an inquiry under the summary jurisdiction. Such inquiries were in the experience of their Lordships attended with enormous expense, and in any event there was a greater difficulty in arriving at a satisfactory decision under such proceedings than when the questions were distinctly raised in a suit between the parties. Thus it would seem that the provision was initially intended to bestow a separate power of inquiry although it is not clear from this case as to the nature of this inquiry. It may be that the court would simply conduct adversarial proceedings in chambers. The report of the decision in the Bank of Gibraltar and Malta case does not disclose whether the officers had already been examined in such a manner upon the hearing of the petition although it would appear that this would have been unlikely.

120 In Re Indopal Pty Ltd (1987) 5 ACLC 278 the Court made injunctive type orders. It would appear that the courts' discretion has never been restricted to such orders. In In re Bank of Gibraltar and Malta (1865-66) 1 Law Rep Ch Ap 69 the Court made an order upon a misfeasance summons giving the petitioners liberty to use the name of the company in proceedings commenced by bill subject only to indemnifying the company for costs. This was on the basis that there was insufficient evidence justifying the making of compensation orders but sufficient to lay ground for an inquiry. However, in the circumstances, the Court thought it appropriate to give leave to issue a bill rather than conduct an examination. This decision was followed in In re Dominion Portland Cement Co Ltd (No. 2) [1919] NZLR 478. Also in the Re Marra Developments case Needham J. indicated that if no substantive order was sought by an applicant under S.367B he could see no reason why the court should not make a declaration to the effect that the respondent had been guilty of wrongful conduct where such was proved. Clearly his Honour did not consider the power in the court to make orders under S.367B to be restricted to those in the nature of compensation. Whether it authorized the making of injunctive type orders was, however, not considered.

121 The first originated as S.308(2) Companies Act 1936 (NSW). This sub-section read as follows: "This section shall extend to and in respect of the receipt of any money or property by any director of the company during the two years preceding the commencement of the winding up, whether by way of salary or otherwise, appearing to the court to be unfair or unjust to other members of the company." Although this provision was not previously enacted in any of the other States it appeared as sub-section(2) in the Uniform Companies Acts with the replacement of the term "director" with "officer". It was retained by the 1966 Victorian amendments but with the deletion of the two year restriction and the extension of the term "officer" to include a former officer. Furthermore, the provision was to apply if the receipt was unfair or unjust "to
Discretion exists not to grant relief or to only grant limited relief
The discretion of the court is not only as to the amount of relief it will grant but also as to whether it will grant relief or not.\textsuperscript{122} This is in contrast to where proceedings are brought by way of an action where judgment must be in accordance with the legal rights established. This is illustrated by the decision in \textit{In re Sunlight Incandescent Gas Lamp Co (Ltd)}\textsuperscript{123} where the Court exercised its discretion by not making the orders sought on the basis that most of the shareholders did not want the money and would return it if paid to them.

This decision was approved of in \textit{In re Home and Colonial Insurance Co Ltd}\textsuperscript{124} where the Court, having observed that the provision did not allow the respondent liquidator to claim a set-off or cross claim against the company, nor apply for security for costs or discovery, stated that the draftsman obviously had in mind the possibility that circumstances might arise which would make it unjust and inequitable to require payment of the total amount which the company might perhaps recover in an action. The Court was of the view that such circumstances existed on the facts before it and accordingly the order that was made had the effect that only the creditors would be compensated and not the shareholders who had accepted their loss honourably and would be unlikely to desire to make a liquidator liable for having, though in ignorance, acted honestly on their behalf.

In \textit{Re Morecambe Bowling Ltd}\textsuperscript{125} it was held that this discretion extended to apportioning the sum awarded between co-defendants in such a way and with such priority of liability as the court thought fit, whereas in \textit{Flitcrofts case} joint and several liability was ordered. The limits of this discretion were, however, attained in \textit{In re Centrifugal...
Butter Co Ltd\textsuperscript{126} where the Court held that it was doubtful whether it had jurisdiction to set aside a contract but even if it did then the jurisdiction was discretionary and would not be exercised on the facts before the Court.

Recently in Re Purpoint Ltd\textsuperscript{127} the amount of compensation ordered was limited to the amount necessary to meet the company's liabilities other than a debt owned to a co-director and another guaranteed by the director himself. The decision in this case is also important for highlighting the possible overlap between a misfeasance application and a claim for wrongful/reckless trading.\textsuperscript{128} Oditah argues that this overlap is, however, more apparent than real as a liquidator would not typically risk a speculative claim under the misfeasance provision in preference to proceedings for wrongful or reckless trading.\textsuperscript{129}

The only Australian case to consider this discretion in any detail is Re International Vending Machines Pty Limited and the Companies Act where Jacobs J. observed that he had a discretion, at least in regard to the amount which he could order to be repaid, citing Re Home and Colonial Insurance Co Limited as his authority. On the facts his Honour was not prepared to exercise this discretion in favour of the defaulting, although arguably bona fide, directors. They had not established evidence to justify such an exercise of discretion and in any event had themselves benefited from their defaults and were therefore not deserving of special treatment.

The courts' powers to make orders would therefore appear sufficiently broad to adequately enable them to adjudicate upon applications alleging breach of the duty to creditors.

4.7.4 The power to order costs

Against a liquidator personally

Most of the cases in which the courts' discretion under the misfeasance provision has been discussed involve the question of cost awards, in particular against the liquidator. It has been held in numerous cases that an application by a liquidator under the misfeasance provision is made in his personal capacity and not in his capacity as representative of the company. Accordingly, any costs awarded against the liquidator must be borne personally by him, although the court has the jurisdiction to order that he be indemnified

\textsuperscript{126} [1913] 1 Ch 188.
\textsuperscript{127} [1991] BCC 121.
\textsuperscript{128} Also see Re DKG Contractors Ltd [1990] BCC 903.
\textsuperscript{129} Op. cit., 218.
This point was not immediately appreciated by the courts. In *In re W Powell & Sons* Romer J. observed that the court had jurisdiction to order a liquidator to personally pay costs where it was considered just and further that it would not hesitate to exercise this discretion. In considering whether the discretion should be exercised an important factor was whether an application for security for costs had been opposed by the liquidator.

Furthermore, in *In re Raynes Park Golf Club Ltd; Ex parte Official Receiver* the Court stated that as such an order is tantamount to a declaration that the liquidator had been guilty of misconduct, there should be evidence to support it.

These decisions can only be reconciled with the authorities which hold that an application under the misfeasance section is made by a liquidator in his personal capacity if the courts are indirectly referring to their discretion whether or not to grant an indemnity out of the assets of the company. The decisions reflect an attempt by the courts to control abuses by liquidators and official receivers of the misfeasance provision. The courts will also prevent liquidators from taking any proceedings which appear useless or vexatious and have held that an official receiver who is indemnified against costs ought not to allow an application to be made unless he is satisfied as to the propriety of the application.

On the other hand, attempts to require liquidators to provide security for costs have generally met with failure notwithstanding expressions of misgiving by the courts. There is considerable authority against the making of such orders except where a liquidator is appealing or the circumstances are exceptional. The fact that personal orders as to costs may be made is often cited as a justification for not granting security.

On an initial reading it would seem that the position stated in *In re W Powell & Sons* and the supporting authorities, namely that the threat of

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130 This is consistent with the general position: Re Speedfix Building Products Pty Ltd (In liq) (1987) 5 ACLC 866.
131 [1896] 1 Ch 681; affirmed in In re Strand Wood Company Ltd [1909] 2 Ch 1. Also see Re Western Counties [1897] 1 Ch 617, 632.
132 [1899] 1 QB 961.
133 Re Exchange Banking Co, sub nom Flitcroft’s case (1882) 21 Ch D 519.
134 See In re Anglo-Sardinian Antimony Co (1894) 38 Sol Jo 682.
135 In re Strand Wood Company Limited [1904] 2 Ch 1; In re New Zealand Gum-Machine Co Ltd (In Liq) [1927] NZLR 100; Re Pavelic Investments Pty Ltd 8 ACLR 417.
personal liability for costs is a sanction that can be imposed on liquidators, is supported by the amendment introduced into the New South Wales provision in 1971 by S. 367B(4) and subsequently enacted in all the other States except Tasmania.\textsuperscript{136} However, in the only case to consider this provision, \textit{Re Asiatic Electric Co Pty Ltd (In Liquidation) and the Companies Act,}\textsuperscript{137} Street C.J. interpreted the provision against the background of the traditional view that liquidators are personally liable for costs in any event. As a result, his Honour admitted great difficulty in interpreting the provision. He concluded that the provision must have the effect of limiting the recovery of costs from the unsuccessful applicant of a misfeasance summons to cases where the application is made without reasonable cause. That is, his Honour read the provision, with reluctance, as displacing, at least so far as concerns a successful respondent and unsuccessful applicant, the ordinary discretion both statutory and otherwise exercisable by the court in litigious proceedings under S.367B. His Honour observed that it may even be possible that the provision covers the whole field of costs in litigation identifiable with S.367B, that is to say, a successful applicant might not recover costs.\textsuperscript{138}

His Honour noted problems presented by this interpretation of the provision and stated that in his view it was regrettable that the provision be so excessively protective of liquidators with a virtual disregard for the ordinary rights or a party, against whom a liquidator fails, to expect to have his costs paid. It was difficult to perceive the legislative policy underlying this departure from ordinary time honoured principles of civil litigation, involving as it did a risk of grave injustice to expose a person to the risk of costly civil litigation of claims against him without preserving to him the ordinary expectation of having his costs paid if those claims fail.

Had Street C.J. accepted the view that a liquidator sues in his representative capacity and adopted the decision in \textit{In re W Powell and Sons} and supporting authorities then the provision would have presented no difficulty. In such a case the provision could be read as clearly authorising personal cost awards against an unreasonable applicant, notwithstanding that the word "personally" does not appear at the end of the section.

\textsuperscript{136} Supra.
\textsuperscript{137} [1973] 1 NSWLR 603.
\textsuperscript{138} This decision was cited by Needham J. in Kimberley Mineral Holdings Ltd (in Liq) v Triguboff & Ors [1980] 1 NSWLR 210 as authority for the proposition that S.367B(4) may have introduced a new standard for the exercise of the courts' discretion as to costs. No comment as to the veracity or otherwise of the decision was ventured, but on the assumption that it was correct it was held that it did not follow that the whole of s.367B should be construed prospectively as breaking new ground.
Street C.J., however, totally ignored these authorities and rather relied on his earlier judgment in *Re Buena Vista Motors Pty Ltd (In Liquidation) and the Companies Act*\(^{139}\) where he had reviewed S.305 and suggested that the provision required reconsideration. In particular, his Honour observed that as the usual applicant in such a summons was the liquidator rather than the company itself, an unfortunate consequence in costs could result in the event of the liquidator failing as indeed happened in that case where the costs were ordered against the liquidator who was to be indemnified out of the assets of the company to the extent possible. His Honour further observed that the fact that the proceedings were brought by the liquidator personally and not as representative of the company had a dual significance. On the one hand it explained why no security for costs will be granted on the basis that the company is insolvent and secondly, it explained why the respondent may not propound cross actions or set-offs that might be available to him against a company in the course of being wound up.

His Honour recommended that the provision be amended to enable the application to be made in the name of the company. Such an amendment would allow security to be granted and enable cross actions. More importantly, it would encourage liquidators to use this section with its attendant procedural advantages and relative cheapness.

His Honour’s decision in the *Re Asiatic Electric Company case* was a clear consequence of following this earlier decision. The interpretation of S.367B(4) was approached from the basis that the legislative reconsideration of S.305 might have been as a result of his earlier recommendation and therefore designed to limit the circumstances in which cost awards would be made against applicants. This was so notwithstanding that, as his Honour conceded, the amendments were not directed effectively to his comments. Nevertheless, it was on this basis that he considered the earlier case as a vital guide to the interpretation of S.367B upon the question of costs.

However, the question remains that if the legislature were acting on his recommendation then why was the recommended amendment not adopted? Furthermore, why did the legislature use in S.367B(4) the term "reasonable cause" which is more in tune with the decision in *In re W Powell and Sons* and the like cases. The criticism by his Honour of the implications of his own interpretation of the provision supports

\(^{139}\) [1971] 1 NSWLR 72.
these doubts.

Does a liquidator sue in a personal or representative capacity? The significance of these considerations is that some doubt must exist as to the accuracy of the Buena Vista decision and of the authorities which state that an application by a liquidator under the misfeasance provision is made in his personal capacity. A perusal of the cost orders made in other decisions in which a liquidator has failed does not advance the matter much further. Most of these decisions are inconclusive except for In re Etic Limited where the award was made personally against the liquidator but he was given an indemnity out of assets of the company.

The cases which consider the granting of security for costs, notwithstanding their purported rationalization by his Honour in the Buena Vista case, would tend to support the view that the liquidator sues on behalf of the company. Furthermore the normal position is that the liquidator acts in his representative capacity. Although in In re National Funds Assurance Co the Court stated that a liquidator had locus standi to bring an application in his own right and that it was unnecessary to decide whether he had brought the application in a representative capacity, the case did not go as far as saying that he did not bring the application in a representative capacity. Furthermore, it seems absurd to argue that the liquidator brings an action in his personal capacity because what possible motive would he have to bring proceedings for misfeasance against the company except as a representative of the company.

S.598 and the duty to creditors

S.598 sheds no light on the issue. The provision simply uses the phrase "on application by". Thus it must be considered unsettled whether a costs award under the provision against an unsuccessful liquidator is against the liquidator personally or against the company.

The existence of proceedings for a breach of duty to creditors does not fit easily with the view that the liquidator brings proceedings as a representative of the company. Although the generally accepted view is that the origins of the duty are in the duty of good faith owed to the company, it is difficult to conceptualize that proceedings for breach of the duty are brought on behalf of the company, rather than on behalf of

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140 [1928] Ch 861.
141 See in particular Cozens-Hardy L.J. at p. 4 in In re Strand Wood Co Ltd [1909] 2 Ch 1.
142 A liquidator is the agent of the company and is not acting in his personal capacity: Knowles v Scott [1891] 1 Ch 717; Warrender Estates Ltd v Simpson (1933) 33 SR (NSW) 390; Thomas Franklin & Sons Ltd v Cameron (1935) 36 SR (NSW) 286.
the creditors, and so the company is *prima facie* liable for costs.

On the other hand, if the view is adopted that *prima facie* the liquidator is personally liable for costs, then it is difficult to accept that anyone other than the creditors should indemnify the liquidator. However, given that the company is most probably insolvent in such circumstances, then, in as much as the company is operating on funds supplied by creditors and it is required to indemnify the liquidator, the creditors will be indirectly indemnifying the liquidator in any event. Thus, although conceptually the status of a liquidator proceeding for a breach of the duty to creditors presents difficulties, it would seem that, at least where the company is hopelessly insolvent, the costs of an unsuccessful application would be borne appropriately by the creditors. In fact, in such situations, the creditors will most likely end up bearing the costs of all unsuccessful misfeasance summons.

### 4.8 Procedure upon a misfeasance summons

#### 4.8.1 Generally

The courts have a general discretion as to the procedure to be adopted upon the filing of a misfeasance summons. In most jurisdictions procedural rules exist but generally these only provide for the manner in which the application is to be brought, service of process, supporting affidavits and directions hearings. Apart from the occasional issue of practice notes or rulings the only guidance on procedural aspects associated with misfeasance summons is that discernible from the authorities.

Where there are no issues of fact and the matter is relatively simple, the general practice is to allow evidence by affidavit.

The procedure to be adopted where issues of fact are concerned was considered by *Jacobs J.* in *Re International Vending Machines Pty Ltd*. His Honour recommended that points of claim and points of defence be filed on the basis that they would be treated as the pleadings upon which the issues should be determined. The matter should then proceed in the normal adversarial manner. This statement of procedure

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143 For example see Companies Winding Up Rules 1932 (Tas.) Rules 53 and 54; Rules of the Supreme Court 1965 (Tas.) Part VI (Rules to Prescribe and Regulate the Procedure and Practice of the Court in the Exercise of its jurisdiction under the Companies Act 1962) Rules 45 (t), 46 and 47; Rules of the Supreme Court (Companies Transitional Provisions) 1982 (Tas.).

144 On procedure generally see O'Donovan (op. cit.) pp.360-362.
was cited with approval in *Re Insurance Associates Pty Ltd (In Liq).*\(^ {145}\)

It would seem that in such a situation, affidavits should not be filed but rather the issues of fact should be determined by oral evidence.\(^ {146}\)

If either party requires the adoption of any pre-trial procedures such as discovery or interrogatories then these matters can be determined by the parties at a directions hearing.

### 4.8.2 Set-offs, cross claims and third party proceedings

The more difficult issue which arises is whether set-offs, cross claims and third party proceedings are authorised upon the filing of a misfeasance summons. *Anderson J.* in *Re John Bruce Home World Pty Ltd (In Liq)*\(^ {147}\) stated the general position as follows:

"The purpose of s.367B is ... to assist a liquidator in the prompt winding up of an insolvent company and the method provided is a summary method without the usual trappings of a full scale action. Any complication of the simple procedure which may delay the determination of the issues raised and of the winding up of the company is to be avoided if possible and the prospect of contingent liabilities of other persons as third parties is not the liquidator's concern. ... The liquidator is in a special statutory position and is entitled to call the tune."

Thus, in that case his Honour refused to stay proceedings or require the liquidator to bring third party proceedings as no substantial benefits would accrue in the winding up of the company from such a course of action.

**Third party proceedings**

It was first decided in *In re Land Securities Company in 1895*\(^ {148}\) that no third party procedure was available upon a misfeasance summons. This was affirmed in *In re A Singer & Co (Hat Manufacturers) Ltd*\(^ {149}\), the Court observing that a winding up court had no jurisdiction to settle disputes between persons who were, for the purpose of those disputes, altogether outside the winding up because such disputes were entirely irrelevant to the winding up.

\(^ {145}\) [1975] VR 776; (1975-76) 1 ACLR 74.
\(^ {146}\) Supra.
\(^ {147}\) (1982) 1 ACLC 200 at 201-203.
\(^ {148}\) (1895) 2 Mans 127.
\(^ {149}\) [1943] 1 Ch 121; Also see *Re Shilena Hosiery Co Ltd* [1979] 2 All ER 6, and *In re B Johnson & Co (Builders) Limited* (supra), 781.
This, however, does not prevent a party to a summons claiming indemnities from other parties to the proceedings. In Re Morecambe Bowling Ltd\textsuperscript{150} such indemnities were granted as it was held that all the parties were already subject to the jurisdiction of the court and there was no question of settling a dispute between persons, one of whom was outside the winding up.

\textit{Cross claims and set-offs}

Similarly, it would seem that no cross claims or set-offs will be entertained upon proceedings under a misfeasance summons.\textsuperscript{151} Street C.J. in the \textit{Buena Vista Motors case}\textsuperscript{152} observed that the reason for this was that a misfeasance summons is not brought on behalf of the company and so it is not open to the respondent to claim cross actions or set-offs against the company. His Honour recommended that the provision be amended to enable applications to be made in the name of the company with the consequence of importing a right in the respondent to propound cross actions or set-offs, a right, which in his Honour's view, would be desirable.

Nevertheless, there is well established authority that even if this amendment were effected the provision may still not authorise a right to set-off. In \textit{Pellys case}\textsuperscript{153} it was held that as a consequence of the decision in \textit{Coventry and Dixons case},\textsuperscript{154} which held that the provision was procedural only, then in the absence of an express or implied right of set-off, none was available.

The discretionary character of the relief provided by the misfeasance provision can, however, result in a de facto set off. For example, in \textit{Toowoomba Welding Works Pty Ltd (No. 2)}\textsuperscript{155} certain amounts owed to the respondents by the company were deducted from the loss assessed to the company. The rule against set-off was also subverted in \textit{Re Derek Randall Enterprises Ltd} where the director was able to treat a secret commission as having been effectively paid back to the company.\textsuperscript{156}

\textsuperscript{150} [1969] 1 All ER 753.
\textsuperscript{151} Oditah examines the various justifications that have been postulated for this rule. He concludes that the want of mutuality of dealings and considerations based on policy, rather than the summary nature of remedy, provide the strongest rationale for the rule: op. cit., 220-222.
\textsuperscript{152} Supra.
\textsuperscript{153} Supra.
\textsuperscript{154} Supra.
\textsuperscript{155} [1969] Qd R 337.
There are some indications from the judgment of Maugham J. in *In re Etic Limited*\textsuperscript{57} that the absence of a right of set-off justified his decision not to make an order against the respondent. Having found that no misfeasance or breach of trust had been proved, the claim being simply for the repayment of a debt, he referred to *Pellys case* and stated that the fact that there is no right of set-off is an indication that the courts have considered that the jurisdiction is a special one and is confined to claims by the company against the officer where it would not be right for the officer to be entitled to set up a right of set-off. Accordingly, as this was an appropriate case for the respondent to have an opportunity to defend the matter in an action in which there were proper proceedings and to which he was entitled to a set-off or counter claim then no orders would be made upon a misfeasance summons.

To the extent that these observations can be interpreted as meaning that the court should not hear a matter on a summons where a set-off is alleged, they are clearly inconsistent with the bulk of authority. The scope of the provision is not limited in this way and the better interpretation of his Lordship’s comments is that he was merely attempting to distinguish a claim in the nature of a breach of contract for which a misfeasance summons is inappropriate from a claim in the nature of a breach of trust where a set-off or cross claim would be most unlikely.

*Implications for proceedings for breach of the duty to creditors*

The absence of these procedural devices must cast doubt on the appropriateness of the misfeasance proceedings as a mechanism by which to conduct actions for breach of the duty to creditors. Such actions, to the extent that they are based on the existence of debts, typically arising from trading, present the type of scenario in which cross claims and set-offs are likely to arise, for example on the basis that goods had been returned or were defective. Similarly third party proceedings might conceivably arise where the goods are in the possession of other parties.

To trust that justice will ultimately be achieved by some form of judicial connivance designed to avoid the limitations of the summary procedure is, it is argued, totally unsatisfactory. Rather the parties should be free to pursue the full extent of their rights and claims and this can only be done if the proceedings take the traditional form.

\textsuperscript{57} Supra.
This conclusion is supported by the further limitations of the summary proceedings where difficult issues of fact arise. As was observed above, typically, in such circumstances, directions hearings will be held with the result that many of the trappings of the traditional form of proceedings will be ordered. Far from saving time and expense over the traditional form of proceedings the result may be that the summary proceedings ultimately take up more court time and are more expensive. These observations are particularly apt where proceedings for breach of the duty to creditors are concerned given the need to establish insolvency, that the duty has arisen in relation to the particular creditor or creditors and that it has been breached, all in the context of the uncertainty identified in chapter 3 as to the precise scope of the duty.

In these circumstances there is some merit in the view, which as was observed in section 4.6 was initially supported by the judiciary, that the summary procedure ought only be available in simple cases. If such a qualification applied it could be expected that the procedure would seldom be available to support actions for breach of the duty to creditors.

5. Conclusion

This chapter has examined the features of the current misfeasance provision, S.598, in the context of the recently developed duty owed by directors to creditors. The legislative extension of the provision over the last century and a quarter was identified as co-existing with a decline in reliance upon the provision. This anomaly could be explained on the basis that the misfeasance provision was initially the only defaulting officer provision whereas subsequently the reckless and fraudulent trading provisions were to supply an avenue of redress arguably superior to that offered by the misfeasance provision. However, it was observed that the forces that led to the enactment of those provisions very nearly induced the judiciary to give the original misfeasance provision scope which would have obviated the need for subsequent legislative intervention of this nature.

It was further observed that the trend away from reliance on the misfeasance provisions has been recently arrested by virtue of the development of a duty to creditors. Furthermore the impact of this duty is dependent on the availability and effectiveness of the summary procedure offered by S.598. Thus the legislative development which gave rise to the current provision now takes on considerable significance.
The features of S.598 were then examined in detail. It can be concluded that where a breach of duty to creditors is alleged then:

(i) that cause of action is within the parameters of S.598.

(ii) it will be necessary to establish "loss" but the trend is towards a liberal application of this requirement.

(iii) a liquidator will have locus standi to bring an application under S.598 but in the event that the duty is extended to allow an individual creditor a cause of action then no automatic locus standi is assured but locus standi is possible with the authorization of the Australian Securities Commission. It is not clear whether a creditor could pursue a cause of action, other than in the nature of a representative action, under this provision although the court would appear to have the power to direct awards in favour of a creditor.

(iv) an application may be made directed at any person against whom an appropriate cause of action exists.

(v) S.598 does not require that the company concerned need be experiencing financial difficulties but at this stage in the development of the duty this would appear to be an element of the cause of action.

(vi) the complexity or otherwise of the case would not appear to be relevant to the availability or otherwise the summary procedure offered by S.598.

(vii) S.598 would appear to envisage adversarial proceedings and does not empower an inquisitional examination of a respondent. There are no fetters on the courts' discretion as to the manner or the amount of relief it may grant nor even as to whether it will grant relief or not. It is unsettled as to the exact nature of cost awards made against liquidators, viz. whether the liquidator may be personally liable or not.

(viii) the general absence of pre-trial procedures and detailed rules of court has given rise to difficult procedural issues where complex cases have been litigated under the misfeasance provision. There are dicta and judicial rulings recommending the filing of points of claim and defence, reliance on oral evidence and the use of directions hearings in complex cases. No third party
proceedings, cross claims or set-offs will be entertained.

Even in the absence of evidence of a breach of duty to creditors, this provision is an essential element in the liquidator's armory against delinquent directors.\textsuperscript{158} There have been innumerable instances where proceedings have been instigated under the section to recover from corporate officers for various misdemeanours against their company.\textsuperscript{159} With the extension of the general duties and obligations imposed on these officers the potential for such redress also increases.\textsuperscript{160} This may prove to be an important avenue in the future by which creditors, via the liquidator, may seek redress from defaulting officers.\textsuperscript{161}

\textit{Difficulties with the procedure as part of a creditors' recovery regime}

Although it can be argued that the provision is generally adequate to support the enforcement of the common law duty, there must be some doubt as to the appropriateness of the summary procedure in the types of cases typical of the enforcement of this duty given that these cases are likely to be complex, deal with substantive issues, involve issues of fact and, possibly, a number of parties. In particular, the absence of third party proceedings, cross claims and set-offs impacts on the ability of the procedure to ensure a just result. Furthermore, the absence of automatic pre-trial procedures and the consequential need for directions hearings, renders it more time consuming, expensive and difficult for an applicant to adduce the evidence necessary to establish both the insolvency of the company and a failure by the directors to consider the interests of the creditors. Whilst this is less of a concern upon an application by a liquidator who has access to the company's records if, as will be argued in chapter 11, a creditor recovery regime ought permit individual creditors a cause of action then the inadequacies of the summary procedure in assisting creditor applicants serves to cast further doubt on the desirability of the common law duty as an element of a creditor recovery regime.

\textsuperscript{158} Baxt suggests that recent cases illustrate a willingness to allow the liquidator to pursue former directors of companies which have gone under, therefore endorsing the use of S.542 in the pursuit of corporate funds from directors to satisfy creditors' rights: Baxt, An Introduction to Company Law (4th edition), Law Book Co Ltd (1987) p.212.

\textsuperscript{159} For a comprehensive statement of these instances see Boyle & Sykes, Gore-Browne on Companies (43rd edition), Jordan & Sons Ltd 1977.

\textsuperscript{160} See section 4.1.3 above. The preference sections may prove to be of particular significance.

\textsuperscript{161} The South African Court of Appeal has recently commented that the peculiar nature of the remedy provided by the misfeasance provision and the fact that it makes drastic inroads upon the normal procedure of enforcement of claims justified a restrictive interpretation of the provision (Rennie NO v Holzman 1989 (3) SA 706, following Lipschitz and Another NNO v Wolpert and Abrahams 1977 (2) SA 732). Whether this sentiment will be embraced by the Australian judiciary remains to be seen.
Whilst creditors might be able to avail themselves of the traditional court procedures to enforce the duty, assuming that it provides them with a cause of action, it must be doubted whether this would be desirable or practical for other than the largest claims. In chapter 11 the arguments against providing individual creditors with a cause of action will be discussed. These include the cost, the difficulties of proof, the undesirability of a multiplicity of actions and the unfairness arising from the fact that the first creditors to successfully recover might do so at the expense of other creditors thereby usurping the statutory scheme of distribution. Whilst it will be argued that some of these arguments are misguided and others may be accommodated by reserving a recovery action to creditors of larger companies with creditors of smaller closely held companies being protected by other avenues, these problems are exacerbated by a regime which envisages creditors enforcing the common law duty through standard legal proceedings. In particular the uncertainty associated with the common law duty renders it a less satisfactory avenue for recovery than a statutory scheme with defined elements and defences, presumptions and statutory guidance as to the quantum of damages.

It is to a consideration of the legislative and judicial development of the other provisions comprising this statutory creditor recovery scheme that it is now proposed to turn.

A general statutory cause of action?
Prior to doing so however, it is of note that it was also observed that the provision was initially interpreted as providing a general cause of action against misbehaving directors. Whilst this interpretation was subsequently displaced the concept provides an interesting reform possibility. In chapters 9 and 11 the possibility of adopting a reform agenda either centred on the misfeasance procedure as a basis for enforcing a code of ethics/conduct or on a general cause of action in the nature of that initially read into the misfeasance provision will be briefly explored. It will be argued that such an approach, whilst having the advantage of flexibility and adaptability, effectively abrogates to the judiciary, or those charged with setting a code of ethics and acceptable conduct, parliament's responsibility. Rather some legislative guidance is necessary. To some extent these competing principles are accommodated by the regime proposed for group companies. It is in this context that adaptability and flexibility is most critical and a more general provision, incorporating some statutory guidance for the judiciary and the corporate community, can be justified. However in the case of the typical trading company where the nature of the problem to be resolved can be more precisely identified, a more detailed statutory scheme is appropriate.
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CHAPTER 5

THE LEGISLATIVE DEVELOPMENT OF THE FRAUDULENT AND RECKLESS TRADING PROVISIONS

"I have no right to add to the requirements of the statute, nor to take from the requirements thus enacted. The sole guide must be the statute itself."


1. Introduction

The failings of both the common law and the misfeasance provision to provide an adequate mechanism to enable creditors to recover from delinquent corporate management was the catalyst for a history of legislative activity. This legislation, known as the defaulting officer provisions, typically has embraced two provisions pursuant to which creditors may recover from corporate management. The first of these applies where a fraud has been committed against the creditors and, accordingly, is known as the fraudulent trading provision. The second deals with managerial liability where a company has incurred debts in circumstances where these debts are unlikely to be paid, and can be variously described as a reckless, insolvent or wrongful trading provision.

These provisions provide the lynchpin of the recovery regime available to creditors. Thus it is appropriate to examine the development of these provisions from the perspective of identifying both the theoretical base for a creditor recovery regime and the most appropriate manner in which to express the legislation. This examination will be divided into a consideration of the legislative development of the provisions followed by an analysis of their judicial treatment, with particular reference to the Australian provisions pre-dating the 1993 reforms. The new provisions are considered separately in chapter 10.

It is proposed in this chapter to consider this legislative development, extending from the origins of the provisions in the United Kingdom and Australia to their adoption in New Zealand and South Africa. It will be argued that the Australian legislation, in particular, has exhibited...
theoretical and practical deficiencies. Many of these relate to the central issue of whether individual creditors ought be provided with a cause of action or whether a collective regime ought apply.

Initially the United Kingdom legislature led the field in the development of its defaulting officer regime with the Australian States, New Zealand and South Africa, simply adopting the United Kingdom initiatives. Only in recent times have these latter jurisdictions ventured independently into this area. Accordingly it is appropriate to commence this analysis with an examination of the legislative development of the defaulting officer regime in the United Kingdom. Recent departures from the United Kingdom approach in South Africa, New Zealand and Australia will then be considered.

2. Legislative Development in the United Kingdom

2.1 The first defaulting officer provision - the misfeasance provision

The Limited Liability Act 1855 naively either did not contemplate the potential for fraud and improper dealings offered by the corporate form or assumed that the equitable jurisdiction of the court would provide sufficient protection. The Act contained no provisions imposing liability on directors, nor did its successor the Joint Stock Companies Act 1856.

Even the Companies Act 1862 did not appear to recognize that an owner/officer of a company might be able to abuse the privilege of limited liability. Although the Act introduced into the corporate scheme elements of bankruptcy law and specified offences with which company officers could be charged, but for one exception there was no provision for defaulting officers.

The exception was the misfeasance provision considered in the previous chapter. It was there observed that both the legislative and judicial development of this provision generally favoured its extension. However, the provision has remained procedural only in its effect, supplying no cause of action against delinquent officers.
2.2 The fraudulent trading provision

2.2.1 The Greene Committee

The first provision to supply a new cause of action against defaulting officers was, as it became known, the fraudulent trading provision. This provision was enacted on the recommendation of the Greene Committee.¹ This Committee had been established in 1925 in response to public comment arising from the collapse of several companies in suspicious circumstances. There was a perception in the community that the common law remedies were inadequate.

The Committee, in its report, extolled the virtues of limited liability and rejected any suggestion of restructuring its availability merely in order to prevent abuse. Such restrictions would be undesirable as they "would seriously hamper the activities of honest men and would inevitably react upon the commerce and prosperity of the country."² Rather the Committee favoured the introduction of the fraudulent trading provision, together with some other minor reforms, as a means of controlling corporate abuse.

_Provision drafted with particular scenario in mind_

This provision was principally directed to the situation where a person in control of a private company on the verge of liquidation, who held a floating charge over the assets of the company, filled up this security by means of goods obtained on credit and then appointed a receiver. In such circumstances the Committee was of the opinion that the person concerned should not be able to hide behind the cloak of limited liability and that the court should be empowered to charge any sum, for which he was found to be liable, upon any debt due to him from the company or upon any charge held by him, or his nominees, over its assets.

The limitations inherent within the provision reflect that the above scenario was clearly in the Committee's mind when drafting the provision. In particular it explains the following limitations:

(i) why the application of the provision was confined to a company in the course of winding up.

(ii) why the requisite intent to defraud was required to be directed at creditors.

¹ Report of the Company Law Amendment Committee 1926 (Cmnd 2657).
² Paragraph 61.
(iii) why the application of the provision was restricted to directors.

Notwithstanding these limitations the provision also contained features giving it a potentially wide application. For example, as will be observed below, the provision required that the impeached director be carrying on business with either an intent to defraud creditors (whether of the company or not) or for any fraudulent purpose. The effect of the phrase "or for any fraudulent purpose" potentially expanded the range of victims beyond persons who are creditors so as to include anyone.³

2.2.2 Legislative origins - S.75(1) Companies Act 1928

This recommendation was enacted as S.75(1) of the Companies Act 1928. The provision provided that:

"If in the course of a winding-up it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the official receiver or the liquidator, or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any of the directors, whether past or present, of the company who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct."

In addition to this civil liability, subsection (3) provided that every director⁴ who "was knowingly a party to the carrying on of the business" in such a manner had committed an offence and was liable to imprisonment for up to one year.

In support of this new cause of action the courts were empowered to make any liability a charge on any debt or obligation due from the company to the defaulting officer and to declare that a person liable under the civil provision or guilty of the offence should not be concerned in the management of a company for up to five years.⁵

The only amendment to this provision over the next 50 years was to be effected by S.101(1) of the Companies Act 1947 in response to the

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³ See the discussion in chapter 6, section 3.3.
⁴ Subsection (5) extended the definition of the term "director" to encompass de facto directors.
⁵ S.75(2) and S.75(4).
recommendations of the *Cohen Committee.* This amendment removed the limitation on the application of the provisions to directors. Henceforth the court could declare any *person* to be personally liable or convict such person of fraudulent trading irrespective of whether the person was a director or not.

The *Consolidating Act 1948* was to also effect some changes to the format of the provision. The fraudulent trading aspects of the previous S.275 were to become the subject matter of S.332 while the subsections dealing with the prohibition on being concerned in the management of companies were removed and made the subject of a separate provision.

### 2.2.3 The Jenkins Committee recommendations

In 1962 the *Jenkins Committee* recommended radical reforms to the fraudulent trading and associated provisions in response to the "widespread criticism that the Companies Act as a whole did not deal adequately with the situation arising from fraud or incompetence on the part of the directors". Most of these reforms were not adopted in the United Kingdom until 1985.

The most radical of the *Jenkins Committee* recommendations was that S.332(1) should be extended to make those who have carried on the business of a company in a reckless manner personally liable. This recommendation was directly adopted in South Africa and probably

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7 This Act also altered the maximum penalty that could be imposed upon a person convicted of fraudulent trading. The potential term of imprisonment was increased from one to two years and the court was also granted the power to impose a fine, not exceeding five hundred pounds, as an alternative or additional penalty.
10 Paragraph 497.
11 However in the early 1980s the criminal offence of fraudulent trading received some attention. First by virtue of S.80 of the Companies Act 1980 the penalties were increased to a maximum of 7 years imprisonment together with a fine of up to £1,000. This amendment was implemented in response to criticism by a number of prominent judges. Then S.96 of the Companies Act 1981 extended the application of the provision to provide criminal penalties for fraudulent trading whether or not the company had been or was in the course of being wound up. This was in accordance with the recommendations of the Jenkins Committee. This Committee stressed that the provision of additional powers itself would achieve nothing unless the Department of Trade was prepared to invoke them. [Para 500] It is well documented that the Department was reticent to take such proceedings. See the detailed critique of the system by Tom Hadden in chapter IV of *The Control of Company Fraud*, a PEP pamphlet (1968). The courts are clearly aware of the problem. See *Wallersteiner v Moir [1974]* 3 All ER 217 and *Wallersteiner v Moir (No 2) [1975]* 1 All ER 849 noted by Farrar and Lowe in (1975) 38 Mod LR 455.
influenced the State legislators in Australia, and later the New Zealand legislature. It was not adopted in the United Kingdom but influenced the Cork Committee recommendations, which were acted upon.

2.2.4 The Cork Committee recommendations

The Cork Committee Report\(^2\) of 1982 commenced by echoing the views of the Greene, Cohen and Jenkins Committees as to the undesirability of imposing restrictions which would hamper the activities of honest men and place fetters on business enterprise. However, it acknowledged at the same time the general public dissatisfaction with the manner in which the law dealt with directors of insolvent companies. The Committee concluded that this public disquiet was fully justified and urgent attention to this area was required. Specifically in relation to S.332 the Committee stated that it was "convinced that the time has come for a radical reappraisal of the section".\(^{13}\)

The recommended reappraisal was the introduction of the concept of "wrongful trading" to supplement the existing provisions. Specifically the Committee recommended that S.332 be repealed so far as it provided a civil remedy and be replaced by a new section under which civil personal liability could arise without proof of fraud or dishonesty and without requiring the criminal standard of proof. The concept of fraudulent trading was to be retained to describe conduct which would amount to a criminal offence.

Wrongful trading
Wrongful trading was to include fraudulent trading and trading in circumstances where a company, being insolvent or unable to pay its debts as they fell due, incurred liabilities without a reasonable prospect of meeting them in full. A person who was a party to the carrying on of such trading was to be made personally liable for the debts of the company if he knew or ought to have known that the trading was wrongful.

When ascertaining the nature and extent of the enquires that the officer ought to make the test was to be what would a reasonable businessman have done in all the circumstances. Thus the proposal would replace the existing subjective provision with an objective one. In determining whether there was a reasonable prospect of the company meeting its liabilities and, if not, whether the director ought to have known this, the standard applied would be that of the ordinary

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13 Paragraph 1760.
reasonable man.

The Committee considered that the remedy of wrongful trading should only be exercisable within the framework of situations analogous to liquidation.

Other features of the proposal included:

(i) the inclusion of a relief provision,
(ii) an extended definition of "officer",
(iii) a wide discretion in the court in regard to the beneficiaries of any award, and
(iv) a power in the court to make anticipatory declarations as to relief.

*Disqualified and inadequate directors*

The Committee also recommended the imposition of personal liability on persons who became concerned in the management of companies whilst disqualified from so acting. Furthermore any officer who acted in accordance with the instructions of a person known to be disqualified would run the risk of being the subject of a declaration as to personal liability.

A further recommendation was that personal liability be imposed on persons who were involved in the affairs of an insolvent company where they had been recently involved with a similar failure.

*White Paper on Insolvency Law*

Subsequently the Government issued the *White Paper on Insolvency Law*\(^4\) which generally adopted the Committee's recommendations on wrongful trading and on the imposition of personal liability on disqualified persons continuing to be concerned with companies. The proposal in relation to directors involved in more than one corporate failure was however perceived as being too far reaching and likely to deter the risking of venture capital.\(^5\)

\(^4\) Cmnd 9175.

\(^5\) Paras 52 to 56.
2.2.5 Companies Act 1985 and Insolvency Act 1986

In response to these recommendations the Insolvency Act 1985, subsequently consolidated into the Insolvency Act 1986, and the Company Directors Disqualification Act 1986 were enacted. Also during 1985 a Companies Consolidation Act was enacted which also effected a number of minor reforms.

The major initiatives in relation to the fraudulent trading provision achieved by this plethora of legislation included:

(i) the separation of the criminal and civil liabilities for fraudulent trading,

(ii) the restriction of standing to make applications under the fraudulent trading provision to the liquidator together with a requirement that any contributions ordered be in favour of the company, and

(iii) the conferring of power on the courts to order that any debt owed by the company to an officer impeached under the fraudulent trading provision should rank in priority after all the other debts of the company.

The fraudulent trading provision is now contained in S.213 of the Insolvency Act 1986. That provision provides:

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16 The wrongful trading provision is considered below. The other recommendations relating to the disqualification of persons from being involved in the management of a company were also enacted (Ss. 12, 13, 14 and 18). In particular, S.18 imposed personal liability for the debts of the relevant company on persons contravening such orders. Furthermore personal liability was also extended to persons taking instructions from those known to be disqualified, although not all the recommendations were adopted, for instance, there were no provisions giving effect to the imposition of automatic personal liability. Furthermore S.16 of the Insolvency Act 1985 empowered a court which made a declaration under either the wrongful or fraudulent trading provisions, to also make a disqualification order against a defaulting officer. Subsequently these provisions were combined with those contained in the Companies Act 1985 into the Company Directors Disqualification Act 1986.

17 S.458 of the Companies Act 1985 and S.213 of the Insolvency Act 1986 respectively. A number of new offences are contained in Chapter X of the Insolvency Act (Malpractice before and during liquidation) including "Fraud in anticipation of winding-up" (S.206) and "Transactions in fraud of creditors" (S.207). No personal liability for corporate obligations is provided for by these provisions however.

18 By S.109 and schedule 6, paragraph 6(1) Insolvency Act 1985.

19 By S.109 and schedule 6, paragraph 6(3) Insolvency Act 1985.
"213 Fraudulent trading

(1) If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person, or for any fraudulent purpose, the following has effect.

(2) The court, on the application of the liquidator may declare that any persons who were knowingly parties to the carrying of the business in the manner above-mentioned are to be liable to make such contributions (if any) to the company's assets as the court thinks proper."

From the perspective of creditors this new provision is a double edged sword. Individual creditors are no longer provided with standing and any funds recovered are to be paid to the company (and then probably to secured creditors). At least one commentator has applauded the amendment requiring the proceeds of an action to be paid to the company and available for the benefit of all the creditors although questioning the restriction of locus standi. It has been argued that there may well be instances where a creditor may take a different view than the liquidator and is prepared to risk his own funds for the benefit of the creditors in general. Such philanthropy ought not be inhibited.20

This matter, and the features and application generally of the current fraudulent trading provision, will be further considered in section 5.6 below and in chapters 6 and 9.

2.3 The wrongful trading provision

2.3.1 Insolvency Acts of 1985 and 1986

As observed above, both the Cork Committee and the subsequent White Paper on Insolvency Law recommended the introduction of a wrongful trading provision. The resultant provision, which first appeared as S.15 of the Insolvency Act 1985, now appears as S.214 of the 1986 Act. Subsections (1) and (2) provide:

"214 Wrongful trading

(1) ... if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who

is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.

(2) This subsection applies in relation to a person if -

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time..."

Other aspects of the provision include a power granted to the courts to relieve a person who had taken appropriate steps in an attempt to minimize loss to the creditors, a statement defining with greater particularity the nature of the test to be applied, a definition of "insolvent liquidation", a statement to the effect that "director" includes "shadow director" and an acknowledgment that the section is without prejudice to the fraudulent trading provision.

Procedural aspects in relation to both S.213 and S.214 are contained in S.215. This provision repeats provisions previously appearing in the fraudulent trading provision contained in S.630 of the Companies Act 1985 as amended by the Insolvency Act 1985.21

2.3.2 Comparison of proposed and actual legislation22

The wrongful trading provision differs significantly from the draft clause proposed by the Cork Committee. In particular:

(i) only the liquidator can apply for orders pursuant to the provision.

(ii) any orders made by the court are restricted to orders that contribution be made to the company's assets.

(iii) there are no provisions enabling the court to make anticipatory declarations granting relief.23

21 Modified by the Building Societies Act 1986, S.90, Sch 15.
22 Also see Sealy & Milman, Annotated Guide to the 1986 Insolvency Legislation (2nd Ed), at 229-232.
23 See Para 52 of the White Paper.
(iv) the application of the provision is restricted to the situation where the relevant conduct is discovered in the course of the winding up of the company and not to situations analogous to liquidation generally.

(v) the relief provision defines the circumstances in which relief will be given whereas the draft clause simply referred the court to the circumstances of the case.24

(vi) the provision is hinged on an expectation of the company going into insolvent liquidation rather than the incurring of debts in circumstances where the company is insolvent or unable to pay its debts.

(vii) the provision refers to directors (including shadow directors) whereas the draft provision imposed liability on persons party to the carrying on of the business of the company.25

As will be observed below, the changes to restrict locus standi to liquidators and to require that compensation be directed to the company are particularly significant in the context of creditors' recovery rights.

2.3.3 Analysis of the wrongful trading provision

The provision would appear to contain a number of features worthy of closer consideration:

(i) A subjective and objective test

The provision includes both a subjective and objective test with the result that a director cannot plead ignorance of the company's affairs to argue that he did not know that it was insolvent.26 Directors are presumed to possess a certain minimum standard of competence and knowledge of the company's financial affairs. However the subjective element of the test will mean that the knowledge and skill required from a director of a company in a modest line of business will be different from that required of a director of a more sophisticated company.27 Furthermore a director with particularly relevant

24 Ibid.
25 It is surprising that the provision is expressed to only apply to directors, this aspect having been deleted from the fraudulent trading provision in 1947.
knowledge or expertise may be subject to a more stringent test.\(^{28}\)

Whilst the flexibility and generality of this test is advantageous in that the provision can be sensibly applied to the variety of corporate types, viz small family companies, medium trading concerns and group companies, it does generate some uncertainty in application making it difficult for business people to know what is expected of them.\(^{29}\)

(ii) \textit{The defence of minimizing creditor loss}

The defence of taking every step to minimise loss to creditors is particularly demanding and raises the issue of whether the steps required to be taken must actually provide the creditors with legal protection.\(^{30}\) In particular there is some doubt as to whether this defence would be available where the directors had merely secured a letter of comfort from an associated company which, beyond their control, later resiled from its moral undertaking?\(^{31}\)

Arguably, because a company's board of directors will comprise persons of varying standards of competence it is unclear as to what practical steps directors ought take in order to raise this defence. If a particular director is at odds with the rest of the board as to the company's financial health he has a variety of options including to resign, arrange to have the company put into administration or advise the creditors of his views.\(^{32}\)

(iii) \textit{Quantum of compensation}

The amount of any contribution to be ordered would, prima facie, equate to the loss caused to the creditors by the directors. This could then be reduced and/or apportioned between the various directors at the discretion of the court taking into account relative blameworthiness and any other relevant considerations.\(^{33}\)

Notably S.214 was recently applied in \textit{Re Purpoint Ltd}\(^ {34}\) to render a director liable for a company's debts. Due to the lack of records the Court was required to determine what liabilities had been incurred in the relevant period for the purpose of fixing the


\(^{29}\) Ibid.


\(^{32}\) Doyle, Id, 98-99.

\(^{33}\) Prentice, op. cit., 270-271.

\(^{34}\) [1991] BCLC 491.
director's liability. Ultimately this liability was not to exceed such amount as necessary to recoup the loss to the company arising from the moment the director ought to have reasonably expected that insolvent liquidation was unavoidable.

(iv) Application of compensation monies

The leading case, to date, of any significance for the interpretation of S.214 is *Re Produce Marketing Consortium Ltd (No 2).*35 The case concerned a fruit importer which fell upon hard times and ultimately became totally dependent on a substantial bank overdraft to finance its activities. Draft accounts submitted to the company by its auditors in January 1987 showed that the company was insolvent. Attempts to work out a solution for the company failed and it went into liquidation in October 1987.

Ultimately the liquidator's application under S.214 was successful. Whilst the Court appeared to assume that the contribution would attach to a charge over the assets of the company it is not clear that this is correct. Most commentators have argued that the contributed funds ought be available for distribution to the unsecured creditors only and that, furthermore, all creditors and not just those the victims of the wrongful trading should share equally. Certainly, in *Re Purpoint Ltd*36 it was emphasised that all of the creditors were to benefit from the compensation awarded, the Court holding that it had no jurisdiction to direct payment to a particular class of creditors, such as the victims of the wrongful trading. This result is seen as more pragmatic, fairer37 and in tune with the philosophy of the provision to increase the protection of trade creditors generally.38

On the other hand it is to be conceded that as banks are the main financiers of wrongful trading actions there is an argument that fairness requires that whatever is recovered go to feed their charge.39

39 Oditah, [1990] LMCLQ 205 at 215-222. However he ultimately rejects this argument preferring the view that the general creditors are to benefit. On the subsidiary issue of whether the victims of the wrongful trading or all the general creditors should share in the proceeds he also supports a pari passu distribution.
(v) **Who are shadow directors?**

Directors and shadow directors may be liable under S.214. The definition of shadow director has raised the possibility that advisers\(^{40}\) and, more importantly, banks taking a concern in the running of a debtor's insolvent business or, indeed, other creditors might be liable for wrongful trading. In *Re A Company (No 005009 of 1987)*\(^{41}\) the Court suggested that a bank may be a shadow director for the purposes of S.214 where the company is managed in accordance with the recommendations of the bank. Subsequent decisions have met this comment with a mixed response\(^{42}\) although most commentators have endorsed the proposition.\(^{43}\)

Most significant is the prospect of a parent company being held to be a shadow director in relation to an insolvent subsidiary. In *Re Augustus Barnett & Son Ltd*\(^{44}\) a parent company was found not to be liable for fraudulent trading as it was not carrying on the business of its subsidiary. *Prentice has* analysed this case from the perspective of the wrongful trading provisions and concludes that the facts where unclear as to whether a conclusion that the company was a shadow director could be formed. To the extent that it is arguable that the decision would have been no different under the wrongful trading provisions he argues that this supports the criticisms of the state of the law in relation to the liability of a parent company for the debts of its subsidiaries.\(^{45}\)

On the other hand, it is arguable that a majority shareholder who makes demands of the board of directors with the threat of their dismissal for failing to comply could fall within the definition of a shadow director.\(^{46}\)

(vi) **Unavailability of general defence**

The general defence contained in the companies legislation

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\(^{44}\) [1986] BCLC 170.
\(^{46}\) See Doyle, "Defining the shadow director", (1992) 136 SJ 494. Whilst Doyle argues that it is not inconceivable that a parent company could be deemed to be a shadow director he concedes that this would be unlikely.
permitting a court to excuse a director where it appears that he has acted honestly and reasonably would not appear to be available to a director impeached under S.214.

This short analysis of the wrongful trading provision illustrates that whilst it may provide a useful means of recovery for creditors from abuse of the privilege of limited liability the provision does contain drafting inadequacies. In particular, whilst its broad provisions enable the provision to be sensibly applied across the range of circumstances in which the corporate form is utilised this generality in turn generates uncertainty in application.

Furthermore the lack of guidance as to the identity of the exact beneficiaries of any recoveries is a concern. Whilst it would appear that the philosophy behind the provision supports an application of any recoveries equally across the general body of creditors it may be that such an approach, together with the restriction of locus standi to the liquidator, will ultimately limit the usefulness of the provision.

3. Legislative Development in South Africa

Until 1973 the South African legislation merely repeated the United Kingdom position. S.184 and S.185 of the Companies Act 1926 provided a summary action against defaulting officers and, since 1939, personal liability for fraudulent trading respectively.

The Companies Act 1973 replaced those provisions with S.423 and S.424. These new provisions were slightly re-drafted versions of the originals designed to embrace the recommendations of the Jenkins Committee. These recommendations had themselves been adopted by the Van Wyk de Vries Commission of Enquiry. The Commission, whilst acknowledging the far reaching implications of importing into S.185 the concept of recklessness, concluded that its introduction was justified.

S.424 extended the offence and civil liability to reckless trading. This was effected simply by inserting the words "recklessly or" before "with intent to defraud" in the section. The effect of this simple amendment is considered in chapter 8.

47 S.727 Companies Act 1985 (United Kingdom); S.1318 Corporations Law (Aust).
49 For a similar conclusion: Oditah, op. cit., 222.
50 Discussed further in chapters 9 to 11.
The misfeasance provision, S.423(1), provides a summary action for breach of "faith" as well as trust. There has been no judicial consideration of this innovation. It may provide, in accordance with the Jenkins Committee recommendations, an attempt to extend the summary procedure provided for by that provision to actions for negligence.

4. Legislative Development in New Zealand

The New Zealand legislature has also been active in enacting defaulting officer provisions. Initially the United Kingdom approach was adopted and the equivalent provisions repeated in the Companies Act 1933. These provisions were also to appear in the Companies Act 1955 as S.320 (fraudulent trading) and S.321 (misfeasance) which were identical to S.332 and S.333 respectively of the 1948 United Kingdom Act.

However by virtue of the Companies Amendment Act 1980 a major departure was effected. This Act amended the misfeasance provision by bringing a receiver within its scope and extending its application to actions for "default or breach of duty". In this way the Jenkins Committee recommendation in relation to the extension of the provision to encompass negligence proceedings was adopted. Furthermore amendments were made to the fraudulent trading provision which were a combination of the Australian and South African innovations. These developments are examined in chapter 8.

It is also observed in chapter 8 that these general defaulting officer provisions have also been supplemented by a special winding-up provision only applicable to private companies registered under a unique part of the New Zealand companies legislation. This provision contains features of both a fraudulent and reckless trading provision.

5. Legislative Development in Australia

5.1 Initial assimilation with the United Kingdom

The most active legislatures in relation to defaulting officers have been the States of Australia, especially Victoria. The following historical account will, at least initially, concentrate on developments in that State because these have been the most innovative and served as the
yardstick for the other States.

Initially the States merely adopted the United Kingdom legislation, although there was a tendency to slightly vary the provisions and add inconsequential amendments for reasons not readily ascertainable. The core of the sections would typically be unaltered but it was common practice to add subsections.\(^{51}\)

The first Victorian *Companies Act* appeared in 1864. This Act was a direct copy of the United Kingdom 1862 Act. It included S.149 which was equivalent to United Kingdom S.165, the misfeasance provision.\(^{52}\)

In 1931 the Queensland *Companies Act* became the first Australian legislation to contain a fraudulent trading provision when, by virtue of S.284, it repeated S.275 of the 1929 United Kingdom Act. The other Australian jurisdictions were soon to follow.\(^{53}\) Again the misfeasance provision repeated the United Kingdom equivalent.\(^{54}\)

### 5.2 The birth of a nation - the Uniform Companies Acts (1961-62)

#### 5.2.1 The offence of reckless trading

The 1958 Victorian *Companies Act* was to substantially reproduce the 1948 United Kingdom Act including S.332 and S.333 which appeared as S.226 (fraudulent trading) and S.227 (misfeasance) of the Victorian Act. This Act was to form the basis for the Uniform Companies Acts of 1961/1962, a move designed to remove inconvenience to the business community caused by varying legislative requirements across the States. The relevant provisions were S.304 and S.305 which repeated S.226 and S.227 respectively.

Whilst this attempt to rationalize corporate law across Australia was to be short-lived it did, at least, have one legacy for it appears that it

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51 S.308 of the Companies Act (NSW) (1936) retained a subsection which had been dropped by all the other States, but retained in the U.K. until 1985, to the effect that orders made under this provision were deemed to be final judgments. Also the NSW provision contained a special provision (ss(2)) which was to be incorporated in to the Co-operative legislation of 1961-62 as S.305(2). See section 4.7.3 of chapter 4 for a discussion of this subsection.

52 In fact the provision first appeared in Australia as S.166 of the Queensland Companies Act 1863. In Victoria the provision reappeared as S.152 of the 1890 Act, S.213 of the 1910 Act, S.215 of the 1915 Act and S.213 of the 1928 Act. In these enactments it appeared in the same format at S.215 of the 1908 Act [United Kingdom].


induced the legislators to abandon their United Kingdom shackles and give Australian company law a separate identity. In particular, S.303(3) of the Uniform Companies legislation was a most innovative addition to the legislation. It provided that:

"If in the course of the winding up of a company it appears that an officer of the company who was knowingly a party to the contracting of a debt provable in the winding up had, at the time when the debt was contracted, no reasonable or probable ground of expectation, after taking into consideration the other liabilities, if any, of the company at the time, of the company being able to pay the debt, the officer is guilty of an offence against this Act."

5.2.2 Drafting difficulties

Unfortunately this provision was found to contain drafting defects. In *Wren v Lyndon* the Court was asked to rule on the wording of S.303(3) in order to ascertain whether prosecutions under the provision had been brought within time. *Redapple J.*, in the course of quashing the convictions on the grounds that the prosecutions were out of time, time running from the date on which the debts were incurred, referred to the imprecise wording of S.303(3). In particular he considered that the words "If it appears" caused difficulties. The section did not specify to whom it must appear and in his Honour's view the provision could not be construed literally otherwise it might be said that the mere appearance to some person that the conduct had taken place would, without more, complete the offence.

His Honour noted that S.303(3) was "the unfortunate product of an uneasy union of certain provisions of previous enactments relating to the winding up of companies and the bankruptcy of individuals". Regrettably, in his Honour's opinion, it did not inherit some of the characteristics of its putative parents, the provisions of which were reasonably clear.

5.2.3 Extension to a civil liability

Furthermore, to the extent that the provision did not impose personal liability for reckless trading and merely created an offence it was a curious application of the *Jenkins Committee* recommendations which

55 Compare the Jenkins Committee recommendation on reckless trading handed down about the same time (see section 2.2.3 above). Notably S.303(3) enacted an offence provision not a civil liability provision.

56 (1972) CLC 27,383.

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suggested the creation of a civil liability but not an offence. Similarly, the failure by the legislature to extend S.305, the misfeasance provision, in accordance with the Jenkins Committee recommendations was surprising.

In any event within 5 years Tasmania\textsuperscript{56}, West Australia\textsuperscript{59}, South Australia\textsuperscript{60} and New South Wales\textsuperscript{61} had amended their legislation to include a civil liability for reckless trading. This was effected by inserting a subsection (1A) into S.304 which provided that:

"Where a person has been convicted of an offence under subsection (3) of section three hundred and three in relation to the contracting of such a debt as is referred to in that subsection the Court, on the application of the liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that the person shall be personally responsible without any limitation of liability for the payment of the whole or any part of that debt."

5.3 Companies (Defaulting Officers) Act 1966 (Vic.)

5.3.1 The first comprehensive defaulting officer regime

Victoria was not to lag behind for long and in 1966 the Companies (Defaulting Officers) Act was enacted.\textsuperscript{62} Although this legislation offended the attempted rationalization of corporate law in Australia it marked an important era for Australian company law, an era characterized by a recognition that the abuses of limited liability by company officials would not be tolerated.

This legislation repealed the defaulting officer provisions contained in S.300 to S.305 and replaced them with more comprehensive provisions.

The misfeasance provision, S.305, was replaced by S.367B. This provision restricted proceedings under the provision to actions by the Attorney-General or a person authorized by the Attorney-General but removed a 2 year restriction on the power to make orders concerning money or property received by an officer in circumstances which

\begin{flushleft}
\textsuperscript{56} No. 28/1966.
\textsuperscript{59} 1964
\textsuperscript{60} No. 52/1964.
\textsuperscript{61} No. 20/1964; In each instance S.304(2) was also amended to extend the powers granted to a court under that provision where orders as to reckless trading were being made.
\textsuperscript{62} No. 7501/1966.
\end{flushleft}
appeared to have been unfair or unjust. Furthermore the requirement that the company be in the course of being wound up was relaxed to merely require proof of financial difficulties. 63

The reckless and fraudulent trading provisions, S.303(3) and S.304, were replaced by S.374C and S.374D. These provisions were coupled with S.374E, an interpretation section, which repeated the extension of the provisions to companies experiencing financial difficulties and also extended locus standi to bring civil proceedings by recognizing that depending upon the reason why the company fell within the definition of a "company to which this section applies", different persons should have the appropriate standing. It was notable however that, unlike the previous provisions, contributories and creditors had to obtain authorization to bring civil proceedings.

S.374C was the offence provision, rendering it an offence to recklessly or fraudulently trade. These provisions were effectively the same as the former offences contained in S.303(3) and S.304(4).

S.374D was the counterpart, imposing personal liability on persons convicted of the offences. Subsection (1) stated as follows:

"Where a person has been convicted of an offence under subsection (1) or subsection (2) of section 374C, the Court on the application of the appropriate officer or, with the consent of the Commission, any creditor or contributory of the company may, if it thinks proper to do so, declare that the person is personally responsible without any limitation of liability -

(a) in the case of a conviction under subsection (1) of section 374C, for the payment to the company of an amount equal to the whole of the debt in respect of which the conviction was made, or such part thereof as the Court thinks fit; and

(b) in the case of a conviction under subsection (2) of section 374C, for the payment to the company of the amount required to satisfy all or any of the debts of the company as the Court directs."

The remaining subsections of S.374D repeated the other provisions of S.304.

63 Discussed further in chapter 4 at section 2.2.
These amendments were in due course enacted in all the other States, except Tasmania.  

Civil and criminal inter-relationship established
The essential change effected by this new regime was the addition of the prerequisite of a conviction for the imposition of civil liability for fraudulent trading. Originally the fraudulent trading civil and criminal liabilities were independent of each other. It was not until the enactment of a civil liability for reckless trading that the notion of a civil liability dependent on a criminal conviction first appeared. In fact this was the only element required to be satisfied in order to make out the civil cause of action. The legislature left it entirely to the discretion of the court to determine whether an applicant should satisfy the court of any other factors. With the enactment of S.374C and S.374D the prerequisite of a criminal conviction was extended to the civil liability for fraudulent trading with a similar broad discretion vested in the court. No rationale for this change, nor for the existence of the feature generally, was offered nor is readily ascertainable.

This inter-relationship between the civil and criminal aspects of the provisions is further considered in section 5.5.2 in the context of the most recent legislation. It will be observed that this feature has generated considerable difficulties.

Furthermore, in chapter 6 the exercise of the discretion vested in the courts is examined from the perspective of whether any further elements have been incorporated into the provision by way of judicial gloss.

5.3.2 Subsequent amendments to this regime

Most of the subsequent amendments to the provisions were cosmetic and effected to the definition sections. The more important included the amendment of S.367B to substitute "negligence, default, breach of duty" for "misfeasance" and the introduction of the concept of a "prescribed person" for the purpose of bringing proceedings. With the introduction of this concept certain persons were automatically authorized to apply for orders. Those authorized included liquidators, official managers and contributories.

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S.374D was amended in all States by the insertion of a subsection (1A) specifying prescribed persons with standing to bring proceedings. This provision simply repeated the earlier position but left it open for the category to be easily extended in the future.\(^{67}\)

**Amendments unique to specific States**
There was also some amendments particular to individual States. The more notable of these were:

(i) Certain New South Wales amendments tidied up the provisions by removing from S.367B the power to order an examination. The power to make such orders was restricted to upon applications under S.367A which provided a specific procedure for seeking orders for the examination of persons associated with companies.\(^{68}\) However, this amendment seems to have been ignored by the legislature given the nature of a subsequent amendment to S.367B effected in 1976.\(^{69}\)

(ii) In New South Wales and South Australia, but not in Victoria, Western Australia or Queensland, a subsection S.374C(3) was inserted to the effect that notwithstanding S.381 (which imposed a 3 year limitation period from the date the offence was committed) a 3 year limitation period from either the date the company became insolvent or the date the debt was contracted, whichever was the latter, would apply. However, no proceedings could be brought where the debt was contracted more than 3 years before the company became insolvent.\(^{70}\)

(iii) In New South Wales S.374D(1) was amended to permit civil applications to be brought where the offences had been committed under the earlier sections, S.303(3) and S.304(4).\(^{71}\)

(iv) In South Australia, S.374D(5) was amended to enable applicants other than "appropriate officers" to give evidence and call witnesses.\(^{72}\) This technical defect had been created by the original Victoria legislation in 1966 and repeated in all other jurisdictions except for New south Wales. Neither Victoria, Western Australia or Queensland took the opportunity to amend their provisions.

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67 Op. cit.; Creditors and contributories now had to have the Commission's authorization to commence proceedings, not merely its consent.
69 No. 1/1976.
70 NSW (No. 20/1973); S.A. (No. 54/1979).
71 No. 20/1973.
72 No. 54/1979.
(v) There was another set of amendments to the provisions in New South Wales during 1976. These amendments were inconsequential, with the exception of an amendment to S.367B(1) which clarified that the court had power to make both examination and payment orders concurrently.

5.4 Companies Code

5.4.1 A new defaulting officer regime

In 1981 a new co-operative scheme was introduced into Australia designed to further the goal of removing the difficulties encountered by businesses operating nationally of having to satisfy varying legislative requirements across the country and, especially, of having to lodge multiple sets of documents. In that year each State enacted legislation applying certain Commonwealth legislation as part of the laws of the State, such laws to be known as the Companies Code, and undertook to only amend these laws in accordance with the other States.

This Code repealed the previous legislation. The misfeasance provision appeared as S.542 of the Code whilst the reckless and fraudulent trading provisions were contained in S.556 and S.557.

Misfeasance provision
The misfeasance provision was analyzed in detail in chapter 4. Basically it repeated S.367B but with a number of innovations. The most important of these included:

(i) the removal of the requirement that the company be insolvent or experiencing financial difficulties,

(ii) the repositioning of the power to order the examination of an officer to a separate provision,

(iii) the removal of the requirement that the person the subject of the application must have taken part in the formation, promotion, administration, management or winding up of the company,

(iv) the extension of the category of causes of action permitted to brought by a misfeasance summons to include "fraud".
(v) the removal of any qualifications on the types of orders the courts might make,

(vi) the reservation of the right in any person to institute other proceedings in relation to the breach or otherwise, and

(vii) the provision for the respondent to have an opportunity to give evidence, call witnesses and employ a solicitor.

Apart from (i), (iii) and (vi) most of these aspects had already been considered by the judiciary and the new provisions simply served to clarify the position.

Reckless trading provision

On the other hand, the changes to the reckless and fraudulent trading provisions were significant. S.374E, the interpretation provision, appeared as S.553. The offences formerly contained in S.374C were placed in S.556, with S.557 essentially providing for civil liability, replacing S.374D.

S.556(1) provided for the offence of reckless trading. The provision provided that:

"If -

(a) a company incurs a debt, whether within or outside the [State or Territory];

(b) immediately before the time when the debt is incurred -

(i) there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due; or

(ii) there are reasonable grounds to expect that, if the company incurs the debt, it will not be able to pay all its debts as and when they become due; and

(c) the company is, at the time when the debt is incurred, or becomes at a later time, a company to which this section applies,

any person who was a director of the company, or took part in the management of the company, at the time when the debt was incurred is guilty of an offence and the company and that person or, if there are
2 or more such persons, those persons are jointly and severally liable for the payment of the debt."

This provision contained solely objective ingredients. The subjective aspects, which had bedevilled the early provisions, were the subject of defences contained in S.556(2). Thus the onus of proving subjective matters was to be borne by the respondent. It is therefore arguably inaccurate to refer to the provision as a reckless trading provision and it is probably more aptly described as a negligent trading provision.

The Explanatory Memorandum states that the reckless trading offence, although based on S.374C(1), was restructured to place greater responsibility on directors and managers of companies. It would appear that this was to be achieved by the reversal of the onus in relation to difficult matters of proof.

In relation to S.556(2) the Explanatory Memorandum states that it was designed to protect persons who had not authorized the incurring of the debt or who did not realize that the company would not be able to pay its debts.

In addition to the normal criminal sanctions, S.556(1) granted the court power to impose personal liability on guilty parties. The over-lap between this aspect of the provision and the civil liability contained in S.557 created some confusion. This was exacerbated by the enactment of S.556(3) which provided that a criminal conviction did not need to be obtained before civil proceedings were instituted, whereas S.557(1) expressly stated that a conviction was a prerequisite for civil liability. Problems arising from these inconsistencies are discussed in section 5.5 below.

S.556(4) was new and sought to ensure that an officer who was ordered to pay a corporate debt was not able to subsequently exercise his rights of indemnity and subordination contained in S.558.

**Fraudulent trading provision**
The fraudulent trading offence was contained in S.556(5). The Explanatory Memorandum states that this was based on S.374C(2) with the clarification that it applied to acts performed both prior to and during the period the company was a company to which the provisions

74 Neither the second reading speeches nor the parliamentary debates considered these provisions.
75 Paragraph 1219.
76 Paragraph 1220.
The provision in fact contained a number of differences from S.374C(2). It provided:

"If -

(a) a company does any act (including the making of a contract or the entering into of a transaction) with intent to defraud creditors of the company or of any other person or for any other fraudulent purpose; and

(b) the company is at the time when it does the act, or becomes at a later time, a company to which this section applies,

any person who was knowingly concerned in the doing of the act with that intent or for that purpose is guilty of an offence.

Penalty: $10,000 or imprisonment for 2 years, or both."

The section acknowledged that it was the acts of the company which were at issue and furthermore particularised the types of acts with which it was concerned.

Other provisions
S.556(6) and S.556(7) were procedural and provided that certificates of conviction were evidence of the matters stated therein. S.557(1) and S.557(2) granted the court power "if it thinks it proper to do so" to declare a person convicted of reckless and fraudulent trading respectively, personally liable. Again the provisions imposed no additional express requirements for the imposition of civil liability other than evidence of a conviction.

The two subsections differed as to who had standing to bring the respective applications and as to whom the liability was owed. S.557(1) restricted standing to the Commission or creditors and directed that liability in the sum of the debt concerned was owed to the creditor whose debt was the subject of the application. S.557(2), together with S.557(3), provided a more generous range of applicants but directed that the liability was owed to the company in the sum of "the amount required to satisfy so much of the debts of the company as the Court thinks proper".

Paragraph 1222.
The policy behind this difference in the two subsections is probably that reckless trading, as defined, was a discrete offence, being directed at the incurring of a particular debt, and so was probably viewed by the legislature as a wrong against a specific creditor. Fraudulent trading on the other hand, was dynamic and was directed at a course of dealings or conduct, so properly regarded as a wrong against the company and its creditors generally.

S.557(4) to S.557(7) repeated the ancillary powers of the court previously contained in S.374D(2) and S.374D(3).\(^78\) These provisions simply empower the court to make such further orders as are necessary to give effect to the declaration of personal liability.

S.557(9) initially was an important subsection. It authorised proceedings under S.557 where the corresponding conviction was obtained under the earlier legislation.\(^79\)

During 1985 S.556(3A) was inserted.\(^80\) It provided that where civil proceedings were brought under S.556(1) the onus of proof was the balance of probabilities. The need for clarification of this nature has been a feature of the history of the fraudulent and reckless trading provisions, arising from confusion generated by the concurrence of civil and criminal aspects within the provisions. Although this aspect has been remedied in most jurisdictions, and indeed was not a feature of the legislation immediately preceding the *Companies Code*, it reappeared as a feature of S.556 and S.557 by virtue of the inclusion of the references to civil remedies and proceedings in S.556. In fact the placement of subsection (3A) within S.556 exacerbated this problem and added to the already confused state of the provisions.\(^81\)

### 5.4.2 Comparison with preceding provisions

The *Explanatory Memorandum* indicates that S.556 and S.557 were based on S.374C and S.374D respectively but with some modifications.

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\(^78\) S.304(2) and (3) of the 1961-1962 legislation. S.374D(A) [S.304(5)] was deleted whilst S.374D(5) [S.304(6)] was enacted at S.557(8). S.374D(5) had been altered in accordance with the earlier N.S.W. and S.A. amendments (supra) to ensure that all applicants could give evidence and call witnesses. See the Explanatory Memorandum, paragraph 1224(c).

\(^79\) This provision is designed to have the same effect as the N.S.W. amendment to S.374D(1) effected by No. 20/1973.


\(^81\) See the discussion in section 4.5.
Generally
In relation to S.556 it has been noted that the offence of reckless trading in particular was modified to contain solely objective elements. Furthermore the criminal sanctions were extended to empower the court to impose personal liability on the delinquent officer. A further modification was that the elements of the offence specified that the relevant debt may have been incurred either "within or outside the [State or Territory]". This was to counter argument, in the nature of that raised in *Lyndon v Wren*,\(^\text{82}\) to the effect that the court of a particular State had no jurisdiction to convict where the offences were committed in another State, namely the State where the debts were incurred. It is likely that this argument would have been frequently raised where inter-State companies were concerned.

Another modification was that the inquiry was not to be whether the company could pay the debt "taking into consideration the other liabilities" but rather could the company pay "all its debts". Whether this modification was of any significance is doubtful. In *Re Concept Constructions Pty Ltd (in liq)*\(^\text{83}\) the defendant argued that as the company could have paid any one of the thirteen debts the subject of thirteen counts then convictions under S.374C(1) could not stand. This argument was rejected on the basis that in relation to each debt the other liabilities had to be taken into consideration. Clearly the same result would have followed under S.556(1).

On the other hand in *3M Australia Pty Ltd v Kemish*,\(^\text{84}\) Foster J., referred to the difference in wording and stated that S.556(1) appeared to demand a more specific inquiry into the status of the other debts. Still, it is difficult to envisage the significance of this "more specific inquiry".

In relation to S.557 the *Explanatory Memorandum* identifies a number of changes from S.374D. The most important of these is that in the case of an application under S.557(1) any court order was to be in favour of the person to whom the debt was payable.\(^\text{85}\)

**Procedural provisions or new rights created?**
It would appear that the differences between the old and new provisions were sufficient to counter the suggestion that S.556(1) was

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82 Sydney Petty Sessions (Berman S.M.) 21 April 1972. The argument was not raised before the appeal court (supra). The importance of this amendment has been highlighted by the applicant creditor's failure in *Re Hanlon Homes Pty Ltd (in liq)* 11 ACLR 481.
83 2 ACLR 219.
84 (1986) 4 ACLC 185.
85 See paras 1223 and 1224.
merely a procedural provision creating no new rights and liabilities but simply providing a different method of doing what could have been done under S.374C.

This argument was advanced in *Russell Halpern Nominees Pty Ltd v Martin and Ano*66 to justify the making of orders under S.556(1) in respect to a debt pre-dating the *Companies Code*. The West Australian Court of Appeal rejected the argument holding that the rights created by S.556(1) had no counterpart under the previous legislation, nor did S.556(1) have a retrospective operation.

*Olney J.* embarked on an extensive comparison of the relevant legislation and observed numerous similarities including:

(i) the existence of a prerequisite of a conviction for personal liability,

(ii) that the company had to be a company to which the section applied at the time the offence was committed,

(iii) that the criteria for conviction included the circumstance that the officer concerned had no reasonable or probable grounds of expectation of payment of the debt, and

(iv) that creditors required Ministerial authorization to apply under the provisions.

However, his Honour was impressed by one essential point of distinction, namely that under the former legislation the orders were made in favour of the company whereas under S.556(1) and S.557(1) liability was owed to the particular creditor. Hence his conclusion that S.556 created a new cause of action.

Nevertheless, his Honour differed from the majority holding that S.556(1) had a limited retrospective operation by virtue of the fact that liability arose under the provision from the date when the company became a company to which the section applied rather than from the date when the debt was incurred. This particular issue is discussed further in chapter 6.

Similarly *Young J. in Ross McConnel Kitchen & Co Pty Ltd (in liq) v Ross & Ors*87 contrasted the old and new provisions, concluding that

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66 (1986) 4 ACLC 393.
67 (1985) 3 ACLC 326.
S.556 had no exact counterpart in the earlier legislation and that S.557 was significantly different from S.374D.

These differences were again canvassed in *3M Australia Pty Ltd v Kemish*88 Foster J., referred to the "clear change in legislative policy in S.556(1)", viz.:

"The net of liability, both criminal and civil, is cast far more widely than in the earlier section. Whereas Sec. 303(3) was aimed solely at a company officer who had knowingly been a party to the contracting of the debt in question, with the attendant necessity that the prosecution prove this threshold matter beyond reasonable doubt, Sec. 556(1) contains no such limiting requirement. A prima facie liability in a director of the company or a person in a managerial position, can be established without proof that such person had any personal knowledge of, let alone involvement in, the incurring of the relevant debt. Such matters form no part of the ingredients of the offence."89

Some of the differences noted by his Honour were considered above. In addition he observed that the heavy burden of proof which rested on the applicant under the earlier provisions no longer existed88 and that the provisions created a new structure.

*Locus standi*

Another major change was in relation to locus standi. Leaving aside S.556, which is discussed below, S.557(1) and S.557(2) differed significantly from S.374D(1) and S.374D(2) respectively. Locus standi under the former provisions was the same. S.557(1) however restricted standing to the Commission or particular creditors which, although a narrower category than under S.374D(1), importantly provided the creditor with standing as of right.

S.557(2) repeated the position under S.374D(2), a creditor requiring authorization, and additionally extended locus standi to shareholders where the company was under investigation. Prima facie this appears anomalous91 but is possibly attributable to the difference in nature between the reckless and fraudulent trading provisions, discussed in section 5.5.3 below.

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89 Id, 190.
90 See chapter 6.
91 Farrar, "The Obligations of a Company's Directors to its Creditors", an unpublished paper, at p.16.
Potential respondents
S.556(5) repeated the feature of the fraudulent trading provision that the respondent only need be a "person". S.556(1), on the other hand, required that the respondent be a director or had taken part in the management of the company when the debt at issue was incurred. This was a departure from S.303(3) and S.374C(1) which had simply required that the person be an officer at the relevant time although it was arguably merely a cosmetic amendment. "Officer" as defined in S.5(1) of the earlier legislation included directors, liquidators and employees generally. "Director" was, in turn, defined broadly to include what can loosely be called "shadow directors" or "de facto directors".

On other hand, whilst the Code adopted this definition of "director" and, in fact, tightened it to ensure that unofficial directors were caught, the requirement of a management capacity arguably reduced the category of potential respondents to exclude employees although as S.374C(1) required that the officer be knowingly a party to the contracting of the debt this would typically have required that he have been involved in management for the requirement to be made out.

The extension to include management within the provision did, however, raise the possibility that any professional advising or assisting corporate management might be caught by S.558(1) in the appropriate circumstances. It is understood that the Accountancy bodies warned their members to be careful should their activities be in the nature of a management capacity.92 Notably the first case in which S.556(1) was successfully raised involved an accountant who had become involved in the management of a company.93

5.5 A national companies scheme - the Corporations Law

Background to the legislation
The recent history of Australian company law is characterised by attempts to rationalise the law across the States. Whilst an attempt at uniformity occurred during the early 1960's the first true co-operative scheme was established in 1981 with each State enacting legislation adopting the Companies Act 1981 (Commonwealth) as part of the law of the State concerned. Any amendments to this law required approval by a Ministerial Council composed of the Attorney-Generals of the States and of the Commonwealth but once approved the Commonwealth was obliged to enact them.92

92 The writer was informed of this development during discussions with members of the accounting profession.
93 3M Australia Pty Ltd v Kemish (1986) 4 ACLC 185.
The administration of this co-operative scheme was the province of the National Companies and Securities Commission (NCSC). However each State retained its own local administration which was required to work with the NCSC and act as its delegate. Whilst the NCSC had broad powers it was generally considered to have been under-funded.94

With the change in the Commonwealth government in the early 1980's moves commenced to satisfy a long-standing ambition of the new governing party to establish the Commonwealth as the sole source of company legislation. This ambition found support in the defects of the co-operative scheme, namely that it was perceived to inhibit law-making, presented problems of ministerial accountability and lacked effective enforcement. Wide business community support for a truly national scheme also existed, at least in the eastern States.

The major hurdle for the Commonwealth was that, in contrast to the State legislatures, it only had limited power under the Constitution to legislate in respect to companies. The original national companies scheme legislation introduced in 1988 and intending to operate to the exclusion of State legislation and without the co-operation of the States was, indeed, successfully challenged by a number of States on the basis that it was beyond the powers of the Commonwealth. In the result the Commonwealth negotiated a compromise with the States whereby the new national scheme with its central administrative body, the Australian Securities Commission (ASC), was, essentially, introduced with the Commonwealth undertaking to pay the States annual indexed grants to compensate them for the loss of revenue they would sustain from no longer administering the legislation. Furthermore, whilst the States would continue to have some input into the form of the companies legislation via the Ministerial Council the jurisdiction of the Council was reduced and the voting rights of the Council members were weighted in favour of the Commonwealth.

The Commonwealth legislation was, accordingly, adopted in each State by legislation and enforcement powers were conferred on the ASC. The mechanics of the enactment of the law involved the adoption by the States of the Corporations Law as enacted in the Commonwealth Corporations Act 1989. Furthermore the Australian Securities Commission Act 1989 provides for the administration and enforcement of the law to be carried out by the Commonwealth body.

94 See Ford, para 113. This outline of the developments preceding the introduction of the 1991 co-operative scheme draws heavily upon the detailed consideration in Ford at paras 111 to 115.
Chapter 5
Legislative Development

Defaulting officer provisions
The legislation dealing with defaulting officers entered into effect on 1 January, 1991. It is contained in Part 5.8 of the Corporation Law, entitled "Offences," and merely repeats the previous Code provisions dealing with liability for fraudulent and reckless trading. Essentially S.592 restates S.556 with only one change of any significance. S.592(8) provides that a document purporting to be a certificate of conviction shall be deemed to be such unless the contrary is established. Similarly S.557 is restated as S.593,95 the misfeasance provision (S.542) as S.598 and the interpretation provision (S.553) as S.589.96

Thus the above commentary in relation to the Companies Code provisions is equally applicable to the Corporations Law.

5.6 Difficulties with the legislation

5.6.1 Generally

This legislative history of the defaulting officer provisions is characterised by ambiguity and uncertainty.

In chapter 4 it was observed that the scope of the misfeasance provision, indeed even whether it provided a summary remedy or a new cause of action, gave rise to considerable debate and eventually legislative reform. The failure to more fully particularize the nature of the summary procedure has also generated some confusion.

Similarly the fraudulent and, more recently, reckless trading provisions have suffered from anomalies and drafting inadequacies. Many of these difficulties derive from the fact that the fraudulent trading provision was initially drawn to counter a particular practice but subsequently it has undergone a piecemeal extension as difficulties in its application to a wider set of practices have become apparent. Indeed the reckless and wrongful trading extensions are illustrative of this piecemeal approach.

Some of the problems encountered in the legislation over the years have arisen from isolated drafting defects and have either been the subject of amending legislation or ameliorative judicial

95 S.557(9) was moved to S.589(6).
96 With some minor reorganisation.
pronouncements. However, many of the difficulties associated with the provisions can be attributed to two particular features. One of these, namely the concurrence of criminal and civil liabilities within the provisions, has been recognised and attended to in the United Kingdom, South Africa and New Zealand but not in Australia where the feature continues to bedevil S.592 and S.593.

The other feature, which has been a problem peculiar to Australia, is the discrete nature of the reckless trading provisions in that they purport to apply to the incurring of a particular debt. In this respect the provisions are to be contrasted with the United Kingdom wrongful trading provision, the South African reckless trading provision and the New Zealand private and general company provisions, which, however, have unique problems of their own, as identified in chapter 8.

The implications of the existence of these features for the Corporations Law provisions is discussed below.

5.6.2 Co-existence of criminal and civil liabilities

Many of the interpretative difficulties discussed in the following chapter have arisen due to the co-existence of civil and criminal liabilities within one set of provisions. For example, doubts as to the relevant onus of proof and as to the rules of interpretation to apply can be attributed to this feature.

In all jurisdictions this aspect has been the subject of legislative attention. Unfortunately the Australian legislature have displayed an inability to successfully structure the provisions to remove this feature.

Drafting and structural defects

From the initial placement of the fraudulent trading provision in the offences sub-division of the part of the Act dealing with winding-up and the placement of the reckless trading offence in the section entitled "Liability where proper accounts not kept", to the subsequent placement of the provision creating a reckless trading civil liability in the following section of the Uniform Companies Acts the legislature has

97 The interpretative difficulties created by combining civil and criminal liabilities within the same provision are well illustrated by Hodgson J. in Metal Manufacturers Ltd v Lewis & Anor (1986) 4 ACLC 739 who stated at p.747 that a penal provision was required to be strictly construed whilst at the same time he acknowledged that the section should bear the same construction in relation to both the civil and criminal liability. Also see Hussein v Good (1990) 1 ACSR 710; Commonwealth Bank of Australia v Friedrich (1991) 5 ACSR 115; Sunshine Management Services Pty Ltd v Russo (1991) 4 ACSR 192. Macquarie Bank Ltd v Focini Pty Ltd (1992) 6 ACSR 553.
exhibited a failure to appreciate the true nature of the provisions. Admittedly the defaulting officer legislation of the mid 1960s partially accommodated these criticisms by repositioning the provisions and separating the criminal and civil aspects. However, with the enactment of the *Companies Code* and *Corporations Law* these drafting defects have returned.

First, all the provisions, including the civil liability provisions, have been categorised under a heading entitled "Offences".

More importantly the provision now contained in S.592 purported to replace S.374C and provide for the offences of reckless and fraudulent trading whereas the S.593 provision purported to replace S.374D and provide a civil remedy. The difficulty is that a conviction for reckless trading under S.592(1) renders the officer jointly and severally liable with the company for the payment of the debt. Not only does this create an anomalous result when compared with the fraudulent trading offence, which does not provide for such liability, but by virtue of Ss. 592(3) and (4) it would appear that civil proceedings may be brought under S.592(1). These subsections are most anomalous if the scheme of the provisions is to provide for civil liability in S.593.

This over-lap between the two provisions would not appear to have been intentional. It has created much confusion, with resultant calls for legislative attention from both commentators and, in particular, the judiciary.

The most emphatic judicial criticism of the provisions is that of Rogers J. in *3M Australia Pty Ltd v Watt; NEC Home Electronics Australia Pty Ltd v White.*98 The defendants sought to have the proceedings dismissed on the basis that on the proper construction of S.556 of the Code a creditor had no standing to institute proceedings for the recovery of a debt incurred by a company. One submission on behalf of the defendants was to the effect that it was incongruous that a creditor should be able to obtain an order against a director pursuant to S.556 for payment of the whole of the debt where that director suffered no conviction, whilst under S.557 a conviction might result in only perhaps a limited liability in respect of the self-same debt.

In the course of dismissing this argument and holding that S.556 is available as a cause of action to a creditor and could not be read down, Rogers J. observed that there were very real problems in giving the provisions an equitable operation. His Honour stated that:

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98 9 ACLR 203.
"I think that it should be acknowledged that the mini-code constituted by Ss.556, 557 and 558 exhibits difficulties. Perhaps insufficient attention was paid by the draftsman to the fact that S.556 creates a civil liability on the part of directors and others to pay the amount of the debt while S.374C of the 1961 Act which it replaces provided only for the criminal offence included in S.556. S. 557 replaced S.374D of the former Act. It is structured the same way as its predecessor in making a conviction under S.556 a condition precedent to the jurisdiction to make, inter alia, a director liable for the whole or part of a debt. In framing S.557, the change effected by S.556 appears not to have been fully taken into account. It is also somewhat odd that S.556(1) establishes both a criminal and civil liability where a debt is incurred without reasonable grounds for repayment while the much more serious offence of fraudulent trading provided for by sub-s(5) does not automatically attract a civil liability. That is a function left to S.557(2) as was the case under the former Act. Again, S.557 deals with an obligation to pay the company. Is this additional to the obligation imposed on say a director by S.556 to make payment direct to the creditor? Is one payment a discharge of the other obligation?"99

His Honour concluded that if he were correct in perceiving these logical inconsistencies in the structure of the Code they should be addressed by the legislature.

On appeal, the New South Wales Court of Appeal agreed that the provisions created difficulties.100 Their Honours were even more adamant that it was desirable that the legislative attention be given to the conflict between the two provisions. Priestley J.A. stated:

"There are parts of those two sections which appear to be marching in quite different directions. In the administration of some liquidations this could quite seriously hamper those concerned with the affairs of the company, both creditors and liquidators, in their efforts to sort out the respective rights of unsecured creditors. It seems to me the possible anomalies arising under the two sections are serious enough to require the urgent attention of the legislatures involved".101

The judgment of Rogers J. was cited with approval in Ross McConnel Kitchen & Co Pty Ltd (in liq) v Ross & Ors102 where Young J. also perceived problems with the provisions resulting from his conclusion

99 Id, 207.
100 (1985) 3 ACLC 324.
101 Id, 326.
102 Supra.
that standing to apply under S.556(1) was not vested in a liquidator. His Honour stated:

"I too can see problems in a case where not only has there been the crime committed set out in Sec.556(1) but that crime was committed in the course of fraudulent trading, which is the more serious crime dealt with in Sec.556(5). In the case of fraudulent trading, not only has a liquidator a statutory right under Sec. 557(2) of the Code, but also there would almost certainly be a misfeasance under the general law which would mean a recovery by the company if loss or damage arose. Problems obviously arise in this area. Fortunately those problems can be put aside for another day".\(^{103}\)

His Honour also observed other difficulties with the legislation arising from the use of the term "debt". This issue is considered in chapter 6.

**Criminal liability a prerequisite for civil liability**

In addition to these drafting difficulties there is the more fundamental issue as to why criminal liability is a prerequisite for civil liability under S.593. The need to rely on the efficiency and effectiveness of the various prosecuting bodies is a source of justifiable concern.\(^{104}\)

It has been observed that the original fraudulent trading provision did not require a criminal conviction as a prerequisite for civil liability. This feature first appeared with the enactment of civil liability for reckless trading and was subsequently adopted as a feature of both provisions in the defaulting officer legislation initiated by Victoria. No rationale has been advanced for this aspect and it may simply be an historical accident that the feature has become such an integral part of the legislation. It is certainly anomalous that under the current legislation a conviction is definitely a prerequisite for civil liability for fraudulent trading whereas it may not be for civil liability for reckless trading. The legislation has swapped the prerequisites for reckless and fraudulent trading civil liability without any rationale being advanced.

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\(^{103}\) Supra, 328.

\(^{104}\) Often prosecuting bodies do not have the resources or decide for various reasons not to pursue a prosecution. This was conceded by Ralph Watzlaff, then head of the investigations department of the NSW Corporate Affairs Commission, who stated that, in NSW at least, they tend to prosecute only the important cases. Reported in English, "Directors Duties", [1989] Aust Accountant 24 at 26. In the United Kingdom, where this prerequisite of a conviction does not exist, another problem arises that it is common for a liquidator to be inhibited from commencing civil proceedings because of the imminence or currency of criminal proceedings against the same defendants based on the same evidence. (Cork Committee Report, para 1759).
Furthermore the relevance of S.592(7) and S.592(8) in providing that certificates of conviction are evidence of the matters stated therein is not immediately apparent. If civil liability is sought under S.592(1) by the prosecutor then these provisions have no application as no conviction would yet have been recorded. The issue does not arise under S.592(6) as no civil liability may be imposed pursuant to that provision.

Similarly S.593(1) and (2) only require proof of a conviction and not proof as to the elements contained in S.592(1) and (6) respectively and so again S.592(7) and (8) are of no significance.

It may be that the provisions are relevant to the issue of sentencing for S.592(1) or S.592(6) offences where there are prior convictions, or where a civil applicant proceeds under S.592(1) after a conviction has been obtained. In the later event it is difficult to envisage why such an applicant would prefer to proceed under S.592(1) rather than S.593(1). Issues of standing aside, where a conviction has already been obtained, and so S.592(3), which provides that a conviction need not be obtained before institution civil proceedings under S.592(1) provides no advantage, an application under S.593(1) would clearly be preferable to one under S.592(1) as it would only be necessary to prove the conviction and not the elements of the offence/action.

Alternatively the existence of S.592(7) and S.592(8) may assist in establishing peripheral matters of proof required by S.593(1) and S.592(6), such as to the quantum of the debt(s) and, where relevant, to whom it is payable, and in aiding the court in the exercise of its discretion under those provisions. A further possibility is that the provisions may be relied upon by civil applicants under S.592(1) in circumstances where no conviction has been secured in relation to their debt but such a conviction has been secured in relation to another debt incurred at about the same time.

5.6.3 Discrete nature of the Australian reckless trading provisions

The other feature of these provisions which has been the source of many difficulties is the discrete nature of the reckless trading provisions. Whilst the fraudulent trading provisions are concerned with a course of dealings, in contrast when the reckless trading provision first appeared in S.303(3) it referred to the unreasonable contracting of a "debt". This feature was perpetuated by S.374C and now appears in

105 Creditors and the Commission have standing under S.593(1). It is unclear who has standing under S.592(1). Ross McConnel Kitchen & Co Pty Ltd (in liq) v Ross & Ors (1985) 3 ACLC 326.
S.592.

One implication of this feature has been the need for the drafting differences between S.593(1) and S.593(2) which were discussed in section 5.4.2 above.

**Evidential difficulties**
Most importantly however are the difficulties this feature creates for an applicant seeking to prove the offence or liability. A major creditor of a company is likely to have many outstanding invoices with the company at any particular time. Thus, an applicant under S.592(1) or S.593(1) will need to establish that the relevant ingredients of the action are made out as at the date of each invoice. This creates evidential difficulties. As a result pre-trial procedures, especially interrogatories and, in the case of actions by the ASC, investigatory hearings, become drawn out and complex as typically does the eventual trial. As a result such actions involve a real risk as to costs, which is compounded by the doubts of success generated by the complexities of the action. Together these aspects substantially reduce the attractiveness of the S.592(1) and S.593(1) proceedings.

**Sentencing difficulties**
Similarly the discrete nature of the S.592(1) offence creates sentencing difficulties. In *De Rossi v Hamilton*\(^{106}\) the defendant had been convicted on 141 counts under S.374C(1) for which he received a sentence of 18 months imprisonment. In the course of ordering a rehearing, *Wickham J.* observed that the maximum penalty for an offence under S.374C(1) (reckless trading) was imprisonment for 3 months or a fine of $500 whereas under S.374C(2) (fraudulent trading) the maximum penalty was imprisonment for 1 year or a fine of $2,500. Accordingly his Honour concluded that it was not easy to see that an overall term of imprisonment of 18 months for what was not fraud but was an activity for which the maximum period of imprisonment was to be 3 months was a reasonable sentence.

In the event, his Honour left open the question of whether when a custodial sentence is called for the sentence should not be more than the maximum provided for in S.374C(1). He resolved the issue on the facts before him by concluding that it was an appropriate case to treat the offences as one continuing transaction and according passed concurrent sentences.\(^{107}\)

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\(^{106}\) 7 ACLR 40.

\(^{107}\) It is clear that although the conduct of the respondent may be treated as one course of conduct for sentencing purposes, a complaint drawn in such a manner would be invalid on the grounds of duplicity. See chapter 6.
A consequence of providing individual creditors with a cause of action
The discrete nature of the provision is, arguably, a necessary consequence of providing individual creditors with a cause of action. The Australian States and New Zealand are the only jurisdictions where creditors have this remedy and the provision has a discrete nature.\textsuperscript{108} It is argued in chapters 8 and 9 that provisions which provide a cause of action directed at a course of conduct, particularly those which confer on individual creditors a cause of action, also exhibit difficulties in their application.

Until recently the dearth of reported decisions on S.592(1)\textsuperscript{109} could have supported an argument as to the difficulties of making out the offence or cause of action. However the recent proliferation of such decisions might suggest that possibly the provision had simply taken some time to become familiar to potential applicants. In any event it has been suggested that the provision has served creditors, both individually and collectively, as a potent weapon of negotiation.\textsuperscript{110}

Whether the defaulting officer provisions ought to contain discrete elements or not depends, in turn, upon whether individual creditors are to be provided with a cause of action. Whilst for the purpose of, in chapter 9, identifying the thematic development of these provisions, it will be assumed that creditors are to retain their individual rights, whether this is ought be a feature of the provision or not will be explored in chapter 11.

5.7 Corporate Law Reform Act 1992

From 24 June 1993 the reforms contained in the Corporate Law Reform Act 1992 take effect with the result that the fraudulent and reckless trading provisions only apply to debts incurred before that date. Debts incurred after that date are subject to a new insolvent trading provision which departs, at least in form, from the old law. An account of the development of this new provision and a consideration of its features will be detailed in chapter 10. It will be observed that the provision addresses many of the deficiencies in the earlier provisions and reflects, with particular clarity, the underlying theme of the creditor recovery regime.

\textsuperscript{108} The New Zealand provision (S.320) contains both a discrete and dynamic limb.
\textsuperscript{109} See chapter 6.
\textsuperscript{110} Gower, chapter 6.
6. Conclusion

**Piecemeal, reactive and unsophisticated legislation**

It was observed in this chapter that the legislative development of the defaulting officer regime has been piecemeal, reactive and unsophisticated. The initial provision, the misfeasance provision, simply provided, notwithstanding some early views to the contrary, a summary procedure by which to enforce the common law actions, typically, for fraud and breach of trust. The inadequacies of the common law in dealing with what was perceived as a particular form of abuse of the privilege of limited liability provided the impetus for the enactment of the first statutory cause of action in the form of the fraudulent trading provision. In due course the ambit of this provision was widened, in all jurisdictions considered, to provide a cause of action against corporate management essentially where debts were incurred by a company in the absence of a reasonable expectation that they would be paid. Whilst this extension has manifested itself in a variety of forms the resultant provision has typically been characterised as a reckless, wrongful or insolvent trading provision.

Whilst these provisions provide the central feature of the recovery regime available to creditors of corporations, by building upon the narrow base initially comprised of the misfeasance provision and latter the fraudulent trading provision, subsequent legislative developments have suffered from a mindset that the creditor recovery regime must be expressed in a particular legislative form and directed at managerial conduct exhibiting particular features. Accordingly this legislative development has been characterised by forced attempts to provide creditors, in the guise of these provisions, with an adequate recovery regime. However this narrow base and the other limitations and drafting defects contracted from the source provisions have cast doubt on the effectiveness of the regime and, particularly, on its ability to adapt to protect creditors from novel avenues of abuse and entrepreneurial ingenuity.

**Identification of an underlying theme**

Furthermore subsequent legislative focus has tendered to tinker with the provisions rather than attempt to identify an underlying theme and the essential nature of the practices against which the provisions are designed to operate. Whilst generally the development of the provisions has witnessed an extension in the width of their application there is a need, in the Australian context at least, to identify the essential aim and theme of this regime and establish a plan for future reform. This will be further explored in chapters 9, 10 and 11.
The thematic development of the defaulting officer provisions

It could be anticipated that the retention of the fraudulent and reckless trading provisions as an element of the creditor recovery regime would witness their thematic development in such a way as to address the deficiencies identified. It was observed that with the enactment of the Companies Code provisions the subjective elements which had previously plagued the substantive provisions of the reckless trading provision had been removed to a defence provision. However it was noted that a number of major limitations remained and that, in fact, some of these defects had been compounded by the reforms. In particular, it was observed that problems continued to plague the provisions created by the concurrence of the criminal and civil liabilities and the discrete nature of the reckless trading provision. The possible development of these provisions in such a way as to address these limitations will be canvassed in chapter 9. Furthermore, in chapter 11 the fundamental issue, inherent in the discrete nature of the reckless trading provision, of whether the provisions ought provide individual creditors with a cause of action or provide only a collective remedy, will be considered in detail.

Judicial interpretation of the provisions

Prior to considering these matters it is appropriate to examine the judicial interpretation of the provisions with a view to identifying further areas where inadequacies exist and what the judicial response has been. Furthermore any judicial insight into the underlying rationale for the legislation needs to be identified. This is the subject matter of the following chapter.