PARLIAMENT OF VICTORIA

LAW REFORM COMMITTEE

CURBING THE PHOENIX COMPANY

FIRST REPORT
ON THE LAW RELATING TO DIRECTORS AND
MANAGERS OF INSOLVENT CORPORATIONS

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FUNCTIONS

PARLIAMENTARY COMMITTEES ACT 1968

4E. The functions of the Law Reform Committee are—

(a) to inquire into, consider and report to the Parliament where required or permitted so to do by or under this Act, on any proposal, matter or thing concerned with legal, constitutional or Parliamentary reform or with the administration of justice but excluding any proposal, matter or thing concerned with the joint standing orders of the Parliament or the standing orders of a House of the Parliament or the rules of practice of a House of the Parliament;

(b) to examine, report and make recommendations to the Parliament in respect of any proposal or matter relating to law reform in Victoria where required so to do by or under this Act, in accordance with the terms of reference under which the proposal or matter is referred to the Committee.

Terms of Reference

To enquire into and report to Parliament as to—

1.1 The adequacy of the existing disqualification procedures where company directors and persons acting in the management of companies have been involved in failed companies and in particular the adequacy of section 599 of the *Corporations Law* as a means of achieving creditor protection.

1.2 The adequacy of penalties imposed where disqualified persons act in the management of companies.

1.3 The adequacy of existing supervisory and enforcement arrangements in relation to disqualified persons.

2.1 Whether the *Corporations Law* provides appropriate remedies against directors and effective execution against directors' personal assets where those directors have been involved in the management of companies which have failed to meet financial obligations.

2.2 Whether the *Corporations Law* provides appropriate means of tracing, for the benefit of creditors, assets divested by company directors.

2.3 Whether the Supreme Court of Victoria and the Federal Court of Australia are appropriate forums for civil actions against directors (for instance under section 592 of the *Corporations Law*) having regard to the costs of such actions.

2.4 What other safeguards might be introduced to protect creditors in their dealings with companies.

3.1 The means by which Victoria might implement any recommendations arising out of this enquiry.

In the conduct of its reference, the Committee should have regard to—

(i) The necessity to regulate the formation of new companies by persons who have been directors of or have been involved in the management of recently failed companies or companies unable to pay their debts;

(ii) The measures that may be taken to control the participation of such persons, either as consultants or by any other form of employment or engagement, whether or not remunerated, in other newly created or existing companies by individuals related to them.

(iii) Measures that may be taken to prevent companies and their operators from avoiding their liabilities by starting again under a new name.

Victoria Government Gazette, G1, 7 January 1993, pp 53–54 (original terms of reference)

Victoria Government Gazette, G12, 25 March 1993, pp 711–712 (amended terms of reference)

Victoria Government Gazette, G25, 1 July 1993, p 1772 (extension of time to Autumn 1994 Session)

CHAIRMAN'S FOREWORD

References to the Law Reform Committee all require rigour in argument and in standards of evidence, but the method of tackling each reference needs to be adapted to its purpose and subject matter. In tackling the reference relating to directors and managers of insolvent companies the Committee has taken note of its origin in the Premier's experience as a small businessman and the evident determination of his government to make Victoria a better place to do business, especially for small business. I have been conscious that, when he was Leader of the Opposition, long before the reference to the Committee, he raised the subject of directors of failed companies neglecting the creditors and immediately starting a new company with the same business, business name and premises.

The Committee has also been conscious of the tendency for committees to assume that there is a problem that requires legislative or other action. Although one justification for action on directors' delinquencies is undoubtedly the contemporary move to recognise the anger and distress of victims, no one has provided the Committee with statistical or other hard evidence that there would be a cost–benefit pay-off to the community if life were made harder for some directors, even if it did improve the recovery of debts. By contrast the anecdotal and expert opinion evidence includes suggestions that there is far too much new statute and regulatory law inhibiting the work of honest business people. Such evidence, however, does also make it clear that there are enough cases of injustice to creditors (including employees) arising from the insolvency of companies to justify concern and moral indignation, if not a major shift of resources towards the protection of creditors. The Committee, in listening to accounts of unjust outcomes and seeking to find remedies, has borne in mind the adage "Hard cases make bad laws".

The general problem of limited liability companies affording excessive protection to the fraudulent and grossly negligent against the claims of creditors is at least 150 years old. The problem will never totally disappear, since the law, the courts, and law enforcement agencies cannot give absolute priority to the prevention of loss over the encouragement of enterprise and the need to limit compliance and

enforcement costs. However, one of the legacies of the 1980s was to ensure that serious efforts would be put into redressing the balance against fraudulent controllers of companies.

At the time the reference was given to the Committee by the Premier and Attorney-General (22 December 1992, revised 16 March 1993) much work had already been done nationally to propose and to enact amendments to the national *Corporations Law* in ways directly relevant to the reference. Major amendments were to come into operation on 23 June 1993. As a result the Committee resolved after receiving submissions and advice from authoritative sources to make a report on its Inquiry after completing the substantial work required for its inquiries on the Wills Bill and on Restitution for Victims of Crime. It was expected that evidence would become available on the effectiveness of the reforms. While it is still too early to cite cases on the operation of the newly amended *Corporations Law* in relation to the subject of the Committee's Inquiry, the Committee has concluded that there are a number of recommendations it can make at this stage which can contribute to the continuing task of protecting commerce from rogue directors. It is possible for Victoria to act on its own on some of the recommendations and, if necessary, it should do so because they would make Victoria a better place to invest, to give credit and to do business generally.

The Committee's recommendations fall into several categories:

- amendments to the national or Victorian law;
- keeping track of directors and publicising those disqualified;
- educating and testing directors in their duties;
- helping small business to protect itself, with a possible role for Small Business Victoria;
- concentrating on the enforcement of the existing law, principally by providing additional resources both as a State law enforcement function and by way of implementing a dormant proposal of the *Harmer Report* to establish a fund to enable liquidators to make a proper assessment of potential actions against directors, and the chances of success;
- procedure—changes to the litigious process, including the costs rules, to assist liquidators and creditors in proceedings against delinquent directors, and facilitating the execution of judgments.

The tendency of evidence to date is that the law provides in theory an adequate armory. The expense and complication of using it to enforce creditors' rights is seen as the greatest problem.

Nonetheless the Committee sees a need to amend the law both to restrict the use of their previous business names by the controllers of insolvent companies and also to prevent insolvent companies being simply struck off as a penalty-free de facto liquidation. Business names can, practically as well as constitutionally, be dealt with by the Victorian Parliament acting alone.

Of its other recommendations, the most important for immediate effectiveness are those directed to changing rules of procedure, especially as to costs, and providing resources to facilitate liquidators' investigations and to funding action against former directors. The Committee considers that Victorian business would benefit from this state being known to pursue dishonest directors more diligently, provided that the pursuit was conducted without the excessive zeal that would penalise risk-taking enterprise or the hindsight that would make every unfortunate, over-optimistic or incompetent business judgment the subject of censure.

As well as to the Committee's Secretaries, Sturt Glacken and Jamie Gardiner, the Committee extends its thanks to the persons who made submissions or gave evidence—they are listed in Appendices A and B—and to the many others who gave of their time and expertise to assist the Committee in its Inquiry.

The Committee invites submissions and comments on the recommendations in this First Report of the Inquiry, and they should be addressed to the Committee's Secretary at its offices, 19th level, Nauru House, 80 Collins St Melbourne.

James Guest
1 June 1994

List of Recommendations

Recommendation 1

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to the *Corporations Law* so that the directors of a failed company which is struck off without a formal liquidation and which pays less than 50¢ in the dollar of its liabilities are subject to the same sanctions as if there had been a formal liquidation and an adverse liquidator's report.

Paragraph 3.1.25, page 18

Recommendation 2

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to the disqualification provisions in s.600 of the *Corporations Law.* There should be two levels: where a corporation is liquidated and pays less than 50¢ in the dollar of its liabilities the ASC should have a discretion to require a director of the corporation to show cause why he or she should not be disqualified; and when a person is involved as a director or manager in two such insolvencies the disqualification should be automatic unless the director can satisfy the ASC otherwise.

Paragraph 3.1.26, page 19

Recommendation 3

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to section 599 of the *Corporations Law.* That section should enable the Court to disqualify a director if satisfied at the civil standard of the matters of mismanagement now requiring proof beyond reasonable doubt, and in the event of only a single insolvency.

Paragraph 3.1.28, page 19

Recommendation 4

The Committee recommends that the Victorian Government should seek a review of the resources devoted to detecting and prosecuting persons who involve themselves in the management of companies while disqualified.

Paragraph 3.2.21, page 23

Recommendation 5

The Committee recommends that the Victorian Government should take steps to change the public and judicial attitudes to culpable mismanagement of corporations and abuse of the corporate form, so that persons who manage companies when disqualified or whose culpable management leads to serious losses to creditors are as likely to go to prison as those who deprive others of their money by theft.

Paragraph 3.2.22, page 24

Recommendation 6

The Committee recommends that the Victorian Government should encourage the ASC to give a higher priority to developing computer programs to detect disqualified persons becoming involved in the management of companies, and should seek the support of the Ministerial Council to require all directors of limited liability companies to have and use a unique identity number..

Paragraph 3.3.11, page 27

Recommendation 7

The Committee recommends that the Victorian Government should take steps both by itself and in cooperation with the other members of the Ministerial Council to secure wider and more regular dissemination of the register of disqualified directors, and should urge banks and other financial institutions to make use of this information so as to make it harder for disqualified persons to manage companies.

Paragraph 3.3.12, page 27

Recommendation 8

The Committee recommends that when a liquidator takes a *bona fide* action against directors or managers of a corporation to recover property of the corporation or to secure compensation for the corporation the Court should not be able to make an order for costs or an undertaking as to damages against the liquidator personally, and the inability of the corporation to provide security for costs or damages should not be a bar to the action proceeding; but that such an action should be subject to the leave of the Court; and that in these circumstances the costs and damages of a successful defendant should normally have priority over all other claims on the corporation's assets.

Paragraph 4.1.43, page 40

Recommendation 9

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to the *Corporations Law* to create a statutory process analogous to a Mareva injunction to enable the courts to freeze assets of a director or manager which are *prima facie* assets on which the corporation has a just claim.

Paragraph 4.1.44, page 40

Recommendation 10

The Committee recommends that the enforcement of money judgments be made the subject of a separate inquiry.

Paragraph 4.1.45, page 41

Recommendation 11

The Committee recommends that Victoria legislate to place restrictions on the use of business names similar to those of a failed corporation by persons associated with the failed corporation, except by leave of the court, based on sections 216 and 217 of the *Insolvency Act* 1986 (United Kingdom); and that the Victorian Government seek to persuade the other Australian jurisdictions to do likewise.

Paragraph 4.4.18, page 53

Recommendation 12

The Committee recommends that the Victorian Government fund Small Business Victoria to investigate the dimensions of the risk to small business posed by the phoenix company phenomenon, and to develop and evaluate a training package to help small businesses improve their credit assessment and credit management.

Paragraph 4.4.22, page 54

Recommendation 13

The Committee recommends that the Victorian Government investigate requiring State licensing and registration bodies to take account of a person's previous involvement with a company which failed without paying its creditors.

Paragraph 4.4.23, page 55

Recommendation 14

The Committee recommends

- that the Government allocate funds to establish a 12 month pilot program within the State Revenue Office or the WorkCover administration to provide funds to liquidators to do more detailed investigations and reports on failed companies where there may be an action against the directors or managers, and where appropriate to take action to recover assets from them
- that the goal of the pilot be to assess whether successful recovery actions would recover sufficient money (where the debts would previously have been written off) to cover the costs of the unsuccessful investigations and actions
- that the Government report to the Parliament within twelve months of the conclusion of the pilot program whether the pilot program meets its objectives, giving details of the cost, the number of phoenix companies detected, the amounts recovered for the State, and the amounts recovered for business creditors who would otherwise have got nothing.

Paragraph 5.1.14, page 59

Chapter 1 Overview

1.1 The problem is the "phoenix" company. A limited liability company fails, unable to pay its debts to creditors, employees and the State. At the same time, or soon afterwards, the same business rises from the ashes with the same directors, under the guise of a new limited liability company, but disclaiming any responsibility for the debts of the previous company.

1.2 The same problem arises in other countries. The Committee has considered the UK experience, in a legal system very similar to our own. French and German approaches are somewhat different, partly because of their very different approach to personal bankruptcy, but may suggest some options. The United States seems less concerned about the plight of small creditors, taking a more laissez-faire or *caveat vendor* view.

1.3 Two principal issues arise from the terms of reference. In what circumstances should those responsible for an insolvent company failure be prevented from managing companies in future? In what circumstances should the directors of an insolvent company be personally liable for its debts?

1.4 Behind these two questions lies a further issue. What measures can be taken to reduce the harm to individuals, small business and the community by company insolvencies of a dubious nature?

1.5 Several submissions and witnesses suggested better education and information. Present and prospective company directors should be advised of their duties, and perhaps required to attend and complete a short course in them.

1.6 Those who are vulnerable to company failures, small business people in particular, should be better informed about the reality of limited liability among those with whom they do business. There is a role in this for organisations such as Small Business Victoria, which could advise them on their credit management practice, and provide standard contracts, for instance, so that small businesses could,

like banks and finance companies, bypass the corporate veil entirely by the use of guarantees. Representatives of employees might benefit from similar assistance.

1.7 A general view is that some minor improvements could be made in the law relating to disqualification, and considerable improvements, necessarily involving higher priorities and greater resources in the ASC, to the supervision and monitoring and detection of breaches of disqualification orders. There was support for much wider public availability of information about disqualified persons.

1.8 The availability of remedies against directors and managers of insolvent corporations is not the problem, especially now that the *Corporate Law Reform Act* 1992 is in force. There are plenty of causes of action.

1.9 The problem is the existence of practical obstacles to their use. These are the cost and risk of litigation, and the lack of a mechanism to enable all the creditors to act in concert, although this latter aspect has improved with the new law. The liquidator cannot be expected to initiate action for which he or she may be held personally liable,[1] and also be required to give security as to costs,[2] when there is no certainty that the company or its creditors can pay for the action.

1.10 Perhaps the most important potential reform identified in this area is the *Harmer Report*'s proposed "assetless companies fund", which was not implemented by the 1992 Act. This fund would be financed by a small levy on all 800,000 or so companies, and would provide funds for the liquidator or creditors to investigate whether the directors had acted improperly, and whether it would be appropriate and worth the effort to pursue the available remedies against them.

1.11 One approach to the problem of funding liquidators' investigations and reports is for a government agency owed money by insolvent companies to fund a number of such reports via a pilot project to determine whether enough money can be recovered from directors and managers in successful cases to cover the investment in investigating and prosecuting the less fruitful cases.

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1 The High Court in *Knight v F P Special Assets Ltd* (1992) 66 ALJR 500 considered that the Court had a power to award costs against a liquidator personally (this concerned the Queensland equivalent of s.24 of the *Supreme Court Act*). This view is supported in *Burns Philp v Bhagat* [1993] 1 VR 203, holding that s.24 gives the Court jurisdiction to award costs against a person not strictly a party on the record.

2 Cf *Quickset Concrete Constructions Pty Ltd (in liquidation) v Jayburn Pty Ltd* (unreported, Supreme Court of Victoria, N° 8108 of 1993, 26 October 1993, Ormiston J).

1.12 The present disqualification procedures do not reach directors of companies which are struck off, under s.574, with no assets, but with outstanding liabilities. Such companies do not undergo a formal liquidation, and so there is no possibility of a liquidators' report adverse to the directors being submitted. This is a loophole in the system which should be closed.

1.13 The procedure for striking off such companies should be the same as for a members' voluntary liquidation—the directors should submit a declaration that there are no unpaid creditors; if they cannot, or cannot truthfully, then the directors should become personally liable for the struck-off company's debts. Alternatively, any company struck off is to be presumed to have paid less than 50¢ in the dollar unless there is such a declaration, with the consequence that the ASC can then take action (at present only after the second such failure) under s.600 of the *Corporations Law* to disqualify the directors.

1.14 State registration or licensing boards might be required to refuse registration to any person who has, or whose directors have, been involved in a company failure with unpaid debts. This is a proposal which needs further exploration.

1.15 A further desirable reform is to limit the use of similar names, by disqualified directors, whether as company names or business names. A successful model for such a limitation is found in the 1986 UK insolvency legislation; the relevant provisions are reproduced in Appendix C. This could be the subject of Victorian legislation alone, although a national approach would be preferable.

1.16 It is too soon to know if the *Corporate Law Reform Act*'s reforms, which came into force only in June 1993, will work in practice. The Committee was told many times that it would be better to defer its Inquiry until it was possible to review their effect, and that this review could not usefully be commenced before at least a year had elapsed, and preferably 18 months. The Committee therefore proposes that it should review the effectiveness of the June 1993 reforms in dealing with the central problem of its terms of reference in the second half of 1994.

1.17 Submissions and evidence to the Committee were strongly opposed to Victoria taking unilateral initiatives at odds with the scheme of the *Corporations Law.* They urged that business be allowed more time undisturbed by further regulatory change to adjust to the *Corporations Law* as it now stands.

1.18 Initiatives in director education, advice to small business and unions, changes to licensing and registration procedures, business names legislation, and enhanced publicity for disqualified directors do not require legislation inconsistent with the *Corporations Law*. Apart from these, Victoria can only exhort the other State and Territory Governments and the Commonwealth to consider the suggested changes to the *Law*, or to the ASC's resources and priorities.

CHAPTER 2 THE PROBLEM

2.1.1 The social problem which gives rise to the Committee's Inquiry is that of companies which fail, unable to pay their debts and their obligations to their employees, but which then reappear in another corporate guise, with substantially the same management.

2.1.2 In these circumstances it appears to the creditors of the first entity that a fraud has been committed, in that the directors have misused the shield of limited liability and are continuing trading but with their debts repudiated. All the burden of failure is borne by the creditors, and little or none by the directors whose management is seen as having led to the failure.

2.1.3 There seem to be two principal approaches to dealing with the perceived wrong in this situation. One is to seek to prevent the directors concerned from doing it again; the *Corporations Law* provides for disqualification of directors in certain circumstances, and sets penalties for contravening the disqualification. The other is to make sure that they do not personally benefit at the expense of the creditors; this involves "lifting the corporate veil" to provide the creditors with access to the directors' personal assets to satisfy the debts. (Strictly speaking, the "corporate veil" separates the company's legal personality from that of its shareholders; but in the smaller private companies on which the present inquiry is focussed the shareholders and directors are frequently the same persons.)

2.1.4 The difficulty confronting the Committee is that not all failures of companies merit action against directors, and that the protection of limited liability may be essential for the encouragement of enterprise and the carrying on of business. There is thus a public interest in permitting some directors to survive a crash relatively unscathed, and able to try again. Dividing the sheep from the goats is here, as always, a difficult task.

2.1.5 Before considering further how to discriminate between those cases where the veil should be lifted and those where liability should remain limited, and before

looking into any other approaches than disqualification and personal liability, it is appropriate to consider examples of the problem on which the Committee is focussing.

2.1.6 A classic example is found in the 1989 Western Australian case of *Jeffree v NCSC*;[3] but on this occasion the law proved adequate to hold the directors to account. The circumstances were that a swimming-pool company faced an adverse commercial arbitration decision, and a director (who appeared to be the controlling mind of the company) arranged for the company to sell its business name and assets to another of his companies. So much of the purchase price as was paid was used to pay the company's trade creditors, so that when the arbitration award was eventually made against it the company was a shell. The Court held that this was an improper use of information acquired in his position as a director, contrary to the then equivalent of s.232(6) of the *Corporations Law*.[4]

2.1.7 Submissions to the Inquiry gave various examples.

2.1.8 The Committee was told of a real estate company which ceased trading on 31 August 1992 with substantial debts arising out of litigation, and whose directors applied to place the company in liquidation. On the same day another company, with the same directors as the first, advertised an application for and received a licence from the Estate Agents Board. That company now carries on the same business, from the same address, with the same telephone number, the same staff and, it appears, the same directors.[5]

2.1.9 The Committee was told of another case where a $2 trustee company appeared to be the vehicle for depriving a creditor of satisfaction.[6] The creditor won a County Court action in 1985 to have paid to him moneys owed for services rendered in 1979–80. The then "owners" of the centre ran it through a $2 company for a family trust; it appears they were the only two shareholders in the company, with one $1.00 share each. Following the judgment this company ceased trading and failed to conform to the requirements of the Victorian Corporate Affairs Commission to provide annual returns, whereupon it was deregistered by the Commission in 1989 as a disciplinary action. It appears that the directors have walked away from

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3 (1989) 7 ACLC 556.
4 *Australian Corporations & Securities Law Reporter* ¶62–200, page 93,302.
5 *Submission 1*, Geoffrey Crowder, John Crowder & Sons Pty Ltd.
6 *Submission 18*, Arthur B Ranken.

the judgment without paying anything, although title searches show they have the means to meet judgment. The Committee was told that they have let other companies lapse the same way over time and have a number of court judgments against them.

2.1.10 The Committee notes that a situation such as this might now be covered by s.233 of the *Corporations Law*—old s.229A—which deals with $2 trustee companies which have incomplete rights against the trust fund, and in such cases the directors can be liable for debts incurred by the company.

2.1.11 Other submissions gave examples of the phoenix problem as it applies to employees, who may be considered a special class of creditor.

2.1.12 The Committee was told of several cases where employees are deprived of legal rights by the device of transmission annually of their employment from one limited liability company to another. This denies continuity of employment and thus deprives employees of rights to long service leave and retrenchment or severance pay. It appears there are also cases where companies cease to trade where no (or no adequate) provision has been paid to workers of their accrued entitlements and severance pay.[7]

2.1.13 In another submission the Committee was told of a practice of using small, financially weak companies as a device for the hiring of labour. It appears that the true employer gains the advantage that the company is in law regarded as the employer, so that liabilities which ought to rest with the true employer (eg responsibility for redundancy payments, long service leave payments and award entitlements) are not enforceable against it. Even though the true employer exerts considerable influence over the workplace and terms and conditions of employment, the worker's security of employment and entitlements are entirely dependent upon the whim of the smaller companies which, in turn, are controlled by the true employer. It is apparently a common practice, when workers press for better entitlements, for the smaller company to wind up, pleading economic incapacity, leaving workers with no redress.[8]

7 *Submission 19*, Textile Clothing & Footwear Union of Australia.
8 *Submission 20*, Media Entertainment & Arts Alliance.

2.1.14 Members of Parliament also told the Committee of phoenix company situations. For example Kelvin Thomson MP had raised the issue on more than one occasion in Parliament. Describing the activities of a Mr Mayo and a Mr Wright, in relation to swimming pool companies, he said:[9]

> "The winding up procedures that have been initiated by the Australian Taxation Office in relation to Lazaway Pools have been defended and there is a challenge to the sales tax regime under which Lazaway Pools are said to owe substantial sums to the Australian Taxation Office. Even if that challenge is successful, advice to me suggests that the company is deeply in debt to the order of $1 million and it would not be capable of surviving.
>
> "With these gentlemen it is not enough that the company should be put out of business, because any honourable member who watches Channel 10 can see that Lazaway Pools Pty Ltd is still advertising. However, if challenged as to how the company can be advertising when it is staring bankruptcy in the face, it is pointed out that the advertisements are not for Lazaway Pools Pty Ltd, but for Lazaway Pools and Spas Pty Ltd!
>
> "The change of names of companies is a device by which proper responsibilities can be avoided, that is, responsibilities in respect of taxation and to consumers. Mr Wright and Mr Mayo have been clever enough to discover that the owner of the In-Ground Pool Construction Company—who had testified in one of the many court cases against them—had not properly registered his business name. They slipped off to the Corporate Affairs Victoria office and registered the business name, so he no longer has the use of that company name.
>
> "The two gentlemen have a raft of companies in which they are able to continue in business. The situation is such that, even if Lazaway Pools—or any other company associated with Glenwood Management Group Pty Ltd—is wound up, although provision exists under section 600 of the Commonwealth legislation relating to corporations for directors to be prevented from managing a company for five years, that can be difficult to achieve because Mr Wright and Mr Mayo have a happy knack of ceasing to be directors of a company over twelve months before it is wound up.
>
> "I am told other people also are able to get around this problem of being forbidden to manage a company after being involved with a company that is wound up. For instance, people like Dr McGoldrick who have been struck off can still be seen around the town managing building enterprises despite having been struck off. It seems that the best weapon against these kinds of people is publicity.
>
> "What is happening with Lazaway Pools Pty Ltd through the activities of Mr Wright and Mr Mayo, aided and abetted by the Westpac Banking Corporation, is part of the corporate sickness that was evident in Australia in the 1980s and reflects an abuse of limited liability and company law. Examples of the sickness can be seen in what has happened not only with

9 *Victorian Parliamentary Debates, Legislative Assembly*, (Kelvin Thomson MP) 21 March 1991, pages 553, 556–7. See also 25 September 1990 pages 863–865 and 30 May 1991, pages 56–57.

> organisations such as the Pyramid Building Society, Tricontinental Corporation Ltd, and the State Bank of South Australia, but also with other organisations.
>
> "In the past few years the state of corporate morality in Victoria and around Australia generally has been such that it has enabled this sort of activity to go on without effective measures being taken to prevent it."

2.1.15 Examples of the problem arise in other countries too. In the United Kingdom, for example, as described (with numerous examples) by Robert Breckman,[10] it seems the law is in practice as unsatisfactory as here.

2.1.16 While these examples give the flavour of the problem confronting the Committee, they do not indicate how widespread it is. As the Premier acknowledged in his submission, "The extent of the problem within the business and wider community is difficult to quantify in dollar terms. However there is evidence that the rolling over of corporate entities is used to evade payment of Government imposts."[11] He went on to say, however, "In the context of payroll tax there was evidence of 19 companies involved in this activity incurring a total debt of approximately $1,292,067.40. In the Workcover area a similar number of companies were involved."[12]

2.1.17 Large though these sums are, they amount to only five per cent of the total amounts written off by the State as a result of corporate insolvencies. The amount written off in payroll tax alone in the 1992 financial year was almost $26 million, while the 1993 sum written off for WorkCover and WorkCare was over $12 million.[13]

2.1.18 The ASC's statistics do not give any clear indication of the magnitude of the problem. This may well be because of resource constraints, and the consequent need to rely on reports from liquidators. As is noted below, this reliance is unlikely to reveal any but the most blatant cases, because there are no funds to enable liquidators to investigate adequately companies with no assets.

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10 Breckman, Robert "A raw deal... something is rotten in the state of liquidation" [1993] *New Law Journal* 1614.

11 *Submission 21*, Victorian Government, paragraph 3.1.

12 Ibid., paragraph 3.4.

13 Ibid., paragraphs 3.2–3.

2.1.19 A closely related question, however, is that of assetless deregistrations under s.574 of the *Corporations Law*. There were over 50,000 in 1992/93, but the *Law* requires no reporting of whether any liabilities remain unsatisfied. There is therefore no way of knowing how many of these might have been phoenix situations. As discussed below, the procedure under s.574 appears to be a loophole through which dishonest directors and phoenix managers can often escape, avoiding both disqualification and personal liability for the debts.[14]

Focus of the Inquiry

2.2.1 The Terms of Reference require the Committee to have regard to:

(i) the necessity to regulate the formation of new companies by persons who have been directors of or have been involved in the management of recently failed companies or companies unable to pay their debts;

(ii) the measures that may be taken to control the participation of such persons, either as consultants or by any other form of employment or engagement, whether or not remunerated, in other newly created or existing companies by individuals related to them;

(iii) measures that may be taken to prevent companies and their operators from avoiding their liabilities by starting again under a new name.

2.2.2 In the light of these paragraphs the Committee has made the focus of its Inquiry the situation where directors or managers of a company cease to carry on business one day and, without attending, or attending adequately, to company debts, shortly thereafter start up a similar business under a different company name.

2.2.3 Some examples have been given above of this situation, where a debt-free corporation arises, like the mythical phoenix, from the ashes of a failed company.

2.2.4 To say that the Committee is concentrating on the situation of "phoenix companies"[15] does not by itself, however, greatly narrow the focus of the Inquiry. For the phoenix situation can lead to the invocation of a wide range of processes and

14 See paragraph 2.1.9 above, referring to *Submission 18*, for such a case.

15 The term is not original; see, for example, the 1986 UK legislation and commentary reproduced in Appendix C.

remedies provided for by the *Corporations Law*, as illustrated in the following chapters.

2.2.5 The *Corporations Law* in force at the beginning of the Inquiry was already about to change, in material respects, as a result of the enactment of the *Corporate Law Reform Act* 1992. Further changes relevant to the terms of reference were in train as this interim report was about to be tabled, as a result of the Corporations Legislation Amendment Bill 1994. If enacted this will, among other things, confer jurisdiction on the County Court and Magistrates' Court with respect to most matters involving money claims against directors and managers.

The *Corporate Law Reform Act* 1992

2.2.6 The *Corporate Law Reform Act* was passed by the Commonwealth Parliament in December 1992 and received Royal Assent on 24 December 1992 (N° 210 of 1992).

2.2.7 The provisions of the Act became operative in two stages: Parts 2, 3, 6 and 7 commenced on 1 February 1993; Parts 4 and 5 commenced on 23 June 1993.

2.2.8 The Act made significant amendments to the *Corporations Law* in four areas:

- directors' duties and civil penalty provisions—Part 2
- related party transactions—"loans to directors"—Part 3
- corporate insolvency and external administration—Part 4
- ASX share transfer procedures—Part 5.

2.2.9 The major features of the amendments made by the 1992 Act are discussed in the following chapters as they arise in the context of the Committee's terms of reference.

3.1.1 The first section of the Committee's terms of reference deals with the disqualification of delinquent directors and managers, and the adequacy of the procedures for disqualifying them, the procedures for supervising them and the adequacy of the associated penalties.

Para 1.1 Adequacy of existing disqualification procedures

Corporations Law before June 1993

3.1.2 Section 230 provides for the Court to make an order prohibiting a person from managing a corporation, for whatever period it specifies, for failing to prevent a corporation from breaching a variety of provisions of the Law.

3.1.3 Section 599(2) provides that the Court may, on an application by the ASC, make an order prohibiting a person from managing a corporation for up to five years from the date of the order.

3.1.4 Section 599(3) provides that a disqualification order can only be made if the Court is satisfied that:

- within a period of seven years, the person was a director of, or was concerned or took part in the management of, two or more companies which were wound up or otherwise placed under another form of external administration because they could not pay their debts;[16]
- the way those companies were managed was wholly or partly responsible for their being wound up or otherwise placed under another form of external administration.[17]

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16 Section 599(1) sets out these criteria in great detail.

17 Before an order can be made the person concerned must have been notified of the application: s.599(3)(a).

3.1.5 The expression "managing a corporation" is defined, in broad terms, by section 91A. It includes being a director or promoter of the corporation and taking part in or being in any way directly or indirectly concerned in its management.

3.1.6 Section 600 provides for a procedure whereby the ASC may order that a person be prohibited from managing a corporation for a specified period, not exceeding five years.

3.1.7 However, an order cannot be made by the ASC unless:

- The person was a director of two or more companies that have been wound up within a period of seven years preceding the issuing of the relevant notice.
- The person was a director of the company at any time within 12 months of the winding up of that company.
- The ASC serves a "show-cause" notice on the person requiring the showing of cause as to why they should not be prohibited from taking part in the management of a company.
- The person has been given an opportunity of being heard in relation to the notice.

3.1.8 Further, a decision by the ASC may be reviewed by the Administrative Appeals Tribunal and, in addition, a person subject to a prohibition order may obtain the leave of the court to manage a corporation.

Corporations Law since June 1993

3.1.9 In addition to sections 599 and 600, new section 1317EA(3)(a) allows the Court to order that a person be prohibited from managing a corporation for a specified period where the court is satisfied that that person has contravened a civil penalty provision. However, by section 1317EA(4) the court has a discretion not to make such an order if it is satisfied that, notwithstanding the contravention, "the person is a fit and proper person to manage a corporation".

3.1.10 An application for a "civil penalty order" or a "civil penalty disqualification" may be made by the ASC, its delegate or some other person authorised in writing by the Federal Attorney-General—see section 1317EB(1).

3.1.11 Section 1317DA defines the following provisions to be "civil penalty provisions":

- Section 232—the duty of officers of a corporation to act honestly in the exercise of their powers and the carrying out of their duties of office
- Section 243ZE—persons involved in improper related party transactions[18]
- Section 318—failing to ensure compliance with certain obligations concerning the preparation of company financial statements
- Section 588G—the duty of company directors to prevent the company incurring debts when the director is aware, or ought reasonably to be aware, that the company is insolvent.

3.1.12 Further, by section 229(3), a person is disqualified for five years[19] where that person is convicted not only, as before, of serious fraud or, on indictment, of an offence connected with the promotion or management of companies, or but also "of any offence for a contravention" of a civil penalty provision.

3.1.13 Thus the 1992 Amendments provide an additional source or power for disqualification, namely upon contravention of the new civil penalty provisions. The operation of these provisions is discussed below.[20]

3.1.14 Section 243 requires the ASC to keep a publicly available Register of Disqualified Company Directors. This includes copies of all notices or orders under s.230, s.599, s.600 and s.1317EA, and may include those under corresponding previous laws.

Submissions

3.1.15 The Committee's terms of reference require it to advert specifically to "the adequacy of section 599 of the *Corporations Law* as a means of securing creditor protection". The submissions and evidence received by the Committee made it clear

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18 This section applies to public companies giving or receiving financial benefits improperly to or from a related party, which includes a director or a director's spouse (de jure or de facto), parent or child, and also a parent company (or its directors) or another company with the same parent company, or an entity controlled by some of the above: see s.243F.

19 From conviction or, where relevant, from release from prison.

20 See paragraphs 3.2.5–16.

this section was barely relevant, let alone adequate, though its companion section 600 was seen as useful.

3.1.16 One witness told the Committee: "There has not been a single application to the court [under s.599] to disqualify a director during this period simply because the authorities, starting from the ASC, thought it was likely to be much too difficult."[21]

3.1.17 This view was confirmed by Mr Ron Trevethan of the ASC, who said that s.599 was never used.[22] He explained that in the ASC's experience:

> it is a waste of time and resources. Where we have to use those circumstances to have a director disqualified we must prove a contravention of the law, which means proving it beyond a reasonable doubt. Then we may as well prosecute under the provision he has contravened and [if convicted] the person will be automatically disqualified [under s.229] from carrying on as a director. [Section 599] has not worked.[23]

3.1.18 Section 600 was considered more useful, as it permits disqualification without obtaining the leave of the court,[24] but it was suggested that it should not be necessary for a person to have been involved in two defaults before it could be invoked.[25] Furthermore, because the section gives the ASC a discretion to require a director to show cause why he or she should not be disqualified, every case has to be individually considered; resource constraints then mean that not every case deserving action to disqualify can in fact be dealt with.

3.1.19 A problem with the existing disqualification procedures was pointed out to the Committee: they assume that formal steps are taken to wind up a failed company, as opposed to the situation where the directors simply cease trading under the company name and then recommence business under a new company name without attending to the liabilities of the former company.[26] Directors of companies that are struck off under s.574, even where there are unpaid liabilities, are not later prohibited from running a corporation.[27] This should be addressed, the Committee was told, as currently directors of insolvent companies can escape liability by selling remaining assets, distributing proceeds to favoured creditors

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21 Mr Don Cooper, *Hansard* 2 June 1993, page 48.
22 Mr Ron Trevethan, *Hansard*, 23 June 1993, page 82.
23 Ibid.
24 *Submission 10*, Ferrier Hodgson.
25 *Submission 11*, Coopers & Lybrand.
26 Professor John Farrar, Meeting with the Committee, 5 March 1993.
27 *Submission 10*, Ferrier Hodgson.

(including themselves) and then applying to have the company deregistered. Creditors are unlikely to appoint a liquidator to such a company.[28]

3.1.20 One solution proposed to the Committee to the problem of no formal winding up was either to increase the scope for directors to be held personally liable, perhaps along the lines of the inoperative *Close Corporations Act* (for small businesses), or as recommended by the *Harmer Report* of the ALRC, to establish a common fund for the payment of liquidators in this sort of situation.[29] Another suggested solution was to make the appointment of an administrator under the new Part 5.7B mandatory where it is likely that creditors would receive less than 50¢ in the dollar.[30]

3.1.21 Others told the Committee that the existing provisions of the *Corporations Law* governing prohibitions, remedies and penalties are appropriate and adequate and do not need to be supplemented. The problems lie with enforcement and the litigation process, it was said; the law does not need amending and to do so would create over-regulation and disrupt the current uniformity of company regulation.[31]

3.1.22 The Committee also noted that the disqualification provisions are scattered throughout the *Corporations Law*, but might usefully be consolidated into one Division.[32] Its attention was drawn to the fact that in the USA and Canada insolvency for individuals and for companies are dealt with in a single Act, which if adopted here might also simplify the disqualification of a bankrupt company director.[33] In so doing, the law relating to bankruptcy might well be tightened to avoid situations such as have occurred with some of the once high-flying so-called entrepreneurs of the 1980s.

Conclusions

3.1.23 The adequacy of the disqualification procedures as a means of achieving creditor protection involves three matters. First, what proportion of those who ought to be disqualified are disqualified? Second, are any disqualified who ought not to be? Third, even if the answers to the first two questions are "100%" and "none", does it follow that the number of instances of companies failing to pay their creditors will

28 Ibid.
29 Professor John Farrar, Meeting with the Committee, 5 March 1993.
30 Mr Brett Matheson, Meeting with the Committee, 5 March 1993.
31 *Submission 9*, Baker & McKenzie.
32 Professor John Farrar, Meeting with the Committee, 5 March 1993.
33 Ibid.

be significantly reduced? The submissions and evidence given to the Committee do not provide an answer to the third question, and the Committee would welcome further submissions on the value of disqualification as a means of creditor protection. Whatever the outcome, the Committee observes that the other measures discussed below may be more useful to deal with the problem posed by its terms of reference.

3.1.24 The existing disqualification provisions of the *Corporations Law* do cover a wide range of circumstances where persons ought to be disqualified.

3.1.25 The principal defect in these provisions is that it is possible for directors to have a failed company struck off without going through the formal liquidation procedure, and thereby to avoid the liquidator's report which might lead to their being disqualified.

Recommendation 1

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to the *Corporations Law* so that the directors of a failed company which is struck off without a formal liquidation and which pays less than 50¢ in the dollar of its liabilities are subject to the same sanctions as if there had been a formal liquidation and an adverse liquidator's report.

3.1.26 The requirement for disqualification under s.600 that the director have been involved in *two* insolvencies which paid less than 50¢ in the dollar may be too generous, and consideration should be given to giving the ASC a discretion to seek a director's disqualification after a single serious insolvency, where it appears necessary for the protection of future creditors. Before such amendments were made it would be desirable for an examination to be made of the incidence, nature and consequences of failure in different classes of corporation—No Liability mining companies being one obvious example. It may be possible to reduce regulatory and business costs by limiting the more stringent regime to less than the whole range of limited liability companies.

Recommendation 2

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to the disqualification provisions in s.600 of the *Corporations Law.* There should be two levels: where a corporation is liquidated and pays less than 50¢ in the dollar of its liabilities the ASC should have a discretion to require a director of the corporation to show cause why he or she should not be disqualified; and when a person is involved as a director or manager in two such insolvencies the disqualification should be automatic unless the director can satisfy the ASC otherwise.

3.1.27 Apart from these problems the existing procedures appear to be adequate, and the interests of creditors, or rather of potential creditors, are thus protected.

3.1.28 Section 599, however, is not used, and so contributes little to the adequacy of the existing law. It might be more useful if it involved a civil standard of proof, and if it permitted the Court to disqualify a director after only one serious insolvency.

Recommendation 3

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to section 599 of the *Corporations Law.* That section should enable the Court to disqualify a director if satisfied at the civil standard of the matters of mismanagement now requiring proof beyond reasonable doubt, and in the event of only a single insolvency.

Para 1.2 The adequacy of penalties where disqualified persons act in the management of companies.

Corporations Law **before June 1993**

3.2.1 In the absence of a specific provision to the contrary, section 1311 provides that penalties for offences under, or contraventions of, the *Corporations Law*, are as set out in Schedule 3.

3.2.2 The relevant offences are:

(a) Section 229—contravening the prohibition against insolvents (individuals under bankruptcy) and persons convicted of certain corporate offences managing a corporation without leave of the Court

(b) Section 230—breaching a court order prohibiting a person responsible for repeated individual or corporate breaches of the *Corporations Law* from managing companies

(c) Section 599—breaching a court order prohibiting a person from managing companies.

3.2.3 By Schedule 3, the criminal penalties for these offences are $5,000 or imprisonment for 1 year, or both.

3.2.4 By section 243 the ASC is required to keep a register of disqualified directors and other company officers. The register consists of copies of orders made under sections 230(1), 599(2), new section 1317EA(3)(a), or notices under section 600(3).

Corporations Law **since June 1993**

3.2.5 In addition to the above, by new section 1317EF, a person must not manage a corporation whilst subject to a civil penalty disqualification—see section 1317EA(3)(a) above. Also see section 229(3) at paragraph 3.1.12 above.

3.2.6 The criminal penalty for contravention of section 1317EF is $5,000 or imprisonment for 1 year, or both.

3.2.7 Further, by section 1317EA(3)(b), where a person has contravened a civil penalty provision (see section 1317DA at paragraph 3.1.11 above), the Court may order that person to pay to the Commonwealth (or the ASC on its behalf) a (civil) pecuniary penalty not exceeding $200,000.

3.2.8 Contravention of a civil penalty provision can also give rise to criminal liability if the contravention is done with a dishonest intention or otherwise with criminality—see section 1317FA(1). The criminal penalty applicable is $200,000 or imprisonment for 5 years, or both.

3.2.9 Section 1317FB precludes criminal proceedings for a contravention of a civil penalty provision where there already has been an application for a civil penalty order, whether the application is finally determined or not.

3.2.10 Section 1317JC provides that the Court's power to make a civil penalty order does not preclude it from making orders for punitive damages for contraventions of a civil penalty provision. Section 1317EA(6) prevents the making of section 1317EA(3)(b) civil penalty orders if a court has already made an order for punitive damages for the same contravention.

3.2.11 Furthermore, new section 588Z provides that where a company has been wound up and within four years before the winding up a person has managed a company whilst disqualified (and therefore contravenes sections 229, 230, 599, 600 or 1317EF) the Court may, on application by the liquidator, order that the person is liable personally for a specified amount of the company's debts.

Comment

3.2.12 The civil penalty provisions in new Part 9.4B implement recommendations made by the Senate Legal and Constitutional Affairs Committee, in its November 1989 report, *Company Directors' Duties*, on the social and fiduciary duties and obligations of company directors, that:

(a) criminal liability under the *Corporations Law* not apply in the absence of criminality;

(b) section 232(4) be amended to confine criminal liability under that section to conduct that is genuinely criminal; and

(c) provision be made for civil penalties for contraventions not involving criminality and that persons suffering loss be able to bring damages claims in the penalty proceedings.

3.2.13 Sections 1317HA and 1317HB allow corporations suffering loss as a result of a contravention to apply in civil penalty or criminal proceedings for compensation. Further, by section 1317HD(1), where a person contravenes a civil penalty provision in relation to a corporation, that corporation may bring proceedings to recover amounts equal to

(a) any profit obtained by the person as a result of the contravention, and

(b) any loss or damage suffered by the corporation as a result of the contravention—

regardless of whether that person has been the subject of a criminal conviction or civil penalty order for that contravention.

3.2.14 The rights of corporations under sections 1317HA, 1317HB and 1317HD are in addition to rights to sue for breaches of common law and equitable duties owed by corporate officers.

3.2.15 Because the rights of a corporation are vested in an appointed liquidator upon winding up, liquidators can bring proceedings under sections 1317HA, 1317HB and 1317HD in the name of the corporation.

3.2.16 In the context of paragraph 1.2 of the Committee's terms of reference, the civil penalty provisions of new Part 9.4B provide additional criminal and civil penalties for persons managing corporations contrary to a section 1317EA(3)(a) disqualification order, namely:

(a) criminal penalties up to $5,000 or imprisonment for 1 year, or both—section 1317EF;

(b) civil pecuniary penalties up to $200,000—section 1317EA(3)(b); and

(c) criminal penalties, for intentional and dishonest contraventions, up to $200,000 or imprisonment for 5 years, or both—section 1317FA.

Submissions

3.2.17 Some submissions pointed out that it was not the penalties which were inadequate, but the likelihood of detecting and the zeal in prosecuting someone in breach.[34]

3.2.18 Others, however, considered the penalties inadequate,[35] especially for offences which include, amongst other things, a contempt of court.[36]

Conclusions

3.2.19 Although several submissions said that the penalties for disqualified directors managing companies were too low, and none argued they were too high, it seems that (as is often the case) a high probability of being caught is a greater deterrent to law-breaking than a high penalty which will not be incurred.

3.2.20 As in other areas of so-called white-collar crime, there is an additional problem when magistrates and courts fail to avail themselves of the option of sending corporate criminals to prison, because they do not see them as truly criminal.

3.2.21 Dealing with the first problem is largely a matter of resources and priorities within the ASC, while the second involves a concerted effort to change public perceptions, and thence judicial ones. This would require a commitment from government to put the issue of corporate crime firmly on the media's agenda.

Recommendation 4

The Committee recommends that the Victorian Government should seek a review of the resources devoted to detecting and prosecuting persons who involve themselves in the management of companies while disqualified.

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34 Eg, *Submission 9*, Baker & McKenzie.

35 *Submission 11*, Coopers & Lybrand; *Submission 18*, Mr Arthur B Ranken; *Submission 16*, County Court of Victoria.

36 *Submission 16*, County Court of Victoria.

3.2.22 It is not obvious what is the most cost-effective way of achieving the recommended publicity and attitudinal change, but it might best be achieved by increasing the rate of criminal and civil penalty prosecutions, and ensuring the media's attention is drawn to the prosecutions.

Recommendation 5

The Committee recommends that the Victorian Government should take steps to change the public and judicial attitudes to culpable mismanagement of corporations and abuse of the corporate form, so that persons who manage companies when disqualified or whose culpable management leads to serious losses to creditors are as likely to go to prison as those who deprive others of their money by theft.

Para 1.3 The adequacy of existing supervisory and enforcement arrangements in relation to disqualified persons

3.3.1 Apart from the ASC register of disqualified corporate officers under section 243, mentioned above, this aspect of the terms of reference is not concerned with the substantive provisions of the *Corporations Law*. It goes instead to the administrative arrangements of the ASC, and the priorities and resources allocated to such supervision.

3.3.2 It also raises the question of the publicity given to disqualifications, and the extent to which business, using that information, can police the activities of disqualified persons in its own interests.

Submissions and Evidence

3.3.3 The desirability of greater publicity for disqualified directors and managers was a theme of several submissions.[37] It was suggested that lists of disqualified persons should be published more regularly by the media and in public places such as post offices or banks.[38]

3.3.4 It was suggested that an annual questionnaire, and field audits designed to monitor the activities of disqualified persons, may assist in preventing them managing a corporation through third parties.[39]

3.3.5 The Committee was told that the disqualification of bankrupts worked well, with accountancy firms only occasionally hearing of bankrupts failing to resign directorships.[40]

3.3.6 Although some told the Committee that there was a problem with lack of enforcement of existing laws,[41] other evidence suggested that the law "has been effective in removing a large number of directors for periods of up to five years".[42]

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37 *Submission 14,* Duesburys; *Submission 5,* Jack Dickinson, Citizen; *Submission 11,* Coopers & Lybrand.

38 *Submission 11,* Coopers & Lybrand.

39 *Submission 14,* Duesburys.

40 *Submission 10,* Ferrier Hodgson.

41 *Submission 9,* Baker & McKenzie.

42 Mr Don Cooper, *Hansard,* 2 June 1993, page 48.

3.3.7 It appears that disqualifications are indeed overseen. Mr Don Cooper of Sly and Weigall told the Committee:

> I happen to know that [they are] because a couple of weeks ago I spoke to a client of mine who had been disqualified. He said—as I warned him he might—that he had a visit from some officials, presumably from the ASC, a year or so after his disqualification had commenced. They paid a visit to his place of business, satisfied themselves that he was not acting as a director because he had been removed officially as a director, and that he was not acting de facto as a director. Then they departed.[43]

3.3.8 Officers of the Australian Securities Commission, Mr Ron Trevethan, Victorian Regional Director, and Mr Pat Whitehouse, Director, Investigations, explained to the Committee the ASC's role in supervising and enforcing disqualification orders. It appears that supervision is largely complaint-driven. The ASC is working on computer verification (matching a person to companies), but at present a company can be incorporated with disqualified directors, because there is no instantaneous check on directors' names.

3.3.9 The Committee is aware of the problems of matching names, but notes that clients of Dun & Bradstreet can now obtain information from the ASC database on the corporate history of individuals, including all current and previous directorships held, for a cost of less than $100 per name.[44] The example shown to the Committee reveals why the process cannot easily be automated: slight variations in the place of birth or other details, such as the spelling or inclusion of second or third given names, can lead the computer to be unsure whether records are of the same or different people. The cost of the "Executive Search" also means that the Committee suspects it will not be used frequently by small businesses doing routine credit assessment.

Conclusions

3.3.10 Improved computer matching to spot activity by disqualified directors would clearly help prevent disqualified persons managing companies. This is a matter of the ASC's resources and priorities.

3.3.11 It would clearly help to overcome the problems of minor variations in directors' details, referred to above at paragraph 3.3.9, if everyone wishing to have

43 Ibid., page 49.

44 Correspondence with Peter Maloney, Dun & Bradstreet, 25 May 1994.

the privilege of being a director of a corporation with limited liability were required to have a unique, one-for-a-lifetime, identity number. Because becoming a director is a matter of choice, and truly voluntary, the privacy issues which ID numbers generally raise are not of concern.

Recommendation 6

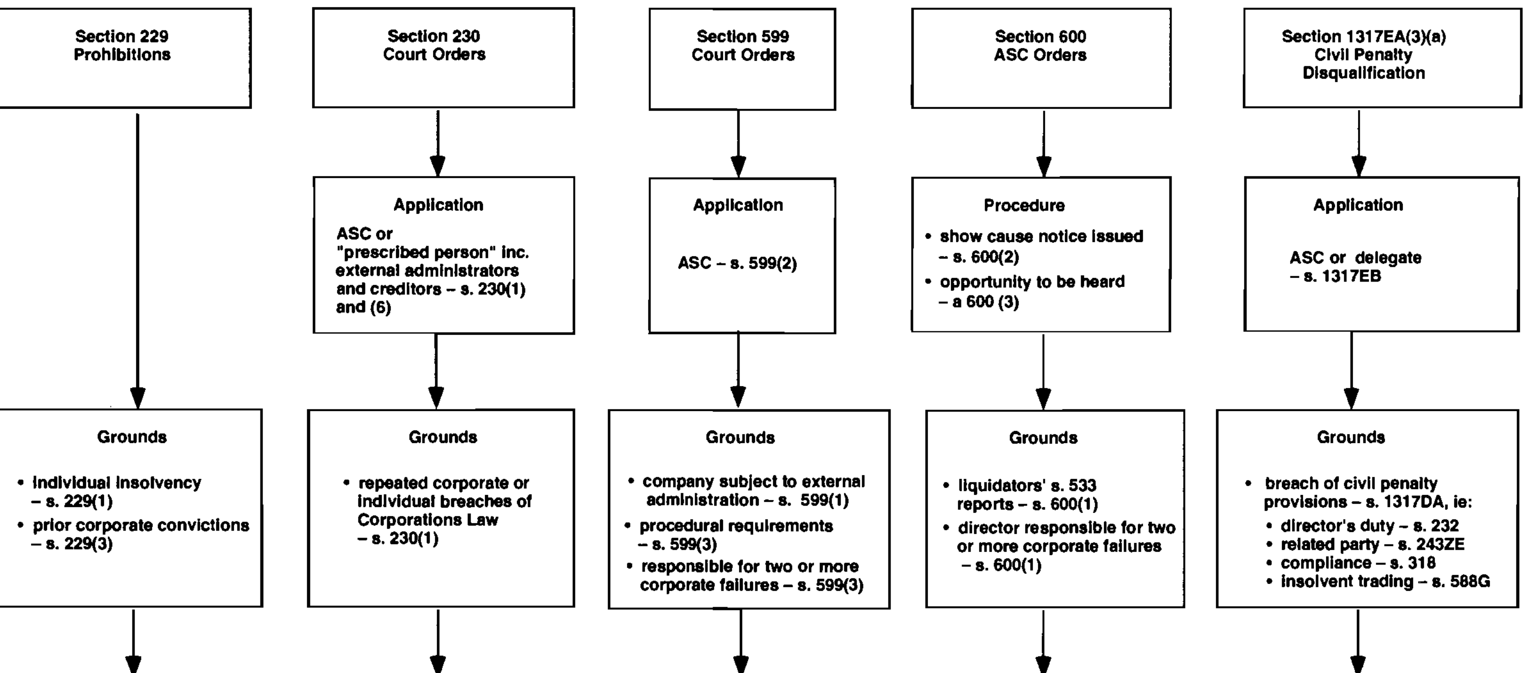
The Committee recommends that the Victorian Government should encourage the ASC to give a higher priority to developing computer programs to detect disqualified persons becoming involved in the management of companies, and should seek the support of the Ministerial Council to require all directors of limited liability companies to have and use a unique identity number.

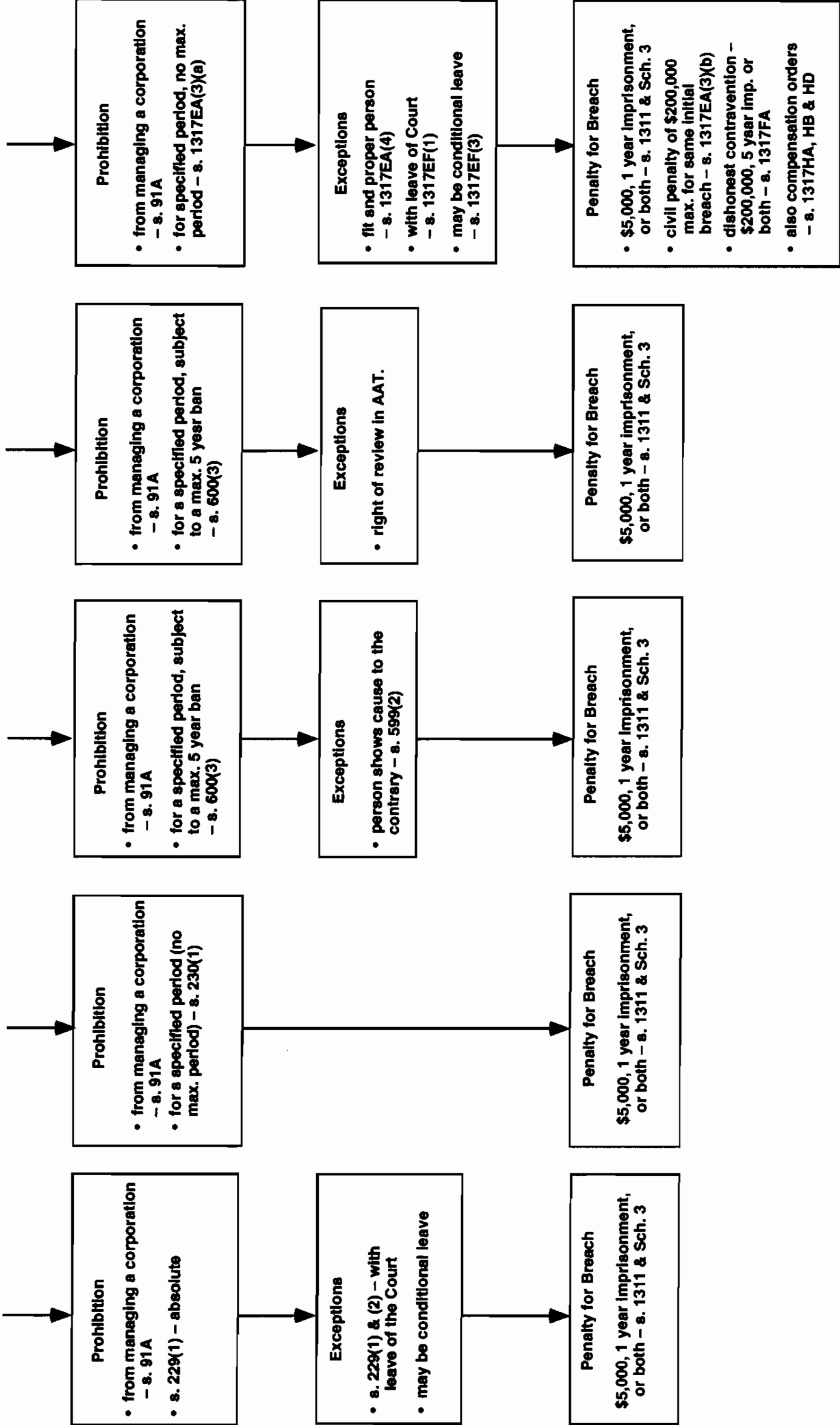
3.3.12 If the list of disqualified persons were made available to banks and credit agencies the ordinary self-interest of those bodies would make it very hard for disqualified persons to act improperly. Banks could be expected to check new account applications against such a list, and perhaps from time to time to check existing customers likewise.

Recommendation 7

The Committee recommends that the Victorian Government should take steps both by itself and in cooperation with the other members of the Ministerial Council to secure wider and more regular dissemination of the register of disqualified directors, and should urge banks and other financial institutions to make use of this information so as to make it harder for disqualified persons to manage companies.

PARAS. 1.1 & 1.2 — DISQUALIFICATION PROCEDURES AND PENALTIES





Prohibition
• from managing a corporation – s. 91A
• for specified period, no max. period – s. 1317EA(3)(a)
Exceptions
• fit and proper person – s. 1317EA(4)
• with leave of Court – s. 1317EF(1)
• may be conditional leave – s. 1317EF(3)
Penalty for Breach
• $5,000, 1 year imprisonment, or both – s. 1311 & Sch. 3
• civil penalty of $200,000 max. for same initial breach – s. 1317EA(3)(b)
• dishonest contravention – $200,000, 5 year imp. or both – s. 1317FA
• also compensation orders – s. 1317HA, HB & HD
Prohibition
• from managing a corporation – s. 91A
• for a specified period, subject to a max. 5 year ban – s. 600(3)
Exceptions
• right of review in AAT.
Penalty for Breach
$5,000, 1 year imprisonment, or both – s. 1311 & Sch. 3
Prohibition
• from managing a corporation – s. 91A
• for a specified period, subject to a max. 5 year ban – s. 600(3)
Exceptions
• person shows cause to the contrary – s. 599(2)
Penalty for Breach
$5,000, 1 year imprisonment, or both – s. 1311 & Sch. 3
Prohibition
• from managing a corporation – s. 91A
• for a specified period (no max. period) – s. 230(1)
Penalty for Breach
$5,000, 1 year imprisonment, or both – s. 1311 & Sch. 3
Prohibition
• from managing a corporation – s. 91A
• s. 229(1) – absolute
Exceptions
• s. 229(1) & (2) – with leave of the Court
• may be conditional leave
Penalty for Breach
$5,000, 1 year imprisonment, or both – s. 1311 & Sch. 3

CHAPTER 4 REMEDIES FOR CREDITORS

4.1.1 The second section of the terms of reference deals with the appropriateness of the remedies for creditors when a company is insolvent, particularly the possibility of proceeding against the personal assets of the directors and managers. The Committee observes that it is not only creditors in the sense commonly understood, but also employees with claims for pay, accrued leave and long-service leave, and retrenchment entitlements whose rights against such persons must be safeguarded.

4.1.2 This section of the reference also raises the question of the appropriate forum for such actions, with a view to minimising the costs that appear to pose a practical obstacle in many cases.

Para 2.1 Remedies against directors and execution against directors' assets where those directors have been involved in the management of limited companies

4.1.3 The Committee is asked to report whether the *Corporations Law* makes appropriate provision for these matters. The Committee notes, however, that there are also important non-statutory causes of action at common law and in equity for breaches of directors' duties. These actions were once confined to duties owed by corporate officers to the corporation and its shareholders (who can in certain cases bring derivative actions in the name of the corporation), but recent case law has extended the liability of corporate officers to creditors where debts are incurred in insolvent or near insolvent situations.[45]

4.1.4 Further, although paragraph 2.1 does not refer to *creditors'* remedies, the context and the specific reference to "companies which have failed to meet financial obligations", suggests it is concerned with remedies or processes designed to recover, from directors, company debts owed to creditors (including employees). This will include statutory and non-statutory actions brought:

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45 Eg, *Kinsela & Anor v Russell Kinsela Pty Ltd (in liq)* (1986) 4 ACLC 215.

(a) by secured, preferred and unsecured creditors directly; and

(b) by liquidators, receivers and managers and agents of debenture holders or mortgagees in possession on behalf of such creditors.

4.1.5 The following discussion is confined to causes of action provided for by the *Corporations Law* with respect to the recovery of company debts from company officers by or on behalf of unsecured creditors. The discussion is also confined to the recovery of debts personally from directors, and does not include the recovery of corporate property from third parties by liquidators which, in turn, is distributed to creditors in the winding up, principally under the voidable transaction provisions.

4.1.6 The appropriateness of the *Corporations Law* provisions has to be judged against the background of the general law. Where the general law provides satisfactory remedies there is no need for statute. It must also be judged in relation to the balance required between the three goals of encouraging enterprise, protecting business against bad debts and minimising the regulatory burden on business.

Corporations Law before June 1993

4.1.7 The principal sections of the *Corporations Law* dealing with directors' liabilities to creditors incurred before 23 June 1993 are sections 592 and 593, discussed below.

4.1.8 Although section 232 imposes on directors a duty to act honestly and use reasonable care and diligence, actions for any losses suffered as a result of a breach can, at present, be brought only by the corporation, or the liquidator in its name. Again, although various other provisions impose more specific "compliance" duties, with penalties attaching, they do not provide for creditors to recover for any losses resulting from non-compliance.

4.1.9 Section 592 makes directors and managers liable for company debts incurred in circumstances where there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due, giving rise to both criminal and civil liability.

4.1.10 The elements of liability are:

(a) that the company falls within the classes mentioned in section 589, that is, it has become subject to a form of external administration;

(b) that the person was a director or took part in the management of the company at the time the debt was incurred and authorised the incurring of the debt;

(c) that the company incurs a debt;

(d) that immediately before the debt was incurred there were reasonable grounds to expect that:

  (i) the company would not be able to pay all its debts as and when they become due; or

  (ii) after incurring the debt, the company would not be able to pay all its debts as and when they become due.

4.1.11 If these elements are satisfied, the company and the director or manager, or if there are two or more persons, those persons, are jointly and severally liable for the debt. The Committee notes that the Commonwealth Attorney-General has established an inquiry to look into the law of joint liability,[46] as a result of the very large actions against auditors and others arising from the corporate crashes of the late 1980s, and this area of law may well change in the near future.

4.1.12 Proceedings for the debt can be brought by a creditor regardless of whether the director or manager has been convicted of an offence—section 592(3).

4.1.13 Under section 593(1), where the Court convicts a person of an offence under section 592(1), it may, on application of the ASC or an affected creditor, declare that person to be liable personally for the whole or part of the debt. A similar declaratory power exists in section 593(2), declaring persons to be responsible for the payment of company debts.

4.1.14 The Australian Law Reform Commission in its 1988 report on *General Insolvency* (the *Harmer Report*) criticised sections 592 and 593 as they then were on the basis that:

(a) they cause inequity among unsecured creditors as the provisions can only be utilised by individual creditors;

(b) the defence of not authorising the incurring of the debt allowed directors to escape liability through lack of due diligence;

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46 Hon Michael Lavarch, Attorney-General, *News Release* 7/94, 17 February 1994.

(c) proving insolvency at the relevant time was fraught with difficulties.

Corporations Law since June 1993

4.1.15 The amendments to the *Corporations Law* made by the *Corporate Law Reform Act* that touch on directors and managers being liable personally for company debts are:

(a) the civil penalty provisions in new Part 9.4B, discussed above; and

(b) the provisions for the recovery of property or compensation for the benefit of creditors of insolvent companies in new Part 5.7B.

4.1.16 The main components of new Part 5.7B are:

(a) transactions by the company that are voidable, as against the liquidator, replacing the previous incorporation of sections 120–125 of the *Bankruptcy Act* 1966—sections 588FA–588FJ

(b) directors' duties to prevent insolvent trading and their liability to compensate the company—sections 588G–588U and 588Y

(c) the liability of holding companies for insolvent trading by subsidiary companies—sections 588V–588X.

4.1.17 New sections 588G–588U and 588Y are of particular relevance to this aspect of the Committee's terms of reference.

4.1.18 To overcome difficulties in proving that a company was insolvent at the relevant time, section 588E prescribes the following rebuttable presumptions as to insolvency:

(a) If it is shown that the company was insolvent on any particular date within 12 months preceding the winding up, it is presumed the company was insolvent from that date until it was wound up;

(b) Where the company has failed to keep adequate section 289 accounting records, the company was insolvent for the period of inadequate or absent records;

(c) If insolvency has been proved in one proceeding, it is presumed in subsequent proceedings that insolvency has been made out.

4.1.19 New section 588G provides that directors have a duty to ensure that a company does not incur a debt while insolvent nor that it become insolvent by the incurring of the debt. Where there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, and a director breaches the duty to avoid insolvent trading, the director may be liable personally for the debt.

4.1.20 As noted above, section 588G is a civil penalty provision for the purposes of new Part 9.4B. Accordingly, by sections 588J and 588K, in proceedings for civil penalties or criminal penalties, respectively, the Court may order the director to pay compensation to the company and the liquidator may intervene in the proceedings to be heard on that question.

4.1.21 Section 588M allows liquidators to bring recovery actions against directors for compensation with respect to loss or damage suffered by creditors as a result of insolvent trading by directors.

4.1.22 Section 588Q provides for the use of certificates issued by the Courts (in civil penalty and criminal proceedings) as conclusive evidence that section 588G has been contravened.

4.1.23 Under sections 588R–588U, individual creditors may sue directors to recover losses incurred by insolvent trading where:

(a) the liquidator gives the creditor written consent to bring the action; or

(b) the creditor gives written notice to the liquidator of an intention to bring a section 588M action; and

(c) the liquidator has not consented to the creditor's action and the creditor obtains the leave of the Court to bring the action.

4.1.24 However, by section 588V, individual creditors' actions cannot be brought where the liquidator has commenced proceedings under the voidable transaction provisions or the insolvent trading provisions with respect to the same debt, or the company (or liquidator) has intervened in civil penalty proceedings to seek compensation for the same contravention.

4.1.25 By section 588Y, any amounts recovered as compensation by liquidators under sections 588J (application for civil penalty order), 588K (criminal conviction),

588M (insolvent trading) or 588W (holding company—insolvent trading) are not available to pay a secured debt until all unsecured debts are paid in full.

4.1.26 The main differences between sections 592 and 593 and the successor insolvent trading provisions in sections 588G–588U and 588Y are:

(a) The liability of directors for insolvent trading debts will be easier to establish due to the presumptions of insolvency and the lowering of the tests of liability. However, on the second aspect, it is arguable that recent case law on sections 592 and 593 leads to the same position as the new provisions.

(b) Actions are to be brought primarily by liquidators and amounts recovered will be available for distribution to all unsecured creditors. This was recommended in the *Harmer Report.*

(c) Only directors, as opposed to persons involved in the management of companies, will be liable for insolvent trading debts. Again, this was recommended in the *Harmer Report.*

(d) The new recovery provisions are intermeshed with the new civil penalty provisions.

4.1.27 It is difficult to decide whether the new insolvent trading provisions provide "appropriate remedies against directors and effective execution against directors' personal assets" so early in their operation. As several submissions pointed out, until a more substantial body of case law has developed on those sections it will not be possible for the Committee to make a considered assessment.

Submissions and Evidence

4.1.28 The Committee was told that the new Act provides an extended range of remedies against directors and managers, which will be more appropriate than before.[47] While it was a problem that the existing laws were inadequately enforced,[48] it was submitted that in recent decisions the existing provisions (sections 232 and 592) are being applied more stringently by the courts.[49]

47 *Submission 10,* Ferrier Hodgson, *Submission 14,* Duesburys.
48 *Submission 9,* Baker & McKenzie.
49 *Submission 10,* Ferrier Hodgson.

4.1.29 The Committee was urged to bear in mind, however, that only directors of companies trading insolvently should be personally liable, and that if the failure of companies to meet their financial obligations is beyond the control of directors they should not be personally liable.[50]

4.1.30 On the other hand it was suggested to the Committee that court decisions relating to $2 companies should be routinely enforced against the directors.[51]

4.1.31 It was pointed out that among the difficulties with the previous and current law were the excessive cost to unsecured creditors of enforcing their legal rights,[52] and the lack of funding for liquidators to pursue recovery, particularly with respect to assetless companies.[53] While the *Corporations Law* now provides for compensation from directors, an application to the Court is still required, and the costs and delays involved may operate as a disincentive.[54]

4.1.32 The Committee has not had an opportunity to examine the changes in legal aid procedures in civil matters announced by the Attorney-General at the end of May 1994, but it is possible that these changes may assist some creditors in recovering from company directors where costs are the barrier.

4.1.33 Additional difficulties arise from the potential liability of liquidators for costs, and the power of the Court to require them to give security for costs.[55] The disincentive to liquidators could be diminished by amending s.24 of the *Supreme Court Act* 1986, which gives the Court full discretion as to costs, so as to put liquidators in a special category. The section at present states:

24. ***Costs to be in the discretion of Court***

(1) Unless otherwise expressly provided by this or any other Act or by the Rules, the costs of and incidental to all matters in the Court, including the administration of estates and trusts, is in the discretion of the Court and the Court has full power to determine by whom and to what extent the costs are to be paid.

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50 *Submission 14,* Duesburys.
51 *Submission 18,* Mr Ranken.
52 *Submission 9,* Baker & McKenzie.
53 *Submission 10,* Ferrier Hodgson.
54 *Submission 11,* Coopers & Lybrand.
55 Mr Reinhardt, *Hansard,* 22 March 1993, page 17; cf *Quickset Concrete Constructions Pty Ltd (in liquidation) v Jayburn Pty Ltd* (unreported, Supreme Court of Victoria, N° 8108 of 1993, 26 October 1993, Ormiston J), where the liquidator *was* required to give security.

(2) Nothing in this section alters the practice in any criminal proceeding.

4.1.34 One procedural innovation which could assist creditors to gain execution against directors' assets would be a statutory injunction to preserve the asset in question and to keep it in the jurisdiction, along the lines of the common law Mareva injunction, which "is designed to freeze all the assets of a defendant where you are able to show you have a good cause of action against the defendant and that the balance of convenience favours you over the defendant, and that there is a real risk that if the court does not make an order the defendant will move the assets offshore or will dispose of or otherwise deal with the assets" to defeat a just claim.[56]

4.1.35 A statutory form of injunction "will be resisted in the community but ... one needs to even it up a bit, perhaps to put the onus onto the person who *prima facie* is in possession of the assets to justify why it is that the assets should not be frozen".[57]

4.1.36 Normally a Court would require a plaintiff seeking an injunction, such as a Mareva injunction, to give an undertaking as to damages, so that if the action ultimately fails and the injunction has caused the defendant loss in the meantime, the plaintiff will compensate the defendant for that loss.

4.1.37 For the same reasons as justify a different costs rule for liquidators, the statutory injunction would have to provide that the liquidator should not be required to give an undertaking as to damages. On the other hand, the rights of defendants should not be arbitrarily interfered with, and if the liquidator is to be protected in this way the action should proceed only with the leave of the Court.

4.1.38 The Committee was also urged to review the whole question of civil debt recovery. One submission described the current civil debt recovery procedures as inadequate, inefficient and expensive, based on experience working in debt collection.[58] It was noted that this led to great difficulties suffered by tradesmen in obtaining payment from creditors, particularly builders.[59]

4.1.39 The Committee observes that this issue goes beyond the terms of reference of the current Inquiry, but that the success of any measure to improve creditors'

56 Mr Reinhardt, *Hansard*, 22 March 1993, page 26.
57 Ibid.
58 *Submission* 2, Mrs Peacock.
59 Ibid.

remedies against directors and managers of phoenix companies nevertheless depends crucially on how the law enforces those remedies in practice. This is a substantial question, and requires a separate inquiry.

Conclusions

4.1.40 The *Corporations Law*, as in force from 23 June 1993, appears to the Committee to provide appropriate remedies against directors and their personal assets, when taken in conjunction with the general law on directors' duties to both companies and their creditors. The provisions are now more effective than they were previously, but they do not appear to overreach so as to place entrepreneurship at risk. The Committee cannot yet conclude whether the provisions are appropriate in practice, as this requires a longer period of time to monitor proceedings in the Courts.

4.1.41 It appears, however, that the practical obstacles presented by legal costs, and the lack of funds to enable liquidators to pursue otherwise worthwhile actions, continue to create problems.

4.1.42 In the Committee's view the application to liquidators of the costs rule in s.24 of the *Supreme Court Act* is outmoded. A liquidator is in a special position, with public duties, and there is a strong argument that he or she should not be liable personally for costs in other than exceptional circumstances, nor should a liquidator acting properly be required to give security as to costs or, in the injunctive situation, as to damages.

4.1.43 An amendment to this effect would not alter the power of the Court to award costs against the corporation in liquidation in whose name the liquidator is acting; the intention would be to prevent the awarding of costs against the liquidator in his or her own name, and also to permit the action to proceed notwithstanding that the liquidator, in the company's shoes, is unable to provide security for costs or damages.

Recommendation 8

The Committee recommends that when a liquidator takes a *bona fide* action against directors or managers of a corporation to recover property of the corporation or to secure compensation for the corporation the Court should not be able to make an order for costs or an undertaking as to damages against the

liquidator personally, and the inability of the corporation to provide security for costs or damages should not be a bar to the action proceeding; but that such an action should be subject to the leave of the Court; and that in these circumstances the costs and damages of a successful defendant should normally have priority over all other claims on the corporation's assets.

4.1.44 The Committee accepts the view put to it in evidence that there should be a more effective mechanism to prevent the removal from the jurisdiction of assets of a corporation which should be available for creditors, and to prevent dealing with them in a way inconsistent with the rights of the corporation and its creditors.

Recommendation 9

The Committee recommends that the Victorian Government should seek the support of the Ministerial Council for a change to the *Corporations Law* to create a statutory process analogous to a Mareva injunction to enable the courts to freeze assets of a director or manager which are *prima facie* assets on which the corporation has a just claim.

4.1.45 Paragraph 2.1 of the terms of reference also asks whether the *Corporations Law* provides for *effective execution* against directors and their assets. This is an essentially different question. It raises a whole new area of inquiry as to methods of enforcement of money judgments in general, which is much wider than the scope of the Committee's present Inquiry.[60] It is a question of great importance, both in itself and for the aims of this Inquiry,[61] and is deserving of a separate and substantial investigation beyond the current resources of this Committee. As some of the submissions imply, it is no use providing remedies in the *Corporations Law* if they are to be rendered nugatory because judgments cannot be enforced.[62]

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60 See, eg, the Australian Law Reform Commission's report *Debt Recovery and Insolvency* (Report N° 36, 1987) and the two substantial volumes of the report of the Alberta Law Reform Institute, *Enforcement of Money Judgments*, Report N° 61, March 1991.

61 See paragraph 4.1.36 and *Submission 2*, Mrs Peacock.

62 See, eg, *Submission 18*, Mr Ranken and *Submission 1*, Geoffrey Crowder, John Crowder & Sons Pty Ltd.

Recommendation 10

The Committee recommends that the enforcement of money judgments be made the subject of a separate inquiry.

4.1.46 Some aspects of the question of *effective execution* are touched on below, however, such as the investigatory tools provided by modern technology in the Titles Office, and other ways of identifying assets of the impugned directors.

Para 2.2 Whether the *Corporations Law* provides appropriate means of tracing, for the benefit of creditors, assets divested by company directors

4.2.1 Apart from the relevance of:

(a) section 483(1)—power of the Court to order officers or agents of the company to deliver to the liquidator property in their hands to which the company is *prima facie* entitled;

(b) section 474—vesting of company's property in the liquidator upon a winding up;

(c) new sections 588FA–FJ—voidable transactions

the *Corporations Law* does not provide specifically for the tracing of divested company assets.

4.2.2 New sections 588FA–FJ are only relevant to the extent that they allow liquidators to avoid certain company transactions and defeat the title of third parties acquiring company assets, thus allowing for recovery by liquidators on behalf of creditors.

4.2.3 The tracing of divested company assets into the hands of third parties, and the recovery of those assets by a liquidator or creditor, is dealt with by the doctrines of tracing at common law and in equity.

4.2.4 In a non-technical sense paragraph 2.2 of the terms of reference is also concerned with locating, or ascertaining the existence of, assets which might be, by tracing in the technical sense, brought back for the benefit of creditors.

4.2.5 There are a number of ways that State law facilitates such searches, such as the LANDATA system that enables the Titles Office to search the Register by name; this facility is available to the public at a nominal fee. This makes it easy to find whether a person owns any land, at least in their own name. Coupled with the rather more expensive Dun & Bradstreet Executive Search,[63] which can reveal all directorships, and certain shareholdings, currently or previously held by the person,

63 See paragraph 3.3.9 above.

the Titles Office search facility can enable the tracking down of many of a person's direct and indirect interests in land, and thus assist the creditors in deciding whether it is worthwhile to pursue the available remedies.

4.2.6 There are, moreover, a number of provisions in the *Corporations Law* designed to assist liquidators, regulators and enforcers in obtaining information relevant to the practical exercise of tracing and identifying divested company assets. These relate to the powers of liquidators to examine company officers, obtain company books and to apply for warrants to search for company property or books.

4.2.7 Powers of this nature are provided for both in the previous provisions of the *Corporations Law* and in the amendments made by the *Corporate Law Reform Act*.

Corporations Law before June 1993

4.2.8 Sections 474 (custody of company property) and 483 (delivery up of company property) have already been mentioned.[64]

4.2.9 Provisions relevant to the obtaining of information by liquidators on divested company assets include the following sections:

(a) 477—general powers of liquidators;

(b) 487—court orders to arrest absconding contributories;

(c) 488—powers of liquidator as an officer of the Court;

(d) 534—prosecution of delinquent officers and members;

(e) 535—qualified privilege of liquidators;

(f) 597—examination of persons concerned with corporations;

(g) 598—Court orders against persons concerned with corporations, including orders to transfer company property.

4.2.10 Similar provisions also apply with respect to Receivers (Part 5.2) and Official Managers (Part 5.3).

64 Paragraph 4.2.1.

4.2.11 In addition, the ASC has substantial investigatory powers under the *Australian Securities Commission Act* 1989.

***Corporations Law* since June 1993**

4.2.12 The following sections were introduced by the *Corporate Law Reform Act*:

(a) 486A—powers of the Court to make orders preventing company officers or related entities from avoiding liability to a company, including orders prohibiting the removal of company property from the jurisdiction;

(b) 486B—Court orders for the arrest of persons avoiding obligations in connection with the winding up;

(c) 530A—company officers to assist liquidators;

(d) 530B—liquidator's right to company books;

(e) 530C—powers of the Court to issue warrants for searching and seizing company property and books;

(f) 596A—requires Court to order examination in certain circumstances.

4.2.13 Further, administrators appointed under the provisions of new Part 5.3A for the administration of company affairs with a view to executing a deed of arrangement have similar powers to those available to liquidators.

4.2.14 This aspect of the Committee's terms of reference has involved the consideration of:

(a) the doctrines of tracing at common law and in equity and their application to insolvency situations;

(b) the substantive and procedural law governing the granting of injunctive relief;

(c) the voidable transaction provisions of the *Corporations Law*, as amended;

(d) provisions in the *Corporations Law*, as amended, dealing with the powers of liquidators and the Courts to obtain information on the divesting of company assets;

(e) the investigatory powers of the ASC and the prosecution and enforcement powers of the Federal Director of Public Prosecutions.

4.2.15 The Committee heard that "there is nothing in the *Corporations Law* ... to actually provide for tracing as such. The rules of tracing have been developed by common law or equity courts and there is nothing in any of the legislative provisions that would assist directly the concept of tracing,"[65] and furthermore, "The question for consideration is whether there should be some attempt at codification of the various circumstances in which courts allow tracing to take place... whether one should not create a code of tracing rules. Of course, the problem with codifying is that lawyers have to interpret it, and, as we all know, interpretation is something that lawyers love to get their teeth into. That can create more problems than imaginable. Perhaps it is best to leave it to the courts."[66]

4.2.16 Submissions to the Committee agreed that the general law as to tracing should be left to common law and equity, and should not be supplanted by the *Corporations Law*.[67] In so far as the *Law* did deal with tracing issues it was adequate, if basic;[68] although the problem of funding liquidators to take advantage of the existing law was again pointed out.[69]

Conclusions

4.2.17 The Committee agrees with the tenor of the submissions and evidence that the *Corporations Law* should not attempt to codify the complex general law relating to tracing, which is best left to the common law and equity courts.

4.2.18 Taking the alternative view, using tracing as a lay term, the Committee considers that the *Corporations Law* now probably makes adequate provision for the examination of persons, the protection of property against removal, and the voiding of transactions. The Committee would welcome submissions as to the value of these and related provisions in enabling the location of property of the directors which should be made available to the creditors. Further experience of their use will reveal whether the new provisions are effective in practice.

65 Mr Reinhardt, *Hansard*, 22 March 1993, page 2.
66 Ibid., page 19.
67 *Submission 10*, Ferrier Hodgson; *Submission 5*, Jack Dickinson, Citizen; *Submission 14*, Duesburys; *Submission 11*, Coopers & Lybrand.
68 *Submission 14*, Duesburys.
69 *Submission 5*, Jack Dickinson.

Para 2.3 Jurisdiction of the Supreme Court and Federal Court as forums for civil actions against directors

4.3.1 Section 42 of the *Corporations (Victoria) Act* 1990 confers jurisdiction on the Federal Court and Supreme Courts of the States and Territories "with respect to civil matters arising under the *Corporations Law*". The Act, however, confers jurisdiction with respect to criminal matters under the *Corporations Law* on lower courts.

4.3.2 A number of judicial decisions in late 1992 and early 1993 have given a literal interpretation to section 42, holding that section 592 actions against directors cannot be brought in the County Court[70] or the Magistrates' Courts,[71] notwithstanding that the corresponding *Companies Code* matters were routinely heard in the lower courts.

4.3.3 The various causes of action discussed in relation to the terms of reference are, by express terms or by necessary implication, "civil matters arising under the *Corporations Law*."

4.3.4 The position remained unaffected by the *Corporate Law Reform Act* 1992, and the jurisdictional issue has been on the Ministerial Council's agenda, resulting in the Corporations Legislation Amendment Bill released on 17 December 1993, which is expected to have been enacted by early June 1994.

4.3.5 The Corporations Legislation Amendment Bill 1994 confers on lower courts "civil jurisdiction in respect of corporate law claims relating to debt recovery or monetary compensation".[72] This jurisdiction "will also be subject to the monetary limits which generally apply".[73] It will not extend to cases which "would involve high level discretionary powers that should be confined to superior courts (such as approval of complex schemes of arrangement for a corporate group)."[74]

4.3.6 This aspect of the terms of reference requires consideration of:

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70 *Sky Channel Pty Ltd v Gray* (1992) 39 ACR 62; 115 ALR 224; 9 ACSR 519; 11 ACLC 22 (Federal Court, Lee J); and see also *Darham Administration Pty & Anor v Jolly & Anor* (unreported, County Court N° MC 924234 of 1992, decision of 16 December 1992, Judge F B Lewis).

71 Eg, *Edwardstown Carpets (Reg) v Churcher & Churcher* (1993) 10 ACSR 405; 11 ACLC 393.

72 *Explanatory Memorandum*, paragraph 13.

73 Ibid., paragraph 14.

74 Ibid., paragraph 13.

(a) the costs and time involved in bringing civil actions in the higher courts;

(b) the complexity of the legal and factual issues involved in such actions;

(c) court processes for the disposition of commercial actions;

(d) the possible use of alternative dispute resolution processes.

Submissions

4.3.7 Several submissions referred to the high costs for creditors and liquidators of litigating in the Supreme and Federal Courts, the long delays involved, and to the problems of lack of funds for liquidators of assetless companies.[75]

4.3.8 Some implied[76] or expressly submitted[77] that the County Court should again have jurisdiction to hear civil actions against directors arising out of the company's activities, as it had before the *Corporations Law* came into force on 1 January 1991. Such jurisdiction should either be unlimited or limited to $200,000,[78] and should be on the basis that if a transaction gives rise to a cause of action triable in the County Court then a jurisdiction in relation to associated causes of action against directors accrues even if the amount claimed would exceed the County Court's jurisdictional limits.[79]

4.3.9 Some submissions urged that jurisdiction to hear relevant *Corporations Law* civil matters should be extended to the Magistrates Courts.[80] If so the current jurisdictional limit of $25,000 would apply unless it were expressly increased.

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75 Eg, *Submission 10*, Ferrier Hodgson; *Submission 9*, Graham Sherry, Managing Partner, Baker & McKenzie.

76 Eg, *Submission 10*, Ferrier Hodgson; *Submission 9*, Graham Sherry, Managing Partner, Baker & McKenzie; *Submission 14*, R G Mansell, Partner, Duesburys; *Submission 11*, Coopers & Lybrand.

77 *Submission 16*, County Court of Victoria.

78 This is the County Court's existing jurisdictional limit in matters other than personal injury matters.

79 *Submission 16*, County Court of Victoria.

80 Eg, *Submission 10*, Ferrier Hodgson; *Submission 9*, Graham Sherry, Managing Partner, Baker & McKenzie.

4.3.10 One submission, however, put the view that jurisdiction with respect to *Corporations Law* matters should rest exclusively with the Supreme and Federal Courts.[81] This was because:

- Decisions are recorded and may therefore be relied upon to ensure consistency and certainty;
- The complex nature of cases and the amounts in issue mean that even if jurisdiction were conferred on lower courts, the same solicitors and counsel would need to be retained as is presently the case, and therefore substantial cost savings are unlikely to be achieved.
- If jurisdiction were conferred on lower courts an increase in appeals is likely, thereby leading to further delays and expense.

Conclusions

4.3.11 The Committee agrees with the view expressed in the majority of the submissions that the lower courts should have jurisdiction. In the light of the decision of the Ministerial Council to proceed by the Corporations Legislation Amendment Bill 1994 with the extension (or restoration) of jurisdiction to the lower courts in accordance with the Committee's view, the Committee does not need to make any further recommendation.

81 *Submission 15*, The Honourable Chief Justice Phillips of the Victorian Supreme Court.

Para 2.4 Other safeguards for the protection of creditors

4.4.1 In addition to a consideration of the provisions of the *Corporations Law* in the areas noted above, as amended by the 1992 Act, and the possibility of suggestions for further amendment or improvements in those areas, under this aspect of the terms of reference the Committee has given consideration to:

(a) The creation of an *Assetless Company Fund* or *Liquidators' Recovery Trust Fund*, as recommended in the *Harmer Report*, to provide a funding base for initial investigations by liquidators of assetless companies.

(b) The concept of a "close corporation", as envisaged by the *Close Corporations Act* 1989 (inoperative), whereby limited liability can be lost where the corporation fails to comply with statutory requirements. The Act proposed that a levy on persons setting up close corporations be used to establish the *Liquidators' Recovery Trust Fund*.

(c) Qualifications and possible training requirements of directors and managers of companies.

(d) Increased publicity and awareness of the duties of directors and managers of companies and of the rights of shareholders and creditors.

(e) The administration and enforcement of the *Corporations Law*.

(f) The role of liquidators and others in protecting the interests of creditors.

(g) Possible legislative reforms in other areas outside the *Corporations Law*.

(h) Processes and types of external administration for insolvent or near-insolvent companies.

(i) The relationship between the *Bankruptcy Act* 1966 and the *Corporations Law*.

4.4.2 The Committee has also considered whether the law in France and Germany may offer some suggestions. In these countries, however, the laws of insolvency and bankruptcy are not separate; furthermore, there is no discharge from bankruptcy until the debts are paid, and this is inconsistent with the principles upon which our law is based.

4.4.3 One rule of German law which would act as a significant barrier to the phoenix phenomenon and other misuses of the corporate form, but might equally arouse a storm of protest if proposed here, is the requirement for a minimum capitalisation for a limited liability company. The minimum is 50,000 DM, which would be of the order of $40,000.

Submissions and evidence

A Restriction on use of similar names

4.4.4 It was suggested to the Committee that restrictions on the transfer or use of the same or similar names should be introduced to prevent directors of a failed company transferring its business to a new legal entity with a similar name, or using the original business name, but no liabilities attaching.[82] An appropriate model was contained in sections 216 and 217 of the *Insolvency Act* 1986 (UK).[83]

4.4.5 Although the Committee was urged to recommend the amendment of the *Corporations Law* to this effect,[84] the Committee notes that business names, unlike company names, are within state jurisdiction, and could be dealt with by Victoria alone.

B Funding for liquidators

4.4.6 Several submissions made the point that there are problems with funding for liquidators to pursue recovery, particularly with respect to assetless companies.[85] The Committee was told that "it is common" for companies to be wound up inadequately because the liquidator lacked funds,[86] and that in such cases "the recovery of property legitimately the property of the company was stymied by the fact that the liquidator did not have resources available to him or her to take proceedings".[87]

82 *Submission 10*, Ferrier Hodgson; *Submission 17*, Law Council of Australia.
83 *Submission 17*, Law Council of Australia.
84 Ibid.
85 *Submission 10*, Ferrier Hodgson; *Submission 14*, Duesburys; *Submission 17*, Law Council of Australia.
86 Mr Reinhardt, *Hansard*, 22 March 1993, page 9.
87 Ibid.

4.4.7 It was submitted that a mechanism needs to be established which enables liquidators of assetless companies to be provided with funds to take action,[88] and that consideration should be given to establishing an "Assetless Companies Fund" as recommended by the Australian Law Reform Commission in the *Harmer Report* (1988).[89]

4.4.8 Section 564 of the *Corporations Law* is intended to encourage creditors to fund liquidators, or give them an indemnity for costs of litigation. It permits the Court to give creditors who do so "an advantage over others in consideration of the risk assumed by them". The difficulty, however, is that the case law on this section (or its predecessor, s.450 of the *Companies Code*) means that this preference is postponed to the natural preference of, for example, secured creditors and employees. This section cannot work if the creditors who take the risk can have the rewards given to others first.

C Education of directors and others

4.4.9 Several submissions identified the need for directors to be educated in their responsibilities.[90] It was also suggested that better education for creditors would help prevent later losses.[91]

4.4.10 The Committee was told that intending company directors should be required to attend a course where their duties and liabilities could be explained in depth.[92] This was necessary to ensure they were aware of their obligations, and to understand the financial aspects of their business.[93] An appropriate length for such a course would be two to five days.[94] (Presumably a course might be taken by correspondence, but a test in person.) Persons with appropriate qualifications might be exempted from the requirement.

88 *Submission 14*, Duesburys; see also Mr Reinhardt, *Hansard*, 22 March 1993, page 12 (suggesting a levy on "successful" liquidations).

89 *Submission 17*, Law Council of Australia.

90 *Submission 10*, Ferrier Hodgson; *Submission 11*, Coopers & Lybrand.

91 *Submission 11*, Coopers & Lybrand.

92 *Submission 10*, Ferrier Hodgson.

93 *Submission 11*, Coopers & Lybrand.

94 *Submission 10*, Ferrier Hodgson (two days); *Submission 11*, Coopers & Lybrand (two to five days).

4.4.11 Persons who have been disqualified as directors ought to be required to attend, and complete satisfactorily, such a course, regardless of their previous qualifications, before they could be permitted to direct or manage companies again.

4.4.12 It was also suggested that directors should be notified by letter of the latest amendments to the *Corporations Law* and warned of the penalties for breach.[95]

D Role of Licensing Boards

4.4.13 One submission described an example of a phoenix company where the directors' ability to escape their company's debts depended on a licensing body transferring a licence from the failed entity to the debt-free entity.[96]

4.4.14 In this case, the Committee was told, a real estate company ceased trading, with substantial debts arising out of litigation, and applied to place the company in liquidation. On the same day a similarly named company advertised an application for and received a licence from the Estate Agents Board. That company now carries on the same business, from the same address, with the same telephone number, same staff and, it appears, same directors.[97] The implication of this submission is that licensing bodies such as the Estate Agents Board should be required to take notice of and not condone directors or managers who walk away from insolvent companies.[98]

E Publicity

4.4.15 Several submissions made suggestions whose common theme is that greater publicity for defaulting directors and companies would better enable potential creditors to protect themselves.

4.4.16 A call for a requirement that all private companies should be required to lodge financial statements at the ASC is an example of this theme, as is a call for greater publicity for actions taken by the ASC against defaulting directors,[99] and

95 *Submission 10,* Ferrier Hodgson.
96 *Submission 1,* Geoffrey Crowder, John Crowder & Sons Pty Ltd.
97 Ibid.
98 Ibid.
99 *Submission 14,* R G Mansell, Partner, Duesburys.

likewise a proposal[100] that directors involved in failed companies over the last 10 years should include details of such companies on letter heads.

F Other issues

4.4.17 Another submission noted the plight of certain innocent bystanders, and urged that there should be more protection for tenants of companies which are in receivership or have defaulted to financial institutions to prevent tenants who have paid their rent in good faith from being evicted from the company's property.[101]

Conclusions

4.4.18 The Committee considers that placing restrictions on the re-use by the former directors and managers, except with the leave of the court, of business or company names similar to those of the failed company, would be a worthwhile initiative. The provisions of ss.216 and 217 of the *Insolvency Act* 1986 (UK) are contained in Appendix C. Such an approach is recommended. Such a reform could be implemented, at least as to business names, by Victoria alone; it would be most effective if the reform were adopted nationally, however.

Recommendation 11

The Committee recommends that Victoria legislate to place restrictions on the use of business names similar to those of a failed corporation by persons associated with the failed corporation, except by leave of the court, based on sections 216 and 217 of the *Insolvency Act* 1986 (United Kingdom); and that the Victorian Government seek to persuade the other Australian jurisdictions to do likewise.

4.4.19 The Committee considers that the *Harmer Report*'s proposed Assetless Companies Fund, to provide sufficient funds for proper liquidators' reports, and proper investigation of the possibility of recovering against directors, could be a valuable reform, and if so would be best done by encouraging the Ministerial Council to adopt it within the *Corporations Law* framework. The Committee is concerned, however, not to place any further impost on business if it can be helped,

100 *Submission 5*, Jack Dickinson.
101 *Submission 4*, Eaglehawk & Long Gully Community Health Centre.

and although a small surcharge, say $10, on an existing universal fee such as that on the Annual Return would yield some $8 million at little extra administrative cost, the benefits to business generally are hard to quantify.

4.4.20 It is possible, however, that Victoria could take some initiatives of its own towards this proposal, by setting up a pilot scheme in the State Revenue Office to evaluate the costs and benefits likely if liquidators of assetless companies are better funded: see paragraphs 5.1.8–11 below.

4.4.21 Education of directors is clearly desirable, and there are some possibilities for State initiatives through Small Business Victoria's existing education programs, and encouragement of other training initiatives. Notwithstanding the enthusiasm of several submissions for better training of directors, however, the Committee is not convinced that rapid progress could be made or should be attempted. This is an area for steady but low-key encouragement.

4.4.22 More widely available education and advice for small businesses (and individuals) to enable them better to protect themselves against giving credit inappropriately or without safeguarding themselves would also be worthwhile, and within Victoria's competence. This is another area where an agency such as Small Business Victoria has a role to play. It already provides materials and is involved in training for small businesses in financial management generally, and this includes credit management and credit assessment. A specific initiative, or just a pilot program, would fit well within the organisation's framework.

Recommendation 12

The Committee recommends that the Victorian Government fund Small Business Victoria to investigate the dimensions of the risk to small business posed by the phoenix company phenomenon, and to develop and evaluate a training package to help small businesses improve their credit assessment and credit management.

4.4.23 The Committee considers that State licence or registration bodies should take account of the conduct of any applicant, or any director or manager of an applicant, in relation to the non-payment of creditors in corporate insolvencies. This process must not interfere with a person's livelihood, but should be directed at the

management of corporations and the protection of creditors. Any reform in this area must also be sure not to invite the abuse of such bodies to litigate (or relitigate) in inappropriate forums matters of corporations law. The Committee would welcome further submissions on how this balance can be struck.

Recommendation 13

The Committee recommends that the Victorian Government investigate requiring State licensing and registration bodies to take account of a person's previous involvement with a company which failed without paying its creditors.

4.4.24 Such an investigation by the Government would be based on a consideration of what licensing and registration bodies should do, and would not preclude the Committee making its own inquiries from the perspective of its present terms of reference.

4.4.25 The Committee notes that in two instances recently the corporate veil has been unequivocally lifted to impose liability on directors. By new clause 8A of Schedule 7 of the *Magistrates' Court Act* 1989, inserted by the *Magistrates' Court (Amendment) Act* 1994, penalty notices can be enforced against a director of a corporation, if execution cannot be satisfactorily levied on the corporation's assets, and subject to certain procedural safeguards. Similarly, the directors of a corporation are now liable for its group tax payments if the corporation defaults.

4.4.26 The Committee is not at this stage prepared to recommend any wholesale extension of these precedents.

Para 3.1 The means by which Victoria might implement any recommendations arising out of the Inquiry

5.1.1 The means to be adopted for implementing any recommendations for change will, of course, depend on the nature of those recommendations.

5.1.2 For example, recommendations on reforming powers and procedures for the granting of injunctive relief, or on the application of the costs rules to liquidators, would involve amendments to the *Supreme Court Act* 1986 and the *Rules of the Supreme Court, Civil Procedure,* 1986.

5.1.3 The Committee has recommended by Recommendation 8 certain changes to court procedure. These can be implemented by the Victorian Parliament.

5.1.4 Recommendation 11, concerning the use of similar business names, likewise involves the Government introducing legislation into the Victorian Parliament. This recommendation also involves the Victorian Government in seeking to persuade other states to introduce similar legislation, but does not depend on this occurring.

5.1.5 Not all of the Committee's recommendations involve legislation, and these can be adopted by the Victorian Government without disturbing the national *Corporations Law.*

5.1.6 Recommendation 12, to involve Small Business Victoria in a specific training program for small businesses, is one which the Government can act on without legislation or interstate negotiation.

5.1.7 The Committee has also identified problems in the existing law concerning the enforcement of money judgments, which should be the subject of a separate inquiry: Recommendation 10.

5.1.8 Several of the submissions referred to the need for greater publicity for lists of disqualified persons, and for the penalties and obligations involved. Some of this could be attended to by Victoria without need for amending the *Corporations Law* and without causing inconvenience to business or upsetting the other jurisdictions.

5.1.9 Other submissions and subsequent discussions referred to the need to educate or inform both directors and creditors, and this too could be implemented by Victoria without breaching the national regime of the *Corporations Law.*

Government as Major Creditor

5.1.10 The Committee has already noted that market forces do not act to encourage accountancy firms, acting as liquidators of assetless corporations, from investigating the possibility of proceeding against directors. This is because there is no possibility of the entrepreneurial risk taken in such investigations being repaid by the amounts recovered in any successful cases, as the liquidator under current law is only entitled to his or her fees, case by case.

5.1.11 The only participant who could make a profit on such an exercise would be a creditor in numerous corporate collapses, with the resources to fund liquidators to do the necessary preliminary work. Such a role could well be filled by the Victorian Government.

5.1.12 In its submission to the Committee the Government noted that many hundreds of insolvent corporations each year owe tens of millions of dollars in payroll tax and in WorkCare or WorkCover premiums.[102]

5.1.13 The Committee therefore suggests that the State Revenue Office should explore the feasibility of, or perhaps institute a pilot project, funding liquidators in cases where there may be a chance of proceeding against directors. The Committee notes that this suggestion has been received favourably by officers of the State Revenue Office, although there are some practical difficulties. In particular they consider that there may need to be a priority for the creditor who funds the liquidator, so that the scheme could be revenue positive overall. To some extent this might be arranged by negotiation, but that is an unnecessarily costly and time-consuming way of achieving the result.

102 *Submission 21,* Victorian Government.

5.1.14 The Committee notes that if such a scheme is successful it will have benefits not only for the Government as creditor, but also its success will mean that some small business creditors will have a chance of being paid which would not otherwise exist.

Recommendation 14

The Committee recommends

- **that the Government allocate funds to establish a 12 month pilot program within the State Revenue Office or the WorkCover administration to provide funds to liquidators to do more detailed investigations and reports on failed companies where there may be an action against the directors or managers, and where appropriate to take action to recover assets from them**
- **that the goal of the pilot be to assess whether successful recovery actions would recover sufficient money (where the debts would previously have been written off) to cover the costs of the unsuccessful investigations and actions**
- **that the Government report to the Parliament within twelve months of the conclusion of the pilot program whether the pilot program meets its objectives, giving details of the cost, the number of phoenix companies detected, the amounts recovered for the State, and the amounts recovered for business creditors who would otherwise have got nothing.**

The National Corporations Regime

5.1.15 Some of the Committee's recommendations would involve changes to the *Corporations Law*. As the submissions and evidence to the Committee warned, this is a national scheme, and Victoria should not take unilateral action.

5.1.16 Following the successful constitutional challenge to the *Corporations Act* 1989, the Commonwealth and the States agreed that:

(a) the 1989 Act would become a law of the ACT—"the *Corporations Law*";

(b) the States would pass legislation—the Application of Laws Acts—applying the *Corporations Law* as a State law;

(c) the States would adopt the *Corporations Law* as it stands at any given moment so that amendments automatically apply throughout Australia.

5.1.17 In Victoria the *Corporations Law* is applied as a law of Victoria by Section 7 of the *Corporations (Victoria) Act* 1990.

5.1.18 The national scheme is also achieved by the cross vesting of Court jurisdictions, the application of Commonwealth administrative law, "national" powers being conferred on the ASC and DPP and by use of the expression "the *Corporations Law* or a corresponding law", thus allowing for the legal recognition by one jurisdiction (say, Victoria) of action taken in another jurisdiction (say, New South Wales).

5.1.19 To effect amendments to the *Corporations Law*, it is necessary for any legislative proposals to be approved by the Ministerial Council, comprising Federal, State and Territory Attorneys General. The Commonwealth is not obliged to introduce any legislation proposing amendments to the *Corporations Law* with which it does not agree.

5.1.20 Nonetheless, by section 5(2) of the *Corporations (Victoria) Act* 1990, Victoria can, by express terms, depart from or override the uniform provisions of the *Corporations Law*.

5.1.21 The Committee considers that any proposal to introduce non-uniformity in the *Corporations Law* by unilateral Victorian action would be counterproductive, and would be likely to disadvantage Victorian businesses and to antagonise national businesses with Victorian operations.

5.1.22 As the Committee has already expressed in the wording of its recommendations, Victoria's means of implementation of recommendations affecting the *Corporations Law* should be confined to advocacy in the forum of the Ministerial Council.

Conclusion

5.1.23 The Committee hopes that its recommendations will be acted on in the near future. It has, however, styled this report its First Report on the reference for two

reasons. First, it expects that the proposals it has made will attract numerous responses, and these should be taken into consideration before the problem of the phoenix company can be considered adequately dealt with. The second reason is summed up in the submission of the Honourable Chief Justice Phillips of the Victorian Supreme Court,[103] who said that in respect of many of the Committee's terms of reference it would be desirable to wait and assess the impact of the amendments to the *Corporations Law* before suggesting further changes. The Committee agrees.

5.1.24 The Committee intends to make a second report on the present terms of reference. This will enable it, inter alia, to take into account the responses to this First Report and the results of cases before the courts using the amendments to the *Corporations Law* introduced by the *Corporations Law Amendment Act* 1992 in June 1993. It therefore invites submissions on its discussion and recommendations.

103 *Submission 15.*

APPENDIX A LIST OF SUBMISSIONS

Nº	*Date of Submission*	*Name*	*Affiliation*
1	January 1993	Geoffrey Crowder	John Crowder & Sons Pty Ltd
2	25 January 1993	Mrs Jane Peacock	Citizen
3	9 February 1993	R G Mansell	Partner, Duesburys
4	25 February 1993	Eaglehawk & Long Gully Community Health Centre	
5	15 March 1993	Jack Dickinson	Citizen
6	17 March 1993	Cornwall Stodart	
7	24 March 1993	D McKee	Acting Commissioner, ACT Revenue Office
8	7 April 1993	Australian Securities Commission	
9	8 April 1993	Graham Sherry	Managing Partner, Baker & McKenzie
10	22 April 1993	Terry Taylor	National Development Partner, Ferrier Hodgson
11	28 April 1993	Greg Hodson	Partner, Coopers & Lybrand

Nº	Date of Submission	Name	Affiliation
12	29 April 1993	Anne Moroney	Australian Securities Commission, Regional Office, South Australia
13	4 May 1993	Ron Trevethan	Regional Commissioner for Victoria, Australian Securities Commission
14	7 May 1993	R G Mansell	Partner, Duesburys
15	10 May 1993	The Honourable Chief Justice Phillips	Victorian Supreme Court
16	18 May 1993	Chief Judge Waldron	County Court of Victoria
17	12 July 1993	Law Council of Australia	
18	26 November and 21 December 1993	Arthur B Ranken	Citizen
19	4 March 1994	Brendan Soraghan	National Industrial Officer, Textile Clothing & Footwear Union of Australia
20	11 March 1994	Louise Connor	Joint Secretary, Media Entertainment & Arts Alliance
21	5 April 1994	Hon Jeffrey Kennett	Premier, Victorian Government

Date	*Witness*	*Affiliation*
25 February 1993	Mr Derek White and Mr Terry Weerappha	State Revenue Office
5 March 1993	Professor John Farrar	University of Melbourne
5 March 1993	Mr Brett Mathieson	Ernst and Young
22 March 1993	Mr Greg Reinhardt	University of Melbourne
2 June 1993	Mr Ian Pyman, Mr Ted Woodward and Professor Bob Baxt	Arthur Robinson and Hedderwicks
2 June 1993	Mr Don Cooper Senior Partner	Sly and Weigall
23 June 1993	Mr Don Cooper Senior Partner	Sly and Weigall
23 June 1993	Mr Ron Trevethan Regional Commissioner Mr Pat Whitehouse Executive Director, Investigations	Australian Securities Commission

Appendix C Similar Business Names

C.1 In Recommendation 11 the Committee recommends placing restrictions on the use by persons associated with a corporate failure of similar business names, on the model of the UK *Insolvency Act* 1986, ss.216 and 217.

C.2 In this Appendix the Committee sets out an extract from the submission of the Insolvency Committee of the Business Law Section of the Law Council of Australia, and the text of ss.216 and 217 of the UK *Insolvency Act,* as supplied in that submission. The text of these sections is followed by the annotations supplied with the Act.

A. Sale of Company Name

1. Upon a liquidation or receivership of a company one of the assets of value of the company is often the name of the company itself and/or the registered business name used by the company. The name of a company can only be changed by a special resolution passed by the members of the company and with the approval of the Australian Securities Commission. However any business name associated with or derived from the company name can often be sold for a substantial price and it is presently the duty of an insolvency practitioner to obtain the best possible price for that asset as part of his overall duty to creditors to realise assets.

2. Often it may be the former directors of a company who are prepared to pay the highest price for the name—sometimes because of an over-optimistic view of the value of the reputation built up by the company, but often on sound commercial principles.

3. It is considered by this Committee that the power of the insolvency practitioner to sell the name of a failed company should not be interfered with and cannot be complained of if the sale is made on the open market at the best price obtainable and to a person or persons who have had no association with the failed company. ...

5. The problem of sale of company names to persons associated with the failed company has been addressed in the United Kingdom *Insolvency Act* 1986. We refer you to sections 216 and 217 of that Act. ...

In broad terms, Section 216 prohibits a person from using the name or a similar name to that of a failed company which he or she is or has been a director or "shadow director" for a period of 5 years from the liquidation of the company, without leave of the Court.

This provision prevents former directors or "shadow" directors of the company cashing in on the goodwill of the company by use of its name and also participating in deception of consumers and suppliers which is inherent in having the same persons "front" the company.

In addition to the criminal sanctions, Section 217 imposes personal liability for the debts of the second company should a person be in breach of Section 216 of the Act.

6. It is the view of this Committee [of the Law Council of Australia] that the inclusion of provisions such as Sections 216 and 217 in the *Corporations Law* would remove the worst excesses of this practice and it recommends that consideration be given to reform along those lines.

Phoenix Provisions of UK *Insolvency Act* 1986

216. *Restriction on re-use of company names*

216(1) [Application]

This section applies to a person where a company **("the liquidating company")** has gone into insolvent liquidation on or after the appointed day and he was a director or shadow director of the company at any time in the period of 12 months ending with the day before it went into liquidation.

216(2) [Prohibited name]

For the purposes of this section, a name is a prohibited name in relation to such a person if—

(a) it is a name by which the liquidating company was known at any time in that period of 12 months, or

(b) it is a name which is so similar to a name falling within paragraph (a) as to suggest an association with that company.

216(3) [Restriction]

Except with leave of the court or in such circumstances as may be prescribed, a person to whom this section applies shall not at any time in the period of 5 years beginning with the day on which the liquidating company went into liquidation—

(a) be a director of any other company that is known by a prohibited name, or

(b) in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of any such company, or

(c) in any way, whether directly or indirectly, be concerned or take part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name.

216(4) [Penalty]

If a person acts in contravention of this section, he is liable to imprisonment or a fine, or both.

216(5) ["The court"]

In subsection (3) **"the court"** means any court having jurisdiction to wind up companies; and on an application for leave under that subsection, the Secretary of State or the official receiver may appear and call the attention of the court to any matters which seem to him to be relevant.

216(6) [Interpretation re name]

References in this section, in relation to any time, to a name by which a company is known are to the name of the company at that time or to any name under which the company carries on business at that time.

216(7) [Interpretation re insolvent liquidation]

For the purposes of this section a company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of winding up.

216(8) ["Company"]

In this section **"company"** includes a company which may be wound up under Part V of this Act.

(Former provision: IA 1985, s.17)

General note

This is one of a number of innovations made by IA 1985 which together form a package designed to strike down the "phoenix" phenomenon. This term was used to describe an abuse of the institution of limited liability which, perhaps more than anything else, showed the inadequacies of the former insolvency law in the corporate sector. A company would be put into receivership (or voluntary liquidation) at a time when it owed large sums to its unsecured creditors. Frequently, the receiver was appointed by a controlling shareholder who had himself taken a floating charge over the whole of the company's undertaking, and there was nothing to stop him from appointing a receiver with whom he could act in collusion. The receiver would sell the entire business as a going concern at a knock-down price to a new company incorporated by the former controllers of the defunct company. As a result, what was essentially the same business would be carried on by the same people in disregard of the claims of the creditors of the first company, who in effect subsidised the launch of the new company debt-free. It was not unknown for the procedure to be repeated several times. The use of nominees or "front men" could add to the confusion and help deceive future creditors: on the other hand, advantage could sometimes be gained from using a new company name similar to that of the old company, and cashing in on what was left of its goodwill. The present section is aimed to counter both of these latter aspects of the "phoenix syndrome". It is not based on any of the Cork Committee's recommendations, and was introduced at a late stage during the passage of the Insolvency Bill through Parliament in 1985. It makes the re-use of the name of a company which has been wound up insolvent a criminal offence in the circumstances defined; but it is rather surprisingly confined in its scope to directors and shadow directors of the extinct company. In addition, any such person and any nominee or "front man" through whom he conducts the second business may incur personal liability, without limitation, under s. 217.

S. 216(1)

Many phrases in this subsection have special meanings. "Company" and "gone into insolvent liquidation" are defined in s. 216(8) and s. 216(7) respectively; the "appointed day" is the day on which the present Act came into force (29 December 1986: see ss. 436, 443); "director" and "shadow director" have the meanings ascribed to them by s. 251.

The section is not retrospective so as to apply to liquidations that were already in force when the Act took effect.

The prohibition applies to anyone who has been a director or shadow director of the old company within the 12 months prior to its liquidation, and lasts for the period of five years that follows that event (s. 216(3)).

S. 216(2)

The ban applies to the use of the same name or a similar name: see, further, the note to s.216(6).

It should be emphasised that the present section is not directed against the re-use of an insolvent company's name in itself: there will be no ban on this practice provided that no director of the former company is associated with the second business. It is only *directors* who can contravene the section, and only directors who are liable to punishment. This explains the phrase "a prohibited name *in relation* to such a person".

S. 216(3)

The ban is not restricted to the use of a prohibited name by a newly formed company: an established company (perhaps a member of the same group as the defunct company) may well have a similar name already, or may change its name to a "prohibited" name, with the result that its directors may be caught by this section. (Note that IR 1986, r. 4.230, may give a director an exemption in the former of these cases.)

The court is given power to grant dispensations from the prohibition imposed by this section, which it is likely to do when the insolvency is not linked with any blameworthy conduct on the part of the director concerned. The Rules also specify three sets of circumstances where the section will not apply: see IR 1986, rr. 4.228ff. These are (1) where the whole, or substantially the whole, of the business of an insolvent company is acquired by a successor company and the liquidator (or equivalent office-holder) of the insolvent company gives notice to its creditors under r. 4.228; (2) for an interim period, where an application is made to the court within seven days of the liquidation and the court grants leave not later than six weeks from that date (r. 4.229); and (3) where the second company has been known by the name in question for at least 12 months prior to the liquidation and has not been a dormant company (r. 4.230). All other cases will have to go to the court for authorisation: the relevant rules are rr. 4.226, 4.227. Paragraphs (b) and (c), by the use of the term "indirectly", will be effective to stop a person from controlling another company or carrying on a new business through others as "front" men. In addition, para. (c) makes it clear that it will be an offence to use a prohibited name even where no second company is involved, but in this case the civil consequences prescribed by s. 217 will be applicable.

The phrase "concerned or take part in the management of a company" is not defined, but the note to s. 217 is relevant in this context.

S. 216(4)

On penalties, see s. 430 and Sch 10.

S. 216(5)

For the courts having jurisdiction to wind up companies, see ss. 117 and 120. It is clear that "the court" need not be the same court as that which may have been involved in the liquidation of the old company.

S. 216(6)

This provision should be read with s. 216(2) above. In addition to forbidding the use of an identical name, the section bans a name "so similar as to suggest an association with" the former company. It is likely that this will catch the common and, in many ways, convenient practice of calling a new company by a name such as "John Smith (1986) Ltd", after the original John Smith Ltd has gone out of business. (There will, of course, be no objection to this as long as the first company was wound up solvent.)

The offence is not confined to the use of a prohibited name by a company: an unincorporated business is caught as well (s. 216(3)(c)). Further, the prohibition is not confined to a company's registered name. A company may carry on business under another name. Thus, for example, John Smith Ltd, before it went into insolvent liquidation, may have used the trade name of "City Autos". It will be an offence for a former director of the company to take part in the management of any business using the name "John Smith", or "City Autos", or any name similar to either. It will also be an offence for him to be a director of any company having the registered name "John Smith Ltd" or "City Autos" and also of any other company, X Ltd, if it trades under the name of "John Smith Ltd" or "City Autos"—or a similar name in each case.

It is the last of these possibilities that is most likely to mislead creditors and members of the public generally, i.e. the use of the same trade name by a succession of limited companies.

S. 216(7)

This subsection defines "goes into insolvent liquidation" in terms identical to s. 214(6). See the note to that provision and, for the meaning of "goes into liquidation", s.247(2).

S. 216(8)

The effect of this provision is to include "unregistered" as well as registered companies within the section. See the note to s.220.

217. *Personal liability for debts, following contravention of s.216*

217(1) [Personal liability]

A person is personally responsible for all the relevant debts of a company if at any time—

(a) in a contravention of section 216, he is involved in the management of the company, or

(b) as a person who is involved in the management of the company, he acts or is willing to act on instructions given (without the leave of the court) by a person whom he knows at that time to be in contravention in relation to the company of section 216.

217(2) [Joint and several liability]

Where a person is personally responsible under this section for the relevant debts of a company, he is jointly and severally liable in respect of those debts with the company and any other person who, whether under this section or otherwise, is so liable.

217(3) [Relevant debts of company]

For the purposes of this section the relevant debts of a company are—

(a) in relation to a person who is personally responsible under paragraph (a) of subsection (1), such debts and other liabilities of the company as are incurred at a time when that person was involved in the management of the company, and

(b) in relation to a person who is personally responsible under paragraph (b) of that subsection, such debts and other liabilities of the company as are incurred at a time when that person was acting or was willing to act on instructions given as mentioned in that paragraph.

217(4) [Person involved in management]

For the purposes of this section, a person is involved in the management of a company if he is a director of the company or if he is concerned, whether directly or indirectly, or takes part, in the management of the company.

217(5) [Interpretation]

For the purposes of this section a person who, as a person involved in the management of a company, has at any time acted on instructions given (without the leave of the court) by a person whom he knew at that time to be in contravention in relation to the

company of section 216 is presumed, unless the contrary is shown, to have been willing at any time thereafter to act on any instructions given by that person.

217(6) ["Company"]

In this section **"company"** includes a company which may be wound up under Part V.

(Former provision: IA 1985, s. 18(1)(part), (2)–(6))

General note

This section imposes personal liability on a person who contravenes s. 216 by re-using a prohibited company name. In addition, it makes similarly liable anyone who allows himself to be used as a "front" man or nominee in breach of that section. Since the criminal liability prescribed by s. 216 affects only directors and shadow directors, the category of those who are potentially liable on a civil basis is wider than those who may be convicted of the statutory offence.

Section 217 is drafted in broadly similar terms to CDDA 1986, s. 15, which is also derived from IA 1985, s. 18.

S. 217(1)

Some of the terms used in this provision are defined or explained in the following subsections, in particular "relevant debts", "involved in the management of a company", "is willing to act" and "company".

For a person to be made liable under para. (b), it will be necessary to show that he knew all the facts which are relevant to a contravention of s. 216.

Liability under the section is automatic, not requiring a special application to the court or court order of any sort and, for a case coming within para. (a), not requiring a prior conviction of the director concerned.

S. 217(2)

A person liable under this section is primarily liable, jointly and severally with the company and others concerned, and not in any secondary way.

S. 217(3)

Liability extends not only to debts in the narrow sense but also to all other obligations, such as claims for damages; and it applies to all debts and obligations arising during the relevant time and not merely those incurred by the acts of the person in question.

The phrase "willing to act" is explained in s. 217(5).

S. 217(4)

A director is irrebuttably presumed to be "involved in the management" of a company.

In regard to other persons, the phrase has been the subject of judicial consideration in one or two cases. In *R v Austen* (1985) 1 BCC 99, 528 "management" was held to include both the internal and external affairs of the company, and in particular the raising of finance. In *R v Campbell* [1984] BCLC 83, a management consultant who acted as adviser to the board of a company was ruled to have "been concerned in" and "taken part in" its management. In contrast, in the New South Wales case *Re Magna Alloys & Research Pty Ltd* (1975) (unreported: see the *British Company Law & Practice* Reporter (CCH), ¶29-650) a former director who acted as marketing adviser, and in that capacity attended directors' meetings, was held not to have taken part in the management of the company. In another part of the same judgment (reported (1975) 1 ACLR 203), the court expressed the view that a majority shareholder might so use his influence and position on questions of management as to infringe a prohibition on "taking part in management"; although it was thought that he might be free to vote as a shareholder, even on a "management matter".

S. 217(5)

This provision creates a presumption against a person who has been proved at any one time to have acted on the instructions of another whom he then knew to be contravening s. 216. Once this is shown, he is rebuttably presumed to have been "willing to act" on the other's instructions at any time afterwards.

S. 217(6)

"Unregistered" companies are included by this formula. See the note to s. 230.