

Defaulting Directors

Introduction

The first Companies Acts imposed relatively few restrictions on officers. *Salomon v Salomon*¹ and the separate corporate entity principle became firmly cemented into law. Even 'sole proprietors' of small businesses enjoyed limited liability, provided that they went through the comparatively cheap and easy process of incorporating a company and steered clear of fraud. Business risks, in effect, moved from the shoulders of owner/directors to those of creditors. Abuses of this privilege of limited liability were bound to arise.

Kahn-Freund concluded that *Salomon* was 'calamitous' because traders, whose business risks were slight, who required no outside capital and whose business was more appropriate in partnership form, could shelter behind limited liability.² Limited liability came to be used by those for whom it was not really intended. Even today, virtually any business, however small, can incorporate with a share capital of a very modest amount (we are familiar with the '\$2 company', where paid-up capital consists of two \$1 shares). When such companies fail, their promoters and officers are usually not liable for any corporate deficit and their personal assets are left intact. Creditors are often left lamenting.

Legislators pondered a variety of solutions. The imposition of a minimum paid-up capital requirement was one proposal; the withdrawal of the privilege of limited liability from proprietary companies was another. Neither solution has been introduced in Australia as yet. The Code offered some protections, but they were flawed. For example, s 116(2) prohibits the issuing of shares at a discount, but the exceptions in ss 117 and 118 undermine its effect. At present, the Code uses only weak reporting requirements for non-cash consideration share issues as a means to control this particular avenue of abuse by company controllers and promoters. There is no independent valuation requirement as in EEC jurisdictions. Similarly, controls on the improper reduction of capital and on the unjustified payment of dividends are virtually ineffective as measures to protect share capital. The statute does not ensure that there

1. [1897] AC 22.

2. Kahn-Freund, 'Some Reflections on Company Law Reform' [1944] MLR 54.

is sufficient capital in a company to run its business; nor does it protect the company's assets from improper reductions or losses. Although investors impliedly accept the reasonable risks of business investment, the burden upon external creditors is greater than that upon owner/officers in the event of company failures.

The statutes have begun to stitch a few zippers into the corporate veil. They enable liquidators and others to get at blameworthy officers and related persons and to extract some personal contribution to the losses of their companies. This chapter examines major provisions that fall into this category: for example, s 229(1) on dishonesty by officers; s 229A on the liabilities of directors of corporate trustees; s 453 on sales to and by the company at incorrect values and preferential payments discharging officers from liabilities; s 542 on losses to companies caused by fraud, negligence, default, breach of trust or duty; ss 556 and 557 on offences relating to the incurring of debts and fraudulent conduct; miscellaneous other provisions that impose liabilities on company officers in default; and s 535 on the court's power to grant relief from liability.

The statutory duty of directors to act honestly

Honesty is fundamental to the director's fiduciary relationship with his company. As one would expect, the Code backs up the fiduciary duty of good faith with a statutory requirement that officers act honestly. It now also imposes meaningful penal sanctions. The main provision is s 229(1):³

An officer of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties of his office.

Penalty —

- (a) in a case to which paragraph (b) does not apply — \$5,000; or
- (b) where the offence was committed with intent to deceive or defraud the company, members or creditors of the company or creditors of any other person or for any other fraudulent purpose — \$20,000 or imprisonment for 5 years or both.

The section distinguishes between failure to act honestly when there is and when there is not an intent to deceive, and adjusts the maximum penalties accordingly.

In addition, state legislation, such as ss 184, 188–192, 195 and 270 of the *Criminal Law Consolidation Act 1935* (SA), offer provisions applicable to fraudulent officers of companies. Section 554 of the *Companies Code* deals with certain acts of suppression of information, concealment and other frauds by officers; s 560 deals with the falsification of books relating to

3. Which replaces part of s 124(1) of the *UCA*. See earlier discussion of s 229 of the Code in Ch 8.

the company's affairs; s 561 outlaws certain frauds by officers, such as obtaining credit for the company by false pretences, wrongly transferring company property or concealing company property to prevent enforcement, against the company or a related corporation, of a court order or judgment; s 563 deals with persons who make false or misleading statements to the Commission or others; and s 564 deals with misleading or false reports or statements by officers relating to the affairs of the corporation.

It is a measure of the seriousness with which the legislature now views 'white collar' dishonesty that the penal sanctions of the *UCA* have been dramatically increased in the Code. A fine of \$10,000 or two years imprisonment is common. Section 229(2) carries \$20,000 and/or five years imprisonment. Civil as well as criminal remedies for breach of the statute proliferate. Corporate officers' defaults may be pursued with greater zest than when penalties were puny, public indignation over 'white collar' crime muted, and the chances of successful prosecution poor.⁴

It should be kept in mind that s 229(6) and (7)⁵ allow the court to order anyone contravening s 229 to pay over profits and compensation to the company.⁶ As soon as a person is convicted under the section, s 229(6) allows the court to order compensation. This is a practical development. Section 229(7) allows the recovery of compensation 'whether or not the person has been convicted of an offence' under s 229. This subsection also may permit the award of double damages, (that is, any profits the contravening person made, *plus* an amount equal to the loss or damage suffered by the company⁷).

Liability of directors for debts incurred by corporate trustee

Like any trustee, a trustee company is personally liable for the debts of the trust. Where the trustee incurs debts properly in the execution of the trust it can dip into the trust assets or property for payment. In other

4. An unpublished MLS Research Paper (Adelaide, 1985) by Lendrum, 'A Consideration of Legislative Regulation of Default by Company Officers with Emphasis on s 229 and ss 556 and 557 of the Companies (South Australia) Code', reports that in South Australia, for example, there have been but three prosecutions under s 124(1) of the *UCA* for failure to act honestly. In one of these — *Morgan v Flavel* (1983) 1 ACLC 831 — a director was convicted for converting company property to his own use and using it to pay personal debts. In another case, the managing director of a newspaper pleaded guilty in 1984 to offences under ss 124, 375 and 375A of the *UCA* for using the common seal without board authority, making a false report to the board of an associated company with intent to deceive and wilfully authorising the publication of a misleading statement in the annual accounts of the company.

5. Formerly s 124(3) of the *UCA*.

6. Only to the company, not shareholders, creditors or others.

7. See discussion of the 'double' damages possibility in *CCH Company Law and Practice*, Vol 2, para 30–854.

words, the trustee has a right 'to be reimbursed or exonerated out of the trust property'.⁸ The trustee has a right of indemnity out of the trust assets.

Creditors of the trustee are entitled to be subrogated to the trustee's right of indemnity. However, there may be no such right of indemnity in the first place if the trustee acted in breach of trust, in a way not authorised by or in excess of the terms of the trust,⁹ or if a provision has been put in the trust instrument purporting to relieve or exclude the corporate trustee's right of indemnity from the trust assets. Creditors of corporate trustees could, then, be at risk, especially if the trustee has only \$2 worth of paid-up capital and has no assets of its own.

Section 229A of the Code¹⁰ now says that where a corporation, 'while acting or purporting to act in a capacity of trustee of a trust', incurs a liability for which it is, for any reason, not entitled to be fully indemnified out of the trust assets, then all directors, except 'innocent directors',¹¹ will be jointly and severally liable with the corporation¹² to discharge the liability. The 'corporate veil' can be lifted to expose directors to personal joint and several liability along with the company itself. This will encourage directors of corporate trustees to pay closer attention to their duties and to creditors' rights.¹³ However, if the creditor is legally entitled to an indemnity, the director is safe, even if the trust is not able to meet its debts financially.¹⁴

8. *RWG Management Ltd v CAC* [1985] VLR 385 at 395, per Brooking J. See also *Vacuum Oil Co Pty Ltd v Wiltshire* (1945) 72 CLR 319. This rule gained statutory recognition in s 35(2) of the *Trustee Act 1936* (SA); s 36(2) of the *Trustee Act 1958* (Vic) and s 59(4) of the *Trustee Act 1925* (NSW). See also *Octavo Investments Pty Ltd v Knight* (1979) 144 CLR 360 (H Ct); Meagher, 'Insolvency of Trustees' (1979) 53 ALJ 648.
9. See *RWG Management Ltd v CCA*, *ibid* at 393ff.
10. Came into force on 31 March 1986.
11. See s 229(3) for definition. Paterson and Ednie, *Australian Company Law Service* (3rd ed), Vol 3, para 59,022 comment: 'where a director is a beneficiary and is, as beneficiary, liable to indemnify the corporation in respect of the obligation [see *J W Broomhead (Vic) Pty Ltd v J W Broomhead Pty Ltd* (1985) 9 ACLR 593] it would appear that he is to be regarded as being notionally liable to indemnify directors who are not beneficiaries. Those other directors, if entitled to a full indemnity in that way, would be "innocent directors".'
12. Presumably the directors and the company, being jointly and severally liable, would share the burden pro rata on the basis that equity is equality. See *Albion Insurance Co Ltd v Government Insurance Office of NSW* (1969) 121 CLR 342; *Armstrong v Commissioner of Stamp Duties* [1967] 2 NSWLR 63.
13. If the directors cause the trustee company to contract an unpayable non-trust debt, thereby prejudicing unsecured creditors of the company, that could amount to an actionable breach of fiduciary duty (*Walker v Wimborne* (1976) 137 CLR 1 at 7; *Nicholson v Permakraft* (1985) 3 ACLC 453) and possibly of ss 542 and 556 of the Code (discussed below).
14. See s 229A(2) of the Code. Austin, 'A Survey of the 1985 Exposure Draft — Part I', a paper delivered on 25 July 1985 at a joint seminar (NSW and Sydney Law Schools) criticised the 1985 draft of these provisions as, in part, 'seriously unsound'. See also Barrett, 'Trading Trusts Under the Companies and Securities Bill (No 2) 1984', Monash University Current Legal Developments Series, August 1984, at 97–103, for analysis of the clause that became s 229A.

Charges in favour of officers may be void in certain cases

Section 205A is also new to the Code. It says that where a company creates a charge on property in favour of an officer or an associated person¹⁵ and the chargee purports to take steps to enforce the charge within six months of its creation, it will be deemed to be void unless the court has given prior leave under subs (3). This does not affect the title of someone who buys property from a chargee under a charge, in good faith and without notice that a charge was created.¹⁶ By including associated persons,¹⁷ s 205A catches companies in which an officer has a material interest.

Like other recent changes to the Code, this provision may sometimes assist liquidators who find the company's coffers empty. If that emptiness is due to an officer, having anticipated the company's collapse, taking say, a mortgage over one of the main assets of the company in order to secure money that he is owed by the company and goes into possession as mortgagee, thereby depriving the other creditors, then s 205A may, within the limits of the six-month period, provide a means of regaining the asset for the general body of unsecured creditors.

The liability of directors to liquidators over certain transactions

Section 453 of the Code also permits promoters, directors and others to be made personally liable for certain debts. The provision falls into two parts. The first part deals with the sale of property by, for example, the promoter or director to the company or vice versa, from which the promoter or director profits. The second part attacks officers who use their position to ensure that, as the company sinks into liquidation, any guarantee or liability the officers may have entered into personally in order to support the business is paid off or satisfied in preference to the claims of creditors. It now appears that the liquidator can act under s 453(5) and (6) to recover money from such officers personally.

Directors profiting from property transactions with own company

Section 453(1)–(4) replaced s 295 of the *UCA*, which had been enacted to make directors and others account for unreasonable profits made through the buying or selling of something to their own companies. Under s 453(1), the liquidator can recover from directors and/or various related persons¹⁸ who sold property to the company, any amount by which the cash paid by the company exceeded the property's value. Section 453(2)

15. See s 205A(7) of the Code.

16. Section 205A(5) and (6) of the Code.

17. 'Associated persons' are defined widely in s 9 of the Code.

18. See s 453(1)(a)–(d) of the Code for a list of these other persons from whom recovery can be sought.

deals with the reverse situation, where the promoter, director or related party has purchased something from the company, thereby reaping undue profits. The excess of the value of the property over the cash paid is recoverable.

Under the section, the liquidator can go back four years from the date of commencement of winding up to uncover undue profiteering by such persons.¹⁹ The legislature hoped to catch most indirect gains to promoters and directors by broadening the category of persons potentially caught by s 453(1) to include related corporations,²⁰ spouses and relatives.²¹ Even if the director or other person has disclosed fully, and the company in general meeting has approved the impugned purchase or sale, it seems that the excess profit is recoverable.²²

A lurking difficulty with these provisions is the valuation of the property and the calculation of the excess, especially with such items as the 'goodwill, profits or gain that might have been made' that are specifically included by s 453(3). Section 453(4) says that 'cash consideration' means 'any consideration payable otherwise than by the issue of shares'. The court, in seeking value, may rely on subsequent sale prices of the property if any are available (for example, where goods are sold by one company to another which, in turn, sells them on the open market, then any underpricing in the first sale can be calculated using the onsale price).²³ It may also rely on the availability and willingness of prospective buyers.²⁴

In *Salomon v Salomon*,²⁵ the promoter's leather and boot business was bought at an overvalue.²⁶ Part of the consideration was in the form of shares in the purchasing company. Salomon was not liable to indemnify the company against its creditors' claims. Would those facts today enable a liquidator to recover, using s 453(1)? Hambrook suggests that where, as in *Salomon* and in *Re Wragg Ltd*,²⁷ issued shares form part of the consideration paid by the companies, then s 453(1) would not apply. This is because s 453(4) says that 'cash consideration' means 'any consideration payable otherwise than by the issue of shares in the company'.²⁸ He asks:

If it is not possible to apply the section sensibly to the non-share consideration does this mean that the possible operation of s 453(1) can

19. Under s 295 of the *UCA* the liquidator could only go back two years.

20. See s 7 definition.

21. This brings s 453 into line with, for example, s 230 of the Code.

22. Cf *Re Innes* [1903] 2 Ch 254 at 265–266, where the court said it was not recoverable.

23. See *Re Norrich Pharmaceutical Co Pty Ltd* [1969] 1 NSWLR 125 at 127, concerning s 295(2) of the *UCA*, equivalent to s 453(2) of the Code.

24. *Re Merchant and Industrial Finance Ltd (in liq)* [1975] Qd R 46 at 51. The valuation of company shares is discussed in Ch 12.

25. [1897] AC 22.

26. *Ibid* at 49, per Lord MacNaghten.

27. [1897] 1 Ch 796.

28. Emphasis added.

readily be avoided by ensuring that one or more shares of the company form part of the company's consideration, no matter how insignificant their value when compared to the balance of the consideration?²⁹

Recovering money from officers who discharge their liabilities

An interesting innovation in the 1981 Code was s 453(5). This section seeks to make officers pay up when they have caused their companies to make preferential payments which have the effect of discharging the officers themselves from a liability (for example, officers of smaller companies are often asked to guarantee personally their companies' bank overdrafts). If it becomes evident that the company is sliding into liquidation and the overdraft is high, the officers may see to it that no more cheques are drawn on that account. The company's incoming money is banked and the overdrawn account climbs back into credit before the company is wound up.³⁰ In that way, the officers hope that on liquidation they will not have to pay up as guarantors to satisfy any overdraft. Section 453(5) seeks to make such officers pay the amount of the preferential payments. It is a useful weapon in the liquidator's armoury.

The intention of section 453(5)

The Explanatory Memorandum for the 1981 Code does not explain the purpose of s 453(5). The provision forms part of a section aimed at promoters, officers and related companies, and persons associated with them, who have in some way used their inside knowledge and position to advantage themselves at the company's and creditors' expense. The legislature had creditors firmly in mind when drafting this provision, which was probably introduced to overcome the effect of such decisions as *Re Linney & Co Ltd*³¹ and *Re Timbatec Pty Ltd*.³² They concern s 122(1) of the *Bankruptcy Act 1966* (Cth) or its equivalent.³³

In *Re Linney & Co Ltd*,³⁴ directors were sureties/guarantors of the company's bank overdraft facility. The company was in financial trouble. All the company's takings were paid into the bank account; only small and pressing accounts were paid by the company. This unusual pattern

29. Corkery & Hambrook, *Associations*, Adelaide Law School Student Materials, (1983) Part A, at 100. See also Sawyer, 'Federal-State Co-operation in Law Reform: Lessons of the Australian Uniform Companies Act' (1963) 4 *Melb ULR* 238 at 248-249, making a similar point.

30. A similar situation was at issue in *Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd* (1986) 4 *ACLJ* 400, which concerned s 122 of the *Bankruptcy Act 1966* (Cth), and in *Re Casual Capers Ltd (in liq)* (1983) 1 *NZCLC* 98,590, where the fraudulent trading provision of the NZ Act was used successfully against a director.

31. [1925] *NZLR* 907.

32. (1974) 24 *FLR* 30.

33. Under s 451 of the Code, s 122 of the *Bankruptcy Act 1966* (Cth), which is aimed at voidable preferences, is incorporated into the *Companies Code*.

34. Above n 31.

of business — there were usually many withdrawals from the account — eventually wiped out the overdraft. The court could not fit the behaviour into the legislation on voidable preferences, so it was unable to find that this payment was a 'fraudulent preference' of the director/sureties, even though they had admitted that they had sharply reduced withdrawals from the account to rid themselves of their potential liabilities as sureties.³⁵

A similar decision on similar facts arose in *Re Timbatec Pty Ltd*.³⁶ The court held that, on the wording of s 122(1) of the *Bankruptcy Act 1966* (Cth), it was not proper to treat a payment to the principal creditor, who held a guarantee from the officer in question, as a payment to the guarantor and to invalidate it only to the extent to which it had the effect of favouring the contingent creditor (guarantor). Accordingly, the liquidator could not get an order that the guarantor pay over the amount he would have had to pay if the payment to the creditor had not been paid and the guarantee had been called into action. The legislation did not deal adequately with such officers, who clearly merited attention. Section 453(5) and (6) of the Code now attempt to fill that gap.

The requirements of section 453(5)

The first requirement of s 453(5) is that, before a director/guarantor can be called to account, there must be 'a disposition of property' within six months of winding up. These words, undefined in the statute, have a wide ordinary meaning. They mean to transfer, alienate or convey property officially or in legal form. More generally, a disposition involves a change in beneficial ownership.³⁷

Paying money into an overdraft account whilst a company is failing is a 'disposition' of that money. When an account is in overdraft, the situation at law differs from when the account is in credit. An overdraft is regarded as a loan of money by the bank to the customer, even though when the bank pays out to a third party on the customer's cheque the bank is only an agent of the customer.³⁸ Accordingly, a payment by a customer into an overdraft account can be seen as a contractual repayment of a loan and, in these terms, a disposition of property.³⁹

35. The decision turned on the drafting of the NZ bankruptcy legislation of the time. The directors were not creditors within the provision at issue; they were only guarantors. They would have only become creditors for the purposes of the legislation if they had actually paid up under the terms of the guarantee.

36. Above n 32.

37. 'Disposition of property' is used in s 368 of the Code and s 121 of the *Bankruptcy Act 1966* (Cth). They were discussed in *Re Mal Bower's Macquarie Electrical Centre Pty Ltd (in liq)* [1974] 1 NSWLR 254 at 257–258, per Street CJ, who relied on the *Oxford Dictionary*. In essence, that court accepted that 'disposition' meant 'to make over or convey officially or in legal form'.

38. *Paget's Law of Banking* (8th ed) at 132; *Re Hone (a bankrupt)* [1950] 2 All ER 716 at 719; *Blackburn and District Benefit Building Society v Cunliffe* (1855) 29 Ch D 902 at 912; *Cuthbert v Robarts, Lubback & Co* [1909] 2 Ch 226 at 233, 235.

39. Tax legislation and cases have taken a broader view of 'disposal'. They have included within the word's ambit transactions and dealings which do not amount to changes of beneficial ownership: see, for example, *Ord Forrest Pty Ltd v Commissioner of Taxation* (1974) 48 ALJR 48; (1974) 48 ALJ 460–461.

Second, under s 453(5)(b), the disposition must confer a preference upon a 'creditor'. There should be few interpretation difficulties with that word. Banks extending overdraft facilities will be creditors of the customer whilst the account is in overdraft.⁴⁰

A third requirement is that the creditor must be preferred. The word 'preference' in s 453(5)(b) is vital to the potential scope of the provision. Creating a 'preference' means creating, by a payment or other disposition, an advantage favouring one creditor over the others, or putting one creditor in a better position than the other creditors. This is the ordinary meaning of the word. The *Shorter Oxford Dictionary* defines 'preference' as a 'priority or payment given to a certain debt or class of debts'. As Kitto J said in *Rees v Bank of NSW*, payments are preferences if they place the debtor 'in a better position viz-à-viz other creditors than he would occupy if the debtor became bankrupt with the amount unpaid'.⁴¹ McPherson suggests that the standard test is 'to ask whether, if the transaction were permitted to stand, it would have the effect of disturbing the statutory order of priorities as regards payment in winding up'.⁴²

This disturbance to priorities is to be judged objectively. Only the results of the debtor's action are material; motive and intention are not.⁴³ The wording of s 453(5) of the *Companies Code* and s 122(1) of the *Bankruptcy Act* indicate this.

Officers attempting to avoid liability may argue that 'preference' in s 453(5) means a void or undue preference within the meaning of s 122 of the *Bankruptcy Act*. In other words, to protect themselves as sureties, they would attempt to incorporate all the defences open to a payee in good faith and for valuable consideration and in the ordinary course of business.⁴⁴ If that argument were successful, an officer could 'escape' s 453(5) if the principal creditor holding the guarantee or surety were acting bona fide and in the ordinary course of business and did not know or could not be expected to know about the company's insolvency.

There is a distinction between preferences and preferences that can be defended. Reported cases on s 122 of the *Bankruptcy Act* draw this distinction.⁴⁵ Further, the word 'preference' in s 453(5) can stand alone and does not need to include or incorporate the defences. There is no good semantic or policy reason to import the defences under s 122(2) of the *Bankruptcy Act* into the concept of preference in s 453(5) of the Code. The defences were intended to allow the 'innocent' principal creditor to resist

40. See authorities listed above n 38.

41. (1964) 111 CLR 210 at 223.

42. *The Law of Company Liquidation* (2nd ed, 1980) at 285. McPherson cites *Burns v Stapleton* (1959) 102 CLR 97 at 104.

43. See *Richards & Co Pty Ltd v Lloyd* (1933) 49 CLR 49 at 64, per Evatt J: 'The test adopted is completely objective and in no way subjective.'

44. See defences in s 122(2) of the *Bankruptcy Act 1966* (Cth).

45. Bowen CJ in *Re Timbatec Pty Ltd*, above n 32 at 38; McDonald, Henry and Meek, *Australian Bankruptcy Law and Practice* (5th ed) at para 687. In *Richardson v The Commercial Bank Co of Sydney Ltd* (1952) 85 CLR 110 at 128, the High Court noted: 'if they be preferences they are void unless good faith is made out in the sense required under s 95(2) and (4) [of the 1924 Act].' See also *Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd*, above n 30 at 402, 407.

the usual consequences of being preferred. But there is no reason why a principal creditor's innocence should shield the guarantor/officers, especially when the officers could, by keeping information from the creditor, manufacture their own defence.

Proof of insolvency

Section 453(5) does not specifically require that the company be insolvent at the time of the payments. It simply says that the payments must be within the period of six months before the commencement of the winding up. However, on the strength of the wording of s 122(1) of the *Bankruptcy Act*, there can arguably be no challengeable preference until the company is unable to pay its debts as they fall due.

Proving insolvency at the date of contested payments is not always easy in the context of an overdraft.⁴⁶ A liquidator needs solid proof of insolvency, not merely a suspicion. Insolvency means the inability to pay one's debts as they fall due. Inability to pay one's debts is distinguished from unwillingness to pay one's debts. Neither does it mean a temporary shortage of liquidity. To quote Barwick C J in *Sandel v Porter*:

. . . the debtor's own moneys are not limited to the cash resources immediately available. They extend to moneys which he can procure by realization by sale or by mortgage or by pledge of his assets within a relatively short time — relative to the nature and amount of the debts and to the circumstances, including the nature of the business, of the debtor. The conclusion of insolvency ought to be clear from a consideration of the debtor's financial position in its entirety and generally speaking ought not to be drawn from evidence of a temporary lack of liquidity. It is the debtor's inability, utilizing such cash resources as he has or can command through the use of his assets, to meet his debts as they fall due which indicates insolvency.⁴⁷

Barwick C J added in *Queensland Bacon Pty Ltd v Rees*:

. . . a great number of quite solvent people . . . would find themselves temporarily short of cash and under a necessity to make arrangements to cover the 'shortfall' in overdraft accommodation.⁴⁸

If creditors habitually are tolerant of the company's tardiness or accept, for some reason or other, that payment will be delayed, then a conclusion of insolvency will be more difficult to achieve.⁴⁹ *Queensland Bacon*,⁵⁰ however acknowledged that the dishonouring of cheques would nearly always call for some inquiry by the bank. Repeated dishonouring would provide strong evidence of insolvency. The ability to borrow money on

46. See *M & R Jones Shopfitting Co Pty Ltd (in liq) v The National Bank of Australasia Ltd* (1983) 7 ACLR 445.

47. (1966) 115 CLR 660 at 670.

48. (1966) 115 CLR 266 at 293.

49. See *M & R Jones Shopfitting Co Pty Ltd (in liq)*, above n 46 at 453.

50. Above n 48.

an unsecured basis to pay debts has been found to be, in itself, insufficient evidence of solvency.⁵¹

Must the liquidator proceed against the creditor first?

Section 453(5) contemplates action against the officers before, or instead of, action against the principal creditor. Paragraph (d) specifically anticipates action against an officer where a liquidator has *not* recovered from the creditor. Paragraph (e) deals with the situation where the liquidator has already successfully recovered something from the creditor. Section 453(6) is also helpful: it anticipates the situation where the liquidator recovers first from an officer and then later from the creditors.⁵²

These provisions, which assume that action may or may not be taken against the creditor as well, also indicate that the legislature anticipated that the principal creditor would often be shielded by s 122(2) of the *Bankruptcy Act 1966*. In other words, the legislature anticipated that action against the creditor itself could be fruitless. Even if the creditor in whose favour the guarantee is drawn has a defence, this should not stop action against the surety or guarantor himself under s 453(5).

Acting in the company's best interests

It may be argued that directors who, for example, ensure that the company pays off an overdrawn account over which they have given a guarantee, are not acting in the best interests of the company.⁵³ A breach of this fiduciary duty may render the directors liable to account to the company for the amount diverted. This depends upon a finding that the concept of the company, to which the duties are owed, includes creditors. Company law now accepts this in certain circumstances.⁵⁴

Orders against wrongdoing persons concerned with corporations: section 542

Another provision of the Code which tries to minimise the damage or loss to companies and creditors by defaulting officers is s 542. The section is based on s 367B of the *UCA* which, it was said,

. . . provides a liquidator with a summary, and what is intended to be a prompt means of recovering from the nominated persons money which as a matter of law they owe to the company and might be recovered by action in the ordinary way by writ. . . . The method provided is a summary method without all the usual trappings of a full scale action.⁵⁵

51. *Kyra Nominees Pty Ltd (in liq) v National Australia Bank Ltd*, above n 30 at 405.

52. See the force of the word 'subsequently' in s 453(6)(b).

53. *Re Linney & Co Ltd*, above n 31, where this sort of argument failed.

54. The duty to act in the company's best interests is discussed in Ch 5.

55. *Re John Bruce Home World Pty Ltd (in liq)* (1982) 1 ACLC 200 at 201, per Anderson J.

Under s 542, liquidators, official managers, the Commission and others⁵⁶ can seek orders where:

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

Misfeasance: the former ground

Section 542 replaces what was known as the 'misfeasance' provision in the UCA.⁵⁷ The wording was changed in 1972 and again in 1981 and no longer includes the word 'misfeasance'. It covers much the same ground, but uses words of a more specific meaning. James LJ in *Coventry and Dixon's* case suggested that

. . . misfeasance is in the nature of a breach of trust, that is to say, it refers to something which the officer of such a company has done wrongly by misapplying or retaining in his own hands any moneys of the company, or by which the company's property has been wasted, or the company's credit improperly pledged. It must be some act resulting in some actual loss to the company.⁵⁸

The authorities on the former provisions therefore remain useful while we await the first reported decisions on s 542.⁵⁹

It was said of a predecessor of s 542 that it was wholly or largely procedural in effect;⁶⁰ that it did

. . . not create any new liability or any new right, but only provides a summary mode of enforcing rights which must otherwise have been enforced by the ordinary procedure of the Courts.⁶¹

Lord Evershed added that 'misfeasance' was not a distinct wrongful act but a clone of other breaches of duty or trust.⁶² The more specific wording of s 542 now lists certain wrongful activities, albeit ones that appear elsewhere in the Code or general law. Although they do not create new

56. See s 542(1) for definition of 'prescribed person'. CCH *Australian Company Law and Practice*, Vol 2, para 66–700 advises: 'where a liquidator or other prescribed person is in doubt as to his liability for costs following an unsuccessful application to the Court under this section, it may be advisable to apply to the NCSC to have the company authorised as an applicant.'

57. Section 367B of the UCA; formerly it was s 305.

58. *Re Canadian Land Co, Coventry & Dixon's Case* (1880) 14 Ch D 660 at 670; cited with approval by Mason J in *Walker v Wimborne* (1976) 137 CLR 1 at 7.

59. See discussion of history and ambit of s 542 by McPherson, above n 42 at 310ff; Guthberlet, 'Personal Liability of Defaulting Officers of Insolvent Companies Under the Companies (SA) Code 1981' unpublished LLB (Hons) Dissertation (University of Adelaide 1985) at 56ff; *Kimberley Mineral Holdings Ltd v Triguboff* (1978) 3 ACLR 624 at 626.

60. *Re City Equitable Fire Insurance Co* [1925] Ch 407 at 527; *Re Buena Vista Motors Pty Ltd* [1971] 1 NSWLR 72 at 74–75.

61. *Re Canadian Land Co, Coventry & Dixon's Case*, above n 58 at 670.

62. *Re B Johnson & Co (Builders) Ltd* [1955] Ch 634 at 648.

causes of action, each of the grounds has a distinct meaning, sometimes overlapping, but distinct nonetheless, and entitled to stand with other substantive provisions of the Code.⁶³

It is likely that the interpretations of breach of duty and trust, fraud, negligence and default will bear the same meanings that they bear elsewhere in the Code or general law relating to directors. If s 542 were not in the Code, the misdeeds that might attract its application would be open to pursuit under other provisions of the Code or general law, but at a slower pace. But, like its predecessors, it gives a summary method of enforcing duties and responsibilities. It is especially useful to the liquidator who, when scrutinising the activities of the company prior to winding up, may uncover otherwise shrouded misdeeds of officers and others. As with former provisions, s 542 proceedings can be brought without preventing other proceedings based on the same matters, and notwithstanding that these matters may amount to an offence.⁶⁴ In *Re Tropic Isle Ltd (in liq)*,⁶⁵ for example, both misfeasance and fraudulent trading proceedings were brought.⁶⁶

Because of its several and overlapping categories, s 542 offers a broad ambit of attack on a defaulting officer. It also offers flexibility of remedy. Under s 542(2), the court may make such orders 'as it thinks appropriate'. Two types of orders are suggested in s 542(4): orders directing the person to pay money or to transfer property to the corporation, and orders directing the person to pay to the corporation the amount of the loss or damage. The court will usually order the person to pay the financial loss or damage suffered by the company as a consequence of the wrongdoing.⁶⁷

Grounds of action under section 542

The grounds listed in s 542(2) are broad. Virtually any action by officers and others that amounts to a breach of duty, or a misuse of their power, falls within the words 'fraud, negligence, default, breach of trust or breach of duty'. The grounds of 'breach of trust' and 'fraud' were added in 1981. 'Default' has the broadest, but most nebulous, meaning. In another context, Bowen L J in *Re Young and Harston's Contract* concluded that 'default' was a relative term meaning 'not doing what is reasonable under the circumstances — not doing something which you ought to do . . .'.⁶⁸

63. Cf McPherson, above n 42 at 320. See also *Re Price Mitchell Pty Ltd* (1984) 2 ACLC 524, 529 where McLelland J held that the words 'negligence, default, breach of duty or breach of trust' in s 237(1) of the Code were not restricted in their ambit to the interpretation of the expression 'misfeasance' in the UCA.

64. See s 542(2) and (5) of the Code.

65. [1967] Qd R 193.

66. Under ss 284 and 285 of the *Companies Act 1931* (Qld).

67. See, for example, *Re Yorke (Stationers) Pty Ltd (in liq)* [1965] NSW 446; *Steen v Law* [1963] 3 All ER 770; *Walker v Wimborne* (1976) 137 CLR 1; *Re Insurance Associates Pty Ltd (in liq)* [1974] ACLC 27,885; *Re Buchanan Enterprises Pty Ltd (No 3)* (1984) 2 ACLC 59.

68. (1885) 31 Ch D 168 at 174. See also *Re Woods and Lewis' Contract* [1898] 2 Ch 211 at 215–216.

Fact situations involving 'misfeasance' provisions have included the payment of dividends out of capital;⁶⁹ the payment of directors' fees without the required general meeting approval;⁷⁰ the disposition of company property after the commencement of winding up;⁷¹ the sale of company property without any payment for goodwill;⁷² the drawing of all 'profits' as salary and the failure to leave funds to pay company debts;⁷³ the advancing of company cash without obtaining any security;⁷⁴ the stripping of assets or the deliberate putting of funds beyond the reach of probable creditors;⁷⁵ the taking of secret profits by officers and liquidators;⁷⁶ the falsification of accounts;⁷⁷ and the making of loans in breach of s 67 of the UCA.⁷⁸ But, at least before 1981, misfeasance did not include 'negligence of itself'.⁷⁹

Negligence under section 542

Negligence amounting to failure to act in the best interests of the company qualifies as misfeasance. Vaughan Williams J in *Re New Mashonaland and Exploration Co* thought it plain that

. . . if directors are guilty of such negligence that it cannot be said that in doing what they did they attempted to perform their duty as directors, then such directors are guilty of misfeasance.⁸⁰

But negligence not amounting to a breach of fiduciary duty has never been enough. In *Re Tropic Isle*,⁸¹ there was a misfeasance summons against directors over some investments in shares which lost value and caused loss to the company. Lucas J branded the investments as imprudent, but not enough to constitute misfeasance.⁸²

In *Re Tropic Isle*, the negligence required to attract the section had to be analogous to a breach of trust.⁸³ Now that negligence stands apart from breach of duty and breach of trust as grounds in the section, it may be argued that something less 'serious' than a breach of trust or fiduciary duty will suffice. To date, a rigid view has prevailed. Lucas J stated in *Re Tropic Isle* that 'negligence of itself was not sufficient to attract liability

69. *Re Exchange Banking Co, Flitcroft's case* (1882) 21 Ch D 149.

70. *Senes v Empress Electric (Sydney) Pty Ltd* (1966) 114 CLR 622.

71. *Couve v J Pierre Couve Ltd (in liq)* (1933) 49 CLR 486.

72. *Re Buchanan Enterprises Pty Ltd* (No 3), above n 67.

73. *Re Day-Nite Carriers Ltd* [1975] 1 NZLR 172.

74. *Wright v Ftisina* (1983) 1 ACLC 716.

75. *Re Avon Chambers Ltd* [1978] 2 NZLR 638; *Peter Buchanan Ltd and Macharg v McVey* [1955] AC 516.

76. *Hermann v Charny* [1976] 1 NSWLR 261.

77. *Re Maney and Sons De Luxe Service Station Ltd* [1969] NZLR 116.

78. *Re Insurance Associates Pty Ltd (in liq)* [1974] ACLC 27,885. Section 67 of the UCA is now s 129 of the Code (it deals with company financing dealings in its own shares).

79. *Re Tropic Isle*, above n 65 at 204.

80. [1892] 3 Ch 577 at 585.

81. Above n 65.

82. Above n 65 at 7.

83. See also Mason J in *Walker v Wimborne*, above n 67 at 7.

on a misfeasance summons'.⁸⁴ Lucas J conceded that negligence could amount to misfeasance only if it were:

. . . accompanied by something more, something which amounted to a breach of trust, either because the act negligently done was *ultra vires*, or if it was within power, because it could be said that it was an act in the performance of which the directors had completely failed to exercise the faculties of independent judgment and discretion.⁸⁵

This attitude may be reviewed in the light of the redrafting of the provision. Meanwhile, no less a standard of care should be relevant to an action on the ground of negligence under s 542 than under s 229(2).⁸⁶ As the latter duty becomes firmer and more is demanded of directors, the negligence ground under s 542 will also become more potent in the hands of liquidators and others.

Will the courts go further than the interpretation of 'negligence' in s 542 and import common law notions of the duty of care?⁸⁷ Williams J in *Mount v Tomlinson*⁸⁸ and Needham J in *Kimberley Mineral Holdings Ltd (in liq) v Triguboff*⁸⁹ were set against such an idea when assessing s 367B. Williams J stressed that the relationship of a company to its directors was well established and concluded that the negligent acts contemplated by the section were those for which officers had always been liable to the company.⁹⁰

Offences related to the incurring of debts and fraudulent and wrongful conduct

In 1926, the UK Greene Committee⁹¹ lamented practices whereby controllers of companies took securities over the company's property and used their position to ensure that their securities were honoured prior to those of other creditors. Section 332 of the UK *Companies Act 1948* (now s 630 of the 1985 Act) emerged as a potentially powerful restraint on directors. It permitted the court to order personal liability for the company's debts or liabilities where, in the course of winding up, it appeared that the company's business had been carried on with intent to defraud creditors, or for any other fraudulent purpose.

84. Above n 65 at 204. See also *Re Day-Nite Carriers Ltd*, above n 73 at 175.

85. *Ibid.*

86. See discussion in Ch 8.

87. Cf the *Donoghue v Stevenson* [1932] AC 562 type of liability as it has developed in the common law.

88. [1981] ACLC 33,337.

89. [1977-78] ACLC 29,973.

90. See also Mason J in *Walker v Wimborne* (1976) 137 CLR 1 at 8. Negligence in the role of director is discussed in Ch 8. Possible orders, defences to proceedings, relief from liability, procedure and evidence are discussed with respect to the pre-1981 statute by McPherson, above n 42 at 315-320.

91. *Report of Company Law Amendment Committee* (Greene Chairman), Cmnd 2657 (1925) at para 61.

In time, this provision, in some form, was adopted widely.⁹² The *Jenkins Report*⁹³ and the *Cork Report*⁹⁴ suggested that the provisions be broadened to also include reckless trading. This was adopted in Australia. The grounds are now enshrined in the complex 'mini-code' of ss 556, 557 and 558.⁹⁵

Section 556(1) deals with *wrongfully incurring a debt*:

If —

- (a) a company incurs a debt, whether within or outside the State;
- (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,⁹⁶ 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.

Penalty: \$5,000 or imprisonment for 1 year, or both.⁹⁷

Section 556(5) deals with the more serious matter of *acting fraudulently*:

- (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.

92. See, for example, South Africa in s 424 of the *Companies Act 1973*; New Zealand in s 320(1) of the *Companies Act 1955*; Australia in ss 303 and 304 originally, then ss 374C and 374D of the *UCA* and now ss 556 and 557 of the Code.

93. Cmnd 1749 (1962) para 503(b).

94. Report of the Review Committee, *Insolvency Law and Practice* (Cork Chairman), Cmnd 8558 (1982) para 1775ff and its concept of 'wrongful trading'.

95. See *3M Australia Pty Ltd v Watt* (1984) 2 ACLC 621; 9 ACLR 203 (on appeal); (1985) 3 ACLC 324 at 325; *Russell Halpern Nominees Pty Ltd v Martin* (1986) 4 ACLC 393 at 396.

96. Section 556 applies only to companies listed in s 553, most notably those companies that are unable to pay their debts, or have been wound up, or are being wound up. See *Bush v Wright* (1985) 3 ACLC 311.

97. See defences in s 556(2), notably under para (a) for a person who, at the time the debt was incurred, 'did not have reasonable cause to expect' the company would be unable to pay its debts.

Section 557 gives the court power to declare personal responsibility for debts of the company if the person has been convicted under s 556(1) or (5).

Section 556 creates both criminal and civil liability. Section 556(3) of the Code says that proceedings can be brought under subs (1) for the recovery of a debt, whether or not the relevant person has been convicted of an offence under subs (1) over the incurring of that debt. There was doubt whether the courts required the criminal standard — beyond reasonable doubt — to be satisfied for both. The UK Cork Committee⁹⁸ criticised the linking of civil and criminal liability in this way.⁹⁹ Section 556(3A) of the Code now makes it clear that the test is only the balance of probabilities standard if the proceedings are under s 556(1) and only for the recovery of a debt (not for offence proceedings and the criminal penalties).¹

It is to be hoped that these provisions do not, like some others in the Code, become paper tigers. Liquidators understandably have been reluctant to take up arms (or the alms of the creditors whose interests they have served) to mount costly and chancy litigation, especially when penalties are soft. Liquidators have no mandate to use the failed companies' usually scarce money to proceed against officers under complex legislation which is held up to scrutiny by courts which read penal statutes strictly.²

Wrongful Trading

Whilst the wording of s 374C of the UCA and of s 556 of the Code (its successor) differ substantially, authorities on the former are valuable guides when interpreting the latter.³ The key words in s 556(1) are 'reasonable grounds to expect' that the company will not be able to pay its debts. It is essentially an objective test.⁴ As Cantor J ruled in *Shapowloff v Dunn*, when applying a similar test, 'One must postulate a reasonable, competent Company Director acting reasonably in the interest of the shareholders of that company and applying his mind to the problem'.⁵ Foster J, in *3M Australia Pty Ltd v Kemish*, adopted a similar stance when

98. Above n 94 at paras 1776–1779.

99. In s 332 of the UK *Companies Act 1948*. Cf ss 458 and 630 of the UK *Companies Act 1985*.

1. See former position in *Helton v Allen* (1940) 63 CLR 691; *Rejsek v McElroy* (1965) 112 CLR 517 at 521, where it is pointed out that the balance of probabilities test would be more onerous in some cases than others. See also s 386 of the *Companies and Securities (Interpretation and Miscellaneous Provisions) Act 1980*, inserted with effect from 31 March 1986.

2. A statute is 'penal' if it imposes a penalty, fine or forfeiture other than in the form of liquidated damages or other civil remedies: 44 *Halsbury* (4th ed) at para 909.

3. See discussion of ss 367B, 374C and 374D of the UCA by Baxt, (1980) 54 ALJ 229.

4. See Mahoney J A in *Dunn v Shapowloff* [1978] ACLC 30,141 at 30,147, considering the words 'no reasonable or probable ground of expectation' in s 303(3) of the *Companies Act 1961–1971* (NSW), a predecessor of s 556 of the Code.

5. [1977] ACLC 29,522 at 29,529 (at first instance).

interpreting s 556(1) of the Code: 'the reasonableness of the grounds relied upon by the prosecution and/or a civil plaintiff, must be judged by the standard appropriate to a director or manager of ordinary competence'.⁶

The reasonably competent director or manager is therefore the guiding test. Subjective considerations intrude to the extent that the reasonableness test is applied to the facts as known to the defendant.⁷

In *Dunn v Shapowloff*,⁸ Mahoney J A analysed s 303 of the UCA.⁹ His analysis was paraphrased by Matheson J in *Flavel v Day* into four situations where liability will arise:

First, where although the officer has never adverted to it, there is at the objective level no reasonable or probable ground of expectation to the relevant effect; second, where the officer himself has a subjective expectation of the relevant kind, that there is no objective ground for the expectation; third, where as a matter of subjective judgment, the officer lacks the expectation yet, unknown to him, there is, on an objective appraisal, a reasonable or probable ground of expectation; and, fourth, where the officer does not care whether the postulated event of payment will occur, and it appears that objectively there was no ground of expectation.¹⁰

In the first and last tests, not turning one's mind to the company's state of solvency, or not caring less about it, would not save an officer. That may have repercussions in the interpretation of the s 556(2) defences. In short, the implication is that a lack of consideration or care, or wilful blindness will not be a defence to s 556(1) proceedings.¹¹ Whilst these tests may be helpful, the third situation is potentially harsh. Why should a person be convicted where the company was in fact solvent and able to pay its debts but the person thought it was not? That steps beyond what is realistic and necessary. 'One is getting very close to punishing a man for his thoughts alone.'¹²

The wording of section 556(1)

• '*Incur a debt.*' The words '*incurs a debt*' in s 556(1)(a) contemplate acts that, when done by the company, expose a director and anyone who took part in management to criminal liability.¹³ A tenant does not incur a debt

6. (1986) 4 ACLC 185 at 187.

7. *Shapowloff v Dunn* (1982) 148 CLR 72 at 85 (H Ct).

8. Above n 4 at 30,146-30,147.

9. Section 303(3), like s 374C (its successor), required there to be no reasonable or probable ground of expectation that the company would be able to pay its debts as they fell due. Section 556 has a more straightforward formula.

10. (1984) 112 LSJS 239 at 243. This summary was accepted by Prior J in *Flavel v Day* (1984) 9 ACLR 502 at 503; (1985) 3 ACLC 320 at 321.

11. For a lively and original interpretation of s 556 see Baxter, 'Liquidating Trading Trusts; *Re Byrne to Suco Gold*'; getting the worms back into the can' unpublished LLB(Hons) dissertation (University of Adelaide 1985) at 44ff.

12. Baxter, *ibid* at 56.

13. *Russell Halpern Nominees Pty Ltd v Martin* (1986) 4 ACLC 393 at 396, per Burt C J.

in the relevant sense whenever a present liability to pay rent on periodic rent days is created under a lease.¹⁴

• ‘Reasonable grounds to expect’. These words were at issue in *CAC v Caratti*¹⁵ and *Flavel v Day*,¹⁶ where proceedings were unsuccessful. In the former, a ‘\$2 company’, which had evidently never been solvent, was wound up. It was one company in a group controlled by C. C was accustomed to transferring funds within the group as necessary. In answer to proceedings under s 374C of the *UCA*, C argued that in the past, funds had been freely transferred as needed within the group¹⁷ and that, on this past practice and understanding, at the time the debts were incurred there was a reasonable ground to expect that the company would be able to pay those debts.¹⁸ Mahoney J A’s test was applied.¹⁹

The same test was applied in *Flavel v Day*.²⁰ Again, s 374C of the *UCA* was at issue. The director argued that, at the time he bought the goods on behalf of the company, he had intended to inject part of the proceeds of what he thought was an impending marital property settlement into the company to pay off the debts created.²¹ The director also pointed out that he had in the past provided his personal money to keep the company in funds. Again, the charge against the director was dismissed. Prior J adopted *Caratti*:

Caratti, like this case, is an example of a subjective expectation which is also capable of being objectively reasonable.²²

If the settled practice that the defendant officer relies on is contrary to law — for example, a breach of directors’ duties is involved — then that could not assist the officer.²³ However, these cases, explicable though they were on their particular facts,²⁴ bode ill for the usefulness of s 556(1). If informal donations to the company’s funds from a director’s own pocket can stave off a prosecution, the section has little punch.

A creditor successfully sued a manager under s 556(1)(b)(i) in *3M Australia Pty Ltd v Kemish*.²⁵ The defendant had taken over full financial control of a troubled company. The court ruled that he had failed to stop

14. *Ibid.*

15. (1980) 5 ACLR 119; (1980) ACLC 34,155 (Petty Sessions); 34,396 (S Ct).

16. Above n 10.

17. Quære duty to act in company’s best interests; above Ch 5. Cf Prior J, in *Flavel v Day*, above n 10 at 505 and 323–324 respectively.

18. Above n 15 at 123.

19. Probably the second element of it; that is, that the officer had a subjective expectation that the company would be able to pay but that there was no objective ground for that. See also *Flavel v Day*, above n 10 at 503 and 321 respectively, where Prior J expressly refers to it.

20. Above n 10.

21. The contract settlement on the property was delayed so the money was not forthcoming.

22. Above n 10 at 506 and 324 respectively.

23. See Prior J in *Flavel v Day*, above n 10 at 506 and 324 respectively.

24. Especially *Flavel v Day*, *ibid.*

25. (1986) 4 ACLC 185.

the company's trading in time (that is, when the company got into a 'hopeless' position).²⁶ Accordingly, he was personally liable for payment of the company's debts (to the plaintiff creditor) incurred by the placing of orders after insolvency.

The word 'expect' means more than 'suspect'. It has been held to be synonymous with 'predicting'.²⁷ The *Shorter Oxford English Dictionary*²⁸ defines 'expect' to mean, amongst other things, 'to regard as about to happen; to anticipate the occurrence or the coming of'.

• 'Not be able to pay all its debts as and when they become due'. This part of the wording of s 556(1) requires that the company be insolvent at the relevant time. This does not mean simply that the company must, at that time, have more liabilities than assets. Nor does it mean a temporary shortage of liquidity:

The cash expected to be available at the particular time will be relevant but not necessarily determinative. It will, for example, be relevant to consider whether the company could be expected to pay the debt by borrowing; whether, if it must realise assets to obtain the money to pay the debt it can be expected to do this by the relevant time and at what price; and whether what it will have to do in paying and being able to pay the debt will involve the company or its officers in voidable transactions, improper preferences, or breach of obligations under the general law or relevant legislation. It would, I think, be proper, in a particular case, for account to be taken appropriately of a promise, legally binding or otherwise, to provide money or financial assistance, by loan, subscription for share capital, or (as was suggested in this case) by the provision of a guarantee.²⁹

The onus of proof under section 556

A significant difference between s 556 and its predecessors is that it changes the onus of proof. The prosecution formerly had to establish that the defendant had 'no reasonable or probable ground of expectation' that the company was solvent (that is, ignorance by the defendant was a sufficient answer). The wording has now changed. If the defendant wishes to plead the absence of his personal involvement or knowledge, it seems the burden is now on him to do so as a defence under s 556(2).³⁰

If an offence under s 556 is alleged, the prosecution has to establish the necessary ingredients beyond reasonable doubt.³¹ However, as noted

26. *Ibid* at 199.

27. Foster J in *3M Australia Pty Ltd v Kemish*, above n 25 at 192.

28. Cited by Foster J, *ibid*.

29. Mahoney J A in *Dunn v Shapowloff*, above n 4 at 30,147; cited with approval in *3M Australia Pty Ltd v Kemish* (1986) 4 ACLC 185 at 189, 193. See also *Queensland Bacon Pty Ltd v Rees* (1966) 115 CLR 266 at 293; *Sandel v Porter* (1966) 115 CLR 660 at 670. See also discussion of meaning of insolvency earlier in this chapter in the discussion of s 453(5) of the Code.

30. *3M Australia Pty Ltd v Kemish*, above n 25 at 191.

31. *Ibid*.

above, where s 556(1) is used to establish civil liability only, the balance of probabilities standard applies.³²

Who can bring section 556 proceedings?

Section 556(3) says that 'Proceedings may be brought' under s 556(1) for recovery of a debt regardless of a conviction. It does not say who can bring these proceedings. Traditionally, liquidators have been able to bring proceedings under such provisions. This is apparently not the case with s 556.

In *3M Australia Pty Ltd v Watt*,³³ it was argued that creditors had no standing to institute proceedings for the recovery of a debt incurred by the company. The NSW Supreme Court concluded that s 556 is available as a cause of action to a creditor who can prove the facts required to enliven the section.³⁴ But the courts did not say that a liquidator could not bring proceedings under s 556. However, this is the interpretation Young J adopted in *Ross McConnel Kitchen & Co Pty Ltd (in liq) v Ross*.³⁵ His Honour reluctantly concluded that the creditor is the *only* person other than the Commission who can bring proceedings. Young J added that this conclusion was supported, first, by the wording of s 557(1), which gives standing for its purposes only to the Commission and to creditors; second, by the fact that s 556(1) makes the officer jointly and severally liable with the company (and thus makes it incongruous for the company (by the liquidator) to sue itself); and by the fact that, on winding up, a debt owed by the company merges in the equitable execution brought about by the winding up,³⁶ so that the company no longer owes the debt.³⁷

The Explanatory Memorandum of the 1981 Code observed³⁸ that s 556 was restructured to ensure that officers and others who incur unreasonable debts on behalf of the company 'are liable to creditors for the repayment of any debts incurred in contravention of cl. 556'.³⁹ This statement of intention does not exclude liquidators from bringing proceedings. The wording of ss 556 and 557 is also by no means clear.⁴⁰ Excluding the liquidator seems contrary to common sense. Individual actions by many creditors should be discouraged; the liquidator should act on behalf of all creditors; and the sum recovered should usually go into the general assets

32. Section 556(3A) of the Code.

33. (1984) 2 ACLC 621 at 625; 9 ACLR 203 at 207.

34. *Ibid.* This conclusion was affirmed on appeal: *Watt v 3M Australia Pty Ltd* (1985) 3 ACLC 324; 9 ACLR 524.

35. (1985) 3 ACLC 326.

36. *Ibid.* at 329.

37. Young J relied on *Re Higginson and Dean; Ex parte the Attorney-General* [1899] 1 QB 325 at 333.

38. At para 1219.

39. This was cited by Street C J in *Watt v 3M Australia Pty Ltd*, above n 34 at 325–326 and 525 respectively.

40. See comment by Rogers J in *3M Australia*, above n 33 at 625 and 207 respectively and, on appeal, Street C J in *Watt v 3M Australia Pty Ltd*, above n 34 at 325.

of the company for distribution to all creditors of the company. Such difficulties with the interpretation of ss 556 and 557 may best be solved by redrafting.⁴¹

Section 557(1) of the Code⁴² allows a creditor, following a conviction for an offence against s 556(1), to obtain a declaration from the court that the convicted person is personally responsible to the creditor.⁴³

Fraudulent conduct

Section 556(5) aims to bring fraudulent officers to book where they try to defraud creditors or others.⁴⁴ The legislature takes a serious view of such offences, awarding penalties of \$10,000 or two years' imprisonment or both. Section 556(5) says that if a company does any act with intent to defraud creditors of the company or any other person or for any other fraudulent purpose, any person who was 'knowingly concerned in the doing of the act with that intent or for that purpose is guilty of an offence'. Its predecessor, s 374C of the *UCA*, was little used, mainly because it was difficult to prove intent to defraud and the relatively soft penalties reduced the incentive to prosecute.

The intent to defraud which is needed for a s 556(5) prosecution must, on the narrow interpretation, be 'express or actual and real',⁴⁵ involving 'actual dishonesty' and 'real moral blame'.⁴⁶ Kitto J bluntly called for a purpose 'of swindling creditors out of their money'.⁴⁷ A broader interpretation is that there is an intent to defraud if a business is carried on with the knowledge that new creditors have no reasonable prospect of ever being paid.⁴⁸

Because s 556(5) uses the words 'knowingly', 'intent' and 'purpose', the test is primarily subjective. It requires proof of criminal intent, the onus of proof being on the prosecution.⁴⁹ It is appropriate that with s 556(1) covering the lesser reckless trading and imposing an objective standard, the more serious s 556(5), with its more severe penalties, should use a

41. Priestley J A in *Watt v 3M Australia Pty Ltd*, above n 34 at 326 and 525 calls for 'the urgent attention of the legislatures involved'.

42. Similar to the former s 374D(1) of the *UCA*.

43. See Olney J (dissenting) in *Russell Halpern Nominees Pty Ltd v Martin* (1986) 4 ACLC 393 at 399.

44. Section 374C(2) of the *UCA* was its predecessor. It required 'the business of a company' to be carried on with intent to defraud creditors or for any fraudulent purpose.

45. *Hardie v Hanson* (1960) 105 CLR 451 at 458, per Dixon C J.

46. *Re Patrick & Lyon Ltd* [1933] Ch 786 at 790; [1933] All ER Rep 590 at 593, per Maugham J.

47. *Hardie v Hanson*, above n 45 at 463, per Kitto J.

48. See *Re William C Leitch Brothers Ltd* [1932] 2 Ch 71 at 77. This interpretation was cited in *Re Grantham Ltd* [1984] 3 All ER 166 at 169, when approving a direction to the jury. See, generally, Farrar, 'Fraudulent Trading' [1980] JBL 336 at 339-342; Williams, 'Fraudulent Trading' (1986) 4 C & SLJ 14 at 23-25. See also Williams, 'Directors' Liability for Fraudulent Trading' (1984) 11 NZULR 189, examining *Re Nimbus Trawling Co Ltd* (1983) 1 NZCLC 98,762 (but reversed on appeal: (1986) 3 NZCLC 99,646) and *Re Casual Capers Ltd (in liq)* (1983) 1 NZCLC 98,590. Williams discusses the 'narrow' and 'broad' interpretations of fraud at 191-195.

49. Cf Williams, *ibid* at 25; see also Farrar, *ibid* at 345.

subjective test. In this, Australia differs from the United Kingdom which does not have both fraudulent and reckless trading provisions; it has only the former. Thus, a more liberal interpretation in the United Kingdom of intent to defraud is understandable. Such stretching of the meaning of the words as occurred in *Re Grantham Ltd*⁵⁰ is arguably unnecessary in Australia. Each provision — s 556(1) and (5) — can do its own job, the first with an objective test, the latter with a subjective one.⁵¹

The use of the words ‘any person’ means that the ambit of persons potentially caught can be wide. The provision is aimed principally at present and past de jure or de facto controllers of the company. Section 557(2) says that, following a conviction for an offence under s 556(5), the court may declare the convicted person to be personally responsible to the company for so much of the company’s debts as the court thinks proper. Such an order may be sought by the ‘prescribed persons’ listed in s 557(3).

Directors must be aware of the company’s state of solvency

It is evident from the expanding body of law on defaulting directors that officers are expected to have enough knowledge of the affairs of their company to be able to assess its state of solvency. Section 269(9)(a)(iii) of the Code reinforces this by requiring directors to inform the annual general meeting whether ‘there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due’. In other words, the directors must state whether they think the company is solvent. Because they must assess whether there are ‘reasonable grounds’, the directors will have even greater motivation to familiarise themselves with such matters as the company’s assets and their real value, the present and contingent liabilities of the company, and its profits, budget and cash flow positions (including knowing what assets are readily realisable). Unless directors are in a position to forecast the company’s financial state, they cannot safely offer an opinion as to whether there are ‘reasonable grounds to believe’.

In general, the Code casts the burden of preparing the company’s accounts and seeing that they are audited onto the directors. Under s 269(7), they must take reasonable steps to ensure that the accounts are complete, that bad debts have been written off, that there is provision for doubtful debts, that the company’s assets are realistically valued, and so on. They must endeavour to see that the company’s true value is stated in the accounts.⁵²

50. Above n 48.

51. See discussion of this issue by Baxter, above n 11 at 95–102.

52. Directors’ responsibilities with respect to their s 270 reports and the annual returns and accounts generally are detailed in CCH, *Australian Company Law and Practice*, Vol 2, para 35-000ff, Paterson and Ednie, *Australian Company Law Service* (3rd ed), Vol 3, para 60,511ff.

Examination of persons concerned with corporations: section 541

This topic will not be dealt with in any detail here.⁵³ Section 541 allows prescribed persons to apply for an examination before the court, or such other court as is specified by the court,⁵⁴ of persons such as directors or promoters concerned with a corporation. The examination is in public, except to the extent that the court considers that, 'by reason of special circumstances', it is desirable to hold it in private.⁵⁵ This procedure is especially useful to liquidators who may seek evidence relating to claims of misbehaviour, fraud or breach of duty or trust by officers to help recover assets for the company; who may seek to ascertain whether proceedings should be brought by the company, or whether or not there has been a preference given to a creditor. Section 541 gives the liquidator a 'statutory aid to enable him to obtain information not otherwise available to him'.⁵⁶ It may not, however, be used for vexatious, oppressive or needlessly injurious purposes.⁵⁷

The category of persons who may be examined is wide.⁵⁸ In addition to directors, it has included such persons as company secretaries, voluntary liquidators, solicitors, auditors, receivers and managers, bankers and even creditors.⁵⁹ The examination is on oath or affirmation.⁶⁰ An examinee is not excused from answering questions on the ground that the answer may incriminate him. However, if he claims before answering that the answer may tend to incriminate him, the answer is not admissible against him in criminal proceedings other than proceedings under s 541 or other proceedings in respect of the falsity of the answer.⁶¹ Subject to subs (12), any written record of the examination signed by the examinee may be used as evidence in legal proceedings against him; so, too, may any transcript that is authenticated as provided by the rules.⁶²

The examinee may take his own solicitor (and counsel) into an examination to put questions that may help to 'explain or qualify' answers or evidence given.⁶³ There are penalties in s 541 for offences such as failure to attend, refusal to take an oath or make an affirmation, refusal to produce books if required, or the making of false or misleading statements.

53. See full coverage in CCH *Australian Company Law and Practice*, Vol 2, para 66–650ff; Paterson and Ednie, *Australian Company Law Service* (3rd ed), Vol 4, para 89,139ff; Ford, *Principles of Company Law* (4th ed, 1976) at para 1757; McPherson, *The Law of Company Liquidation* (2nd ed) at 298, 387.

54. Section 541(15): see *Concorde Homes Pty Ltd (in liq)* (1985) 3 ACLC 830.

55. Section 541 (5) of the Code.

56. *Re Hugh J Roberts Pty Ltd (in liq)* (1970) 91 WN (NSW) 537 at 542, per Street J.

57. *Ibid* at 540; *Rees v Kratzmann* (1965) 114 CLR 63 at 66, per Barwick C J.

58. See s 541(2) of the Code.

59. See list and authorities in McPherson, above n 53 at 299–300.

60. Section 541(4) of the Code.

61. Section 541(12) of the Code.

62. Section 541(14) of the Code.

63. Section 541(16) of the Code.

The advisability of instituting a s 541 inquiry is an issue often faced by a liquidator. The costs of such an examination must be weighed against the prospects of recovery for the company. The liquidator should generally not become involved in highly speculative proceedings or inquiry proceedings which are not 'warranted commercially'.⁶⁴

The court's power to grant relief

Under s 535, the court has power to grant relief to officers and other persons.⁶⁵ This may be granted where certain proceedings are actually instituted, or are about to go to a jury, or are merely anticipated, if it appears to the court that the applicant has acted honestly *and* ought fairly to be excused. Both elements must be satisfied. In *Re Franklin & Son Ltd*,⁶⁶ the director at issue had been paid remuneration pursuant to a regulation passed without a quorum. Relief was denied, even though it was held that the directors had acted reasonably and honestly.⁶⁷ Ford suggests that the word 'honestly' is to be given a narrow meaning so that everything short of fraud or recklessness will be regarded as honest.⁶⁸ The relevant proceedings in which this relief may be given are, as in s 237 of the Code, those for 'negligence, default, breach of trust or breach of duty' which are actually instituted or are merely anticipated.

In *Lawson v Mitchell*,⁶⁹ it was held that s 365 of the UCA did not allow the court to relieve an officer from criminal liability under the Act.⁷⁰ Section 535 of the Code, the replacement for s 365, is now quite explicit — it only applies to 'any civil proceeding'.

Some guidance as to how the courts may apply s 535 can be taken from *Re J Franklin & Son Ltd*⁷¹ and *Permakraft (NZ) Ltd (in liq) v Nicholson*.⁷² The basic test in both the United Kingdom and New Zealand provisions has been whether a person has acted 'honestly and reasonably' and so ought to be excused in whole or part. Section 535, in contrast to s 365 of the UCA, requires only that the person has acted 'honestly', not 'honestly and reasonably'. This relaxation of the prerequisites may have sprung from the argument that a person who acted honestly and reasonably would be unlikely to need the relief of s 535.

There is some authority for the view that, where the director receives

64. *Gray v Bridgestone Aust Ltd* (1986) 4 ACLC 330 at 332, per Cox J. See also *Re Suncoast Tile Merchants Pty Ltd* (1986) 4 ACLC 511.

65. See s 535(4) of the Code.

66. [1937] 4 All ER 43.

67. See also *Re Day-Nite Carriers Ltd* [1975] 1 NZLR 172 at 175.

68. Ford, *Principles of Company Law* (4th ed 1976) at para 1540.

69. [1975] VLR 579.

70. Cf *Barry v Staines Linoleum Ltd* [1934] Ch 227.

71. Above n 66 where s 372 of the 1929 UK Act was at issue and no relief was granted.

72. (1982) 1 ACLC 488 at 510. See also (1985) 3 ACLC 453, on appeal (concerning s 468 of the NZ Act).

a personal benefit from the misfeasance, the courts will be reluctant to exercise their discretion in the director's favour.⁷³

It seems that s 535 relief may be restricted to where there is civil liability to the *company*, brought by or on behalf of the company against an officer for his personal breaches of duty in his capacity as an officer. In *Customs & Excise Commissioners v Hedon Alpha Ltd*,⁷⁴ the English Court of Appeal ruled that a claim by an 'outsider' (that is, the Commissioners claiming duty under the *Betting and Gaming Duties Act 1972*) was outside the ambit of the section.⁷⁵ Further, the court noted that the word 'default' used in the section connoted personal misconduct by the officer in his corporate capacity. Thus, an officer, and others covered by the section, could not use the section 'to claim relief in "any" legal proceedings which may be brought against him in his capacity as an officer . . . of a company by the rest of the world'.⁷⁶ The New Zealand Court of Appeal has ruled that a similar provision⁷⁷ was intended to operate in respect of claims 'brought by the company concerned, its shareholders or by some person in whose favour a duty has been created by the legislation'.⁷⁸

The liability of directors for torts

It is appropriate, in a discussion of defaulting directors, to consider briefly their liability for torts committed whilst they are carrying out their functions as directors. The companies statutes expressly contemplate that the company is a separate entity and that the members enjoy the privilege of limited liability, 'with the object that by this means enterprise and adventure may be encouraged'.⁷⁹ To what degree, if any, however, do these principles buffer or 'shield' a director from liability when he is personally involved in the commission of a tort by the company, such as the infringement of copyright or of a patent, or the personal injury of the plaintiff?

The first observation is acknowledged but rarely discussed in the authorities; a director, as in the case of an employee acting in his employment or an agent acting in the course of his agency, is liable personally for torts 'personally committed by his own hands (or mouth)'.⁸⁰ After all, the director's liability is 'limited' only with respect to his company, not to outsiders.

73. *Re International Vending Machines Pty Ltd* (1962) NSWLR 1408 at 1424; *Montgomerie's Brewery Co Ltd v Blythe* (1901) 27 VLR 175; *Markwell Bros Pty Ltd v CPN Diesels (Qld) Pty Ltd* (1982) 7 ACLR 425 at 438. *Re Claridge's Patent Asphalte Co Ltd* [1921] 1 Ch 453 offers an example of a successful application for relief.

74. [1981] 2 WLR 791.

75. Section 448 of the 1948 UK Act: now s 727 of the 1985 Act (equivalent of s 535 of the Code).

76. Stephenson L J, above n 74 at 797.

77. Section 468 of the *Companies Act 1955* (NZ).

78. *Dimond Manufacturing Co Ltd v Hamilton* [1969] NZLR 609 at 630.

79. *Rainham Chemical Works Ltd v Belvedere Fish Guano Co* [1921] 2 AC 465 at 475, per Lord Buckmaster; *Salomon v Salomon & Co* [1897] AC 22.

80. *C Evans Ltd v Spritebrand Ltd* [1985] 1 WLR 317 at 323.

But what if the director's involvement is indirect to the extent that he authorises or directs others to do the operation that led to the tort? A director cannot be personally liable just by virtue of being director of a company involved in a tort.⁸¹ In some circumstances, however, there can be personal liability. Atkin L J, in *Performing Right Society Ltd v Ciryil Theatrical Syndicate Ltd*, ruled that:

Prima facie a managing director is not liable for tortious acts done by servants of the company unless he himself is privy to the acts, that is to say unless he ordered or procured the acts to be done.⁸²

In *Rainham Chemical Works v Belvedere Fish Guano Co*,⁸³ two directors, as well as the company, were held to be personally liable for damage caused to neighbouring property by an explosion in the company's chemical works.⁸⁴ The directors were held liable because, under the lease, they were technically in occupation of the property on which the chemical works was sited. They were not guilty of any direct personal act of negligence, but were liable nonetheless. In *Wah Tat Bank Ltd v Chan*,⁸⁵ the managing director was personally liable when he agreed with his directors that the company would continue wrongfully to convert goods. Having thus procured the act, as party to the conversion, he was a joint tortfeasor.

Conclusion

The provisions in the Code regulating, punishing and demanding compensation from defaulting officers are not well co-ordinated. Corporate officers may well lament the prolix and haphazard nature of the sanctions and controls facing them. There is little evidence of a well thought out, coherent pattern of regulation. There are also major interpretation problems with several provisions. The difficulties with the 'mini-Code' of ss 556–557 seem too complex to be settled by judicial interpretation alone. Legislative surgery and reconstruction is urgently needed.

On the positive side, Australia has of late been quicker to attempt changes and to strengthen this legislation on defaulting officers than many other jurisdictions. In provisions such as s 453(5), for example, it has shown creativity in attacking a long-standing problem. The 1982 Cork Committee⁸⁶ lamented the ease with which officers who were sureties or guarantors of the company could be 'preferred' by payments by the company, yet escape having to repay the amount by which they were preferred (like ordinary creditors). The Australian Code in s 453(5) and (6) offers a solution.

81. *Wah Tat Bank Ltd v Chan* [1975] AC 507 at 514.

82. [1924] 1 KB 1 at 14.

83. Above n 79.

84. The principle in *Rylands v Fletcher* (1866) LR 1 Ex 265; (1868) LR 3 HL 330 applied.

85. Above n 81.

86. The Cork Committee, *Report on Insolvency Law and Practice*, Cmnd 8558 (1982) paras 1270–1276.