# CHAPTER 5

## DIRECTORS' WIDER DUTIES - CREDITORS

### Introduction

5.1 Berle and Means developed the view that company law does not allow (or require) the interests of all the people affected by directors' decisions to be considered. They said that companies were now so massive that they had a great impact on the community generally.[1] Mr Jim Kennan, formerly Attorney-General for Victoria and Chairman of the Ministerial Council for Companies and Securities, told the AULSA Conference in 1987 that there was a need for law makers and others to consider ways in which the law can respond to 'the demands of the modern corporation':[2]

> It is simply not acceptable to argue that because our legal culture is not presently constructed to allow for an extension of directors' duties, we must accept the law as it is.[3]

5.2 Mr Kennan pointed out that although the law as it now stands emphasises the duties directors have to the company and shareholders, the courts have held that they have wider duties, for example, to creditors.[4] This extension has given impetus to suggestions that the scope of directors' duties should be widened to include other groups and interests within the community.

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1. *Berle, Adolf A, and Means, Gardiner C,* ***The Modern Corporation and Private Property*** *(revised ed), Harvest, USA, 1968, p 313.*
2. *Kennan, JH, 'Comments on "Directors' Wider Responsibilities - Problems Conceptual, Practical and Procedural"', speech given at AULSA Conference, Monash University, 25 August 1987.*
3. *Ibid.*
4. *Ibid.*

5.3 Mr Kennan made these comments following a paper given to the AULSA Conference by Dr LS Sealy.[5] Dr Sealy highlighted legal developments which required directors to take the interests of creditors into account in certain circumstances. Dr Sealy also pointed out that if a director was to be required to take into account groups and interests extrinsic to the company and the shareholders, then logically those other groups and interests should be able to ratify directors' acts, just as shareholders are able to do. If this were to occur, courts would have to adopt a wider reviewing role. Possibly they would become more interventionist in their approach because, in essence, they would be required to review directors' business judgment. As discussed in chapter 3, this kind of development would be undesirable. It is the role of directors, not courts, to make business judgments on behalf of companies.

5.4 Examples of persons connected with the company are the company's employees, its creditors and its regular suppliers. The umbrella can be extended even wider to include the local community (especially if a whole town depends for its livelihood or existence on the company's business) and 'global' interests such as the preservation of the environment.

5.5 Several submissions[6] argued that these wider interests were effectively protected by directors' duties to act for the benefit of the company. The directors, the argument runs, must safeguard the long term interests of the company. This entails making the company a good employer, maintaining good relations with creditors, avoiding activities which will harm the company's public image and so on.

5.6 Dr Pascoe, for the Business Council of Australia,

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5. *'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural', reproduced in (1987) 13 Mon LR 164.*
6. *Eg submissions from the Company Directors' Association of Australia, p 7 (Evidence, p 86); Institute of Directors in Australia, p 7 (Evidence, p 125); Australian Stock Exchange Ltd, p 1.*

illustrated this point of view:

> The employees of an organisation are its most vital asset and if you have bad employment practices and so on, no training, no development, it is bad management - putting aside the law. Similarly if you do not give attention to your customers, the consumers, it is bad management ... the marketplace itself is a good discipline ... any board that fails to take into account all the constituencies is ... not carrying out its responsibilities to its shareholders. Secondly, it is just gross bad management.[7]

Dr Pascoe also referred to the importance of a company's 'reputation'.[8]

5.7 Similarly, BHP Limited submitted:

> The duty [of directors] towards the company, properly understood, includes consideration by directors of matters such as the interests of employees, consumers and the environment. It does not call for a single-minded pursuit of profits in the short term regardless of consequences ...
>
> In practice, the preservation and advancement of the interests of a company calls for consideration to be given to the interests of employees and other groups or social interests.[9]

5.8 Fiduciary law does not exclude outside interests being taken into account, as long as, in doing so, the interests of the beneficiary are also served.[10] Regard to the future will often, but not always, promote responsible behaviour. For example, a company's prosperity might not involve it being a good employer

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7. *Evidence, pp 504-5.*
8. *Evidence, p 504.*
9. *Submission, paras 12, 13 (Evidence, p 606).*
10. *See, eg, Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at p 135.*

if the labour market condition is such that people have little choice but to work for it. A company might have no incentive to avoid polluting the local environment if there is little chance of it being detected or if the cost of rectifying any resulting 'image problems' would be less than the cost of better waste disposal systems.

5.9 Proper protection of interests outside the company would seem to require something more than the directors' duty to act 'in the interests of the company'. One way of doing this would be to extend directors' fiduciary duties, either by judicial development or legislation, specifically to cover certain interests outside the company. However, the Committee did not find wide support for steps such as this in the submissions and evidence it received.

5.10 The Business Council of Australia submitted that the statement of directors' duties in the Companies Code was 'vague but powerful',[11] and that the duties were 'broadly similar to those in comparable overseas countries'.[12] It submitted that '[i]ncreasing legislative controls on directors will lead to lower not higher corporate performance'[13] and that '[t]here is no basis for widening directors' duties'.[14] The Business Council recommended that 'the burdens of liability ... for directors under the Companies Act and other legislation' be lightened.[15]

5.11 The NCSC submitted that 'existing statute law provides a reasonable basis for ensuring that directors safeguard non-shareholder interests when exercising their duties to shareholders and creditors'[16] and expressed concern that 'any significant increase in scope of the existing legal duties on

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11. *Submission, p 9 (Evidence, p 455).*
12. *Submission, p 15 (Evidence, p 461).*
13. *Submission, p 20 (Evidence, p 466).*
14. *Submission, p 22 (Evidence, p 468).*
15. *Submission, p 30 (Evidence, p 476).*
16. *Submission, p 5 (Evidence, p 564).*

directors of companies may discourage suitably qualified people from taking up positions as directors'.[17] It suggested that education and policy statements be used to promote the 'social responsibilities' of directors.[18]

5.12 The Chairman of the NCSC, Mr Henry Bosch, urged the Committee to reject the argument that directors' responsibilities be extended by legislation requiring them to have regard to customers, creditors, employees and the environment.[19] He said 'there is no clear theoretical basis' for specifying how directors should decide between the conflicting interests.[20]

5.13 Mr Bosch did agree, however, that the common law (that is, judge-made law, developed in the course of adjudicating upon a dispute) was developing in that direction.[21] The advantage of leaving such development to the common law, Mr Bosch said, was that a judge was subject to appeal:

> [O]ur elected representatives are restricted to doing these things suddenly, by virtue of the passage of a law, which means that they take large steps which need to be thought out with particular care. If a judge makes a mistake, he is subject to appeal and there is the possibility of other subsequent judgments.[22]

5.14 Mayne Nickless Limited did not agree with the view that 'the law which governs the responsibilities of directors is largely outmoded and does not reflect the realities of the modern Australian corporation'.[23] Mr Ian Webber, Managing Director of Mayne Nickless, said that the 'broad general obligation of

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17. *Submission, pp 5-6 (Evidence, pp 564-5).*
18. *Submission, p 6 (Evidence, p 565).*
19. *Evidence, p 572.*
20. *Evidence, pp 572-3, 577.*
21. *Evidence, p 576.*
22. *Evidence, pp 576-7.*
23. *Submission, p 1 (Evidence, p 373).*

directors is a very powerful one'.[24]

5.15 BHP Limited submitted that, in practice,

> the preservation and advancement of the interests of a company calls for consideration to be given to the interests of employees and other groups or social interests.[25]
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> ...
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> The imposition by legislation of duties towards particular groups or interests, independent of the duty towards the company considered as the members as a whole, would only serve to confuse.[26]

**Duties to creditors**

5.16 Company law has developed to the point where directors owe a duty to the company's creditors where the company is insolvent or near-insolvent. The rationale for this is that, at times of insolvency or near-insolvency, it is the funds of the creditors, rather than the shareholders, with which the directors are dealing.

5.17 While the creditors of a company are entitled to expect that the company's capital will not be unlawfully reduced so as to jeopardise their chances of repayment, the traditional view is that there is no separate fiduciary duty owed by the directors to them.[27] If the company becomes insolvent the liquidator may be able to sue the directors (in this way providing some return to the creditors) for breaches of their duty to the company, but the creditors cannot sue in their own right and an action on their behalf cannot succeed unless the directors have breached their

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24. *Evidence, p 425.*
25. *Submission, para 13 (Evidence, p 606).*
26. *Submission, para 14 (Evidence, p 606).*
27. *See, eg, Re Horsley & Weight Ltd [1982] Ch 442 at 453-4 per Buckley LJ; Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd and Others [1983] Ch 258 at 288 per Dillon LJ.*

duty to the company.

5.18 This view has been challenged by a series of cases following the decision of the High Court in Walker v Wimborne and Others.[28] It is generally accepted that the catalyst for extending directors' duties to the company's creditors was the High Court's decision in Walker v Wimborne, particularly the judgment of Justice Mason (as he then was).

**Walker v Wimborne**

5.19 In Walker v Wimborne the company was one of a collection of companies, with common directors, which was administered as a group. Shortly before the company went into liquidation, various sums of money were paid out by the directors of the company to related companies (of which they were also directors), resulting in a benefit to those companies. There was no benefit to the company making the payments except an implied promise by the related companies to repay the money.

5.20 When the company eventually went into liquidation, the liquidator challenged the payments as having been made in breach of duty or breach of trust within the applicable companies legislation. The High Court essentially agreed, finding against the directors in respect of the majority of the payments. The court also found that the policy the directors had adopted governing the movement of funds between the companies in the group ignored the interests of the company and its creditors. In reaching this conclusion, Justice Mason said:

> [I]t should be emphasised that the directors of a company in discharging their duty to the company must take account of the interest of its shareholders and its creditors. Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for

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28. *(1976) 137 CLR 1.*

> them. The creditor of a company, whether it be a member of a 'group' of companies in the accepted sense of that term or not, must look to the company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.[29]

5.21 It is arguable that Justice Mason was, consistently with the orthodox view, referring simply to the directors' duty to keep creditors 'on side' as part of their duty to the company,[30] but several recent cases have developed and refined the proposition in Walker v Wimborne. They have taken these passages as a basis for suggesting that directors in some circumstances owe an independent fiduciary duty to creditors (see below).[31] A similar trend has occurred in English law.[32]

**Ring v Sutton**

5.22 The rights of creditors were considered by the Supreme Court of New South Wales in the case of Ring v Sutton.[33] In that case the liquidator of a company brought proceedings against a director in relation to loans he had arranged for himself from the company. The loans were at a significantly lower level of interest than the prevailing commercial rate. The Supreme Court found that this amounted to a breach of duty on the part of the director and ordered that the director repay the sum borrowed plus interest calculated at the market rate.

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29. *(1976) 137 CLR 1 at 7.*
30. *This is Heydon's view: see Heydon, JD, 'Directors' Duties and the Company's Interests', in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at pp 124, 134.*
31. *Eg Ring v Sutton (1980) 5 ACLR 546, Kinsela v Russell Kinsela Pty Ltd (in liq) (1986) 4 NSWLR 722; Nicholson v Permakraft (NZ) Ltd [1985] 1 NZLR 242.*
32. *Eg Re Horsley & Weight Ltd [1982] Ch 442 at 455-6 per Cumming-Bruce and Templemann LJJ. (Contra: Multinational Gas & Petrochemical Co v Multinational Gas & Petrochemical Services Ltd and Others [1983] Ch 258 at 288 per Dillon LJ.)*
33. *(1980) 5 ACLR 546.*

5.23 The decision in Walker v Wimborne was cited with approval in Ring v Sutton. It was explicitly recognised that the liquidator had a right to challenge the terms of the loans 'in the interests of the creditors [of the company]'.[34]

## Nicholson v Permakraft

5.24 The rationale for the doctrine of creditors' rights was discussed by the New Zealand Court of Appeal in Nicholson v Permakraft (NZ) Ltd.[35] This case, once again, involved a company in financial difficulties. Briefly, the company, in the face of the difficulties, was restructured in such a way as to show a capital profit in its favour. The profit was then distributed to the shareholders as a capital dividend. It was accepted that the directors and shareholders were all actively involved in, and in agreement with, the restructuring.

5.25 The company subsequently encountered further difficulties and, eventually, went into receivership. Although the company's secured and preferential creditors were virtually paid in full, there were no funds to meet the company's liability to its unsecured creditors. In an attempt to remedy this deficiency, the company's liquidator attempted to recover the money which had been distributed to shareholders as a result of the restructuring. The court rejected the liquidator's argument, finding that the whole process was within the power of the directors who were found to have acted honestly.

5.26 Despite this finding, Justice Cooke went on to make statements about the directors' obligations to the company's creditors. He said:

> The duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider inter

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34. *(1980) 5 ACLR 546 at 547.*
35. *[1985] 1 NZLR 242.*

> alia the interests of creditors. For instance creditors are entitled to consideration, in my opinion, if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.
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> ... as a matter of business ethics it is appropriate for directors to consider also whether what they do will prejudice their company's practical ability to discharge promptly debts owed to current and likely continuing trade creditors.
>
> To translate this into a legal obligation accords with the now pervasive concepts of duty to a neighbour and the linking of power with obligation ... In a situation of marginal commercial solvency such creditors may fairly be seen as beneficially interested in the company or contingently so.[36]

The other judges did not disagree with Justice Cooke but did not find it necessary to discuss this point.

5.27 Justice Cooke linked the 'extended' duty to creditors to the privilege of limited liability:

> The recognition of duties to creditors, restricted as already outlined, is justified by the concept that limited liability is a privilege. It is a privilege healthy as tending to the expansion of opportunities and commerce; but it is open to abuse. Irresponsible structural engineering - involving the creating, dissolving or transforming of incorporated companies to the prejudice of creditors - is a mischief to which the courts should be alive.[37]

5.28 Justice Cooke limited the protection of the extended duty to existing and 'likely continuing' creditors of the company (including suppliers who had established trading relationships with the company and continued to extend credit to it). He said

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36. *[1985] 1 NZLR 242 at 249.*
37. *Ibid at 250.*

that it would be 'difficult' to make out a case for 'future new creditors':

> Those minded to commence trading with and give credit to a limited liability company ... must normally take the company as it is when they elect to do business with it. Short of fraud they must be the guardians of their own interests.[38]

## Kinsela v Russell Kinsela Pty Ltd

5.29 Kinsela and Another v Russell Kinsela Pty Ltd (in liq),[39] a decision of the Court of Appeal of New South Wales, endorsed Justice Cooke's approach in Nicholson v Permakraft. In Kinsela v Russell Kinsela, a company in a precarious financial position entered into a lease arrangement (including an option to purchase) with two of the directors in their individual capacity. The prices of the lease and the purchase option, which related to the company's business premises, were significantly less than the commercial rate. The purpose of the transaction was 'to put a valuable asset of the company out of the reach of creditors'.[40]

5.30 Shortly after the lease was executed, the company went into liquidation. The liquidator of the company sought to avoid the lease and recover the property.

5.31 The Court of Appeal upheld the liquidator's claim. Relying on both Walker v Wimborne and Nicholson v Permakraft, (then) Chief Justice Street, with whom the remainder of the court agreed, recognised

> [t]he obligation by directors to consider, in appropriate circumstances, the interests of creditors.[41]

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38. *[1985] 1 NZLR 242 at 250.*
39. *(1986) 4 NSWLR 722.*
40. *Corkery, JF, Directors' Powers and Duties, Longman Cheshire Pty Ltd, Melbourne, 1987, p 69.*
41. *(1986) 4 NSWLR 722 at 732.*

5.32 Chief Justice Street went on to say that

> the directors' duty to a company as a whole extends in an insolvency context to not prejudicing the interests of creditors.[42]

5.33 Chief Justice Street said it was difficult to formulate any general test as to the degree of financial instability necessary to impose an obligation on the directors to consider the creditors' interests. He observed that the degree of instability and the degree of risk to creditors were 'inter-related'.[43] Relying on <u>Nicholson v Permakraft</u>, he indicated that the existence of the obligation in an insolvency situation was clear,

> inasmuch as it is the creditors' money which is at risk, in contrast to the shareholders' proprietary interests.[44]

**The effect of the cases**

5.34 Corkery has concluded that the cases discussed above 'firmly establish the principle that the directors of insolvent companies must act in the interests of creditors'.[45] However, he is unsure what the obligation of directors of solvent companies is.[46] He refers to Justice Cooke's suggestion in <u>Nicholson v Permakraft</u> that there may be a direct duty owed by directors to creditors. This would not be a duty imposed by company law but would be a duty of care similar to the 'neighbour principle' in the law of torts.[47]

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42. *(1986) 4 NSWLR 722 at 732.*
43. *Ibid at 733.*
44. *Ibid.*
45. *Corkery, JF, <u>Directors' Powers and Duties</u>, Longman Cheshire Pty Ltd, Melbourne, 1987, p 69.*
46. *Ibid.*
47. *[1985] 1 NZLR 242 at 249.*

5.35 The existence of a positive duty owed by directors to creditors has been recently recognised by the House of Lords. In Winkworth v Edward Baron Development Co, Lord Templeman said:

> [A] company owes a duty to its creditors, present and future. The company is not bound to pay off every debt as soon as it is incurred and the company is not obliged to avoid all ventures which involve an element of risk, but the company owes a duty to its creditors to keep its property inviolate and available for the repayment of its debts. The conscience of the company, as well as its management, is confided to its directors. A duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors.[48]

5.36 The Winkworth formula is not confined to insolvency, although this extension has been rejected in at least one Australian case.[49] The Winkworth duty also seems to be less demanding than the one imposed by Australian and New Zealand courts.

5.37 In making a decision where the company is insolvent or nearly so, directors are dealing with the assets of people who have given credit to the company. The creditors' interests are already in the directors' hands and, according to Justice Cooke in the Permakraft case, the directors must protect them. On the other hand, in making their decision the directors cannot be expected to look after anyone who might later choose to extend credit to the company:

> There is no good reason for cultivating a paternal concern to protect business people perfectly able to look after themselves.[50]

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48. *(1987) 1 All ER 114 at 118.*
49. *Grove v Flavel (1986) 4 ACLC 654.*
50. *Nicholson v Permakraft NZ Ltd [1985] 1 NZLR 242 at 250.*

5.38 Against this view, Sealy[51] points out that in many situations the 'existing creditors' at the time the directors make their decision will eventually be paid. By the time the company goes into liquidation there may well be a new set of creditors, and it will be these creditors who will need to seek a remedy against the directors. Business people rarely have access to current information about the financial affairs of companies with whom they are dealing, and therefore may not be able to look after their own interests in the way Justice Cooke has suggested. A decision which prejudices existing creditors' chances of being paid also prejudices the interests of future creditors, since if the former are ever paid it will probably be at the expense of the company's ability to pay the latter.[52]

5.39 In most situations, a breach of a director's duty to the company can be forgiven, or approved in advance, by the shareholders in general meeting (see paragraphs 4.21, 4.22). However, there are several statements to the effect that a breach of the duty to have regard to creditors' interests cannot be forgiven by the shareholders.[53] As Chief Justice Street said in the Kinsela case, the creditors

> become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets ... that ... are

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51. *Sealy, LS, 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 177, 185.*
52. *Note also Jeffree v National Companies and Securities Commission (1989) 15 ACLR 217, where the Supreme Court of Western Australia held that a director had a duty to protect the interests of a person who, by virtue of a pending arbitration, was likely to become a creditor of the company in the near future. This probably represents an extension of the duty from the position in the Permakraft case.*
53. *Re Horsley & Weight Ltd [1982] Ch 442 at 455-6 per Cumming-Bruce and Templemann LJJ; Nicholson v Permakraft (NZ) Ltd [1985] 1 NZLR 242 at 250 per Cooke J; Rolled Steel Products (Holdings) Ltd v British Steel Corporation and Others [1985] 3 All ER 52 at 86 per Slade LJ.*

> under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.[54]

Where the interests at risk are those of the creditors, the Chief Justice saw 'no reason in law or in logic to recognise that the shareholders can authorise the breach'.[55] The creditors have thus 'replaced' the shareholders and the directors' duty can be seen as owed to creditors.

**Should creditors be able to sue?**

5.40 Although the cases have stopped short of describing the duty as one owed to creditors (rather than a duty owed to the company to have regard to the interests of creditors), the duty can in a sense be seen in this light. A logical consequence is that creditors themselves should be able to bring actions against the directors for its breach, but the decided cases are silent on this point and commentators differ.[56] Nevertheless it seems that the existing framework of company law does not allow creditors to seek a direct remedy against directors.[57] Creditors will only look to directors personally when the company cannot pay. In these situations, insolvency law will apply. This means that, in the majority of cases, a liquidator will act on behalf of creditors.

5.41 In the cases discussed above the action has been brought

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54. *(1986) 4 NSWLR 722 at 730. See also Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at pp 129-30.*
55. *(1986) 4 NSWLR 722 at 732.*
56. *See Corkery, JF, Directors' Powers and Duties, Longman Cheshire Pty Ltd, Melbourne, 1987, p 69; Heydon, JD, 'Directors' Duties and the Company's Interests' in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 120-36 at pp 131-3.*
57. *See Sealy, LS, 'Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 177, 184. See also Goldberg, AH, 'Who'd be a company director?', address given to Second Business Lawyers' Conference, presented by Business Law Section of the Law Council of Australia, Melbourne, 10 April 1989.*

by a liquidator in the name of the company. This is the usual situation. It ensures that the proceeds, if any, of the action against the directors will be shared by all unsecured creditors (or at least those with respect to whom there has been a breach of duty) rather than accruing only to a creditor with sufficient resources to bring an action.

**Statutory provisions**

5.42 Mr Alan Goldberg QC has said

> the controversy surrounding the issue whether directors have a duty outside the Companies Code to creditors will remain substantially academic because of the specific standing provisions found in sections 556 and 557.[58]

5.43 Section 556(1) of the Companies Code (Corporations Act, s592(1)) makes directors and others involved in the management of a company personally liable for debts incurred when there are no reasonable grounds to expect that they will be paid. Section 556(3) (Corporations Act, s592(2)) provides for proceedings to be brought to recover such debts.[59]

5.44 Section 557(1) (Corporations Act, s593(1)) only gives a remedy to a person to whom a debt is incurred. It gives no rights to pre-existing creditors whose chances of repayment might be prejudiced by the transaction, or to any creditors whose interests are prejudiced by a corporate restructuring. Its scope is therefore in important respects narrower than the duty to creditors developed in the case law.

5.45 In its recent report, General Insolvency Inquiry, the

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58. *Goldberg, AH, 'Who'd be a company director?', address given to Second Business Lawyers' Conference, presented by Business Law Section of the Law Council of Australia, Melbourne, 10 April 1989.*
59. *See, eg, Watt v 3M Australia Ltd [1984] 3 NSWLR 671; 3M Australia v Kemish (1986) 4 ACLC 185; Metal Manufacturers Pty Ltd v Lewis (1988) 13 NSWLR 315.*

(Australian) Law Reform Commission criticised the operation of section 556 because, inter alia, it:

> - gives any benefit of the civil liability to the creditor taking action and thus is only of advantage to a creditor with the resources to take such action
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> - fails to provide a liquidator with standing to bring an action for the benefit of all creditors
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> . . .
>
> - requires a multiplicity of actions if all creditors who have been affected by the behaviour of the directors are to be compensated, with the possible result that the first creditors to take action may exhaust the assets of errant directors.[60]

5.46 Accordingly, the Law Reform Commission recommended

> the abandonment of the existing s556 and the enactment of a totally restructured provision which is clear, rational and readily enforceable in a manner which permits all creditors to share equally in the sums recovered.[61]

5.47 The Law Reform Commission suggested that this would promote the principle of 'equal sharing in an insolvency'.[62] The Committee endorses this recommendation. The Committee recommends that **the companies legislation be amended to permit all creditors to share equally in sums recovered from directors.**

5.48 Section 229(6) of the Companies Code (Corporations Act,

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60. *The Law Reform Commission, Report No 45, General Insolvency Inquiry, AGPS, Canberra, 1988, vol 1, p 125.*
61. *Ibid. See also Sealy, LS, 'Directors "Wider" Responsibilities - Problems Conceptual, Practical and Procedural' (1987) 13 Mon LR 164 at 185.*
62. *The Law Reform Commission, Report No 45, General Insolvency Inquiry, AGPS, Canberra, 1988, vol 1, p 125.*

s232(7)) may afford similar opportunities.[63] Under section 229(6), if a person has been convicted of an offence against section 229, and the company has suffered loss or damage as a result, the court can order the convicted person to pay compensation to the company, in addition to any fine or other penalty imposed.

5.49 A recent case illustrates the use of these provisions. In R v Oades,[64] the liquidator of a company, on behalf of the creditors, sought compensation from a former director of the company pursuant to section 229(6). The director had previously been found guilty of acting 'dishonestly' for the purposes of section 229(1), with intent to defraud creditors of the company. He was sentenced to a four and a half year prison term as a result.

5.50 The liquidator's application was successful and the director was ordered to pay almost $6.1 million to two of the company's creditors. The liquidator indicated afterwards that this was the first such order under section 229(6). He also said he found section 229(6) was an easier section under which to obtain compensation than section 556, which liquidators had previously used against directors.[65]

5.51 Creditors would also appear to have standing to seek an injunction or damages against a director under section 574 of the Code (Corporations Act, s1324). This provisions seems to have been virtually unused. (See the discussion of section 574 at paragraphs 11.33, 11.34.)

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63. *See Lampe, A, 'Former director must pay liquidators $6m, judge finds', The Sydney Morning Herald, 20 May 1989, p 39.*
64. *NSW District Court, Sydney, 17 March 1989, per Madgwick DCJ (unreported).*
65. *See Lampe, A, 'Former director must pay liquidators $6m, judge finds', The Sydney Morning Herald, 20 May 1989, p 39.*

**Intersection of fiduciary and statutory duties**

5.52 Grove v Flavel,[66] a decision of the Supreme Court of South Australia, involved a company with liquidity problems, one of whose directors arranged a complex series of payments between the company, himself, and several other companies of which he was also a director. The payments did not change the company's overall financial state but had the effect of giving the director and his other companies an advantage over other creditors when the company went into liquidation.

5.53 The court rejected the argument that there was a general duty owed by directors to protect creditors' interests irrespective of the company's financial situation.[67] However, it held that a director who acts to the detriment of creditors, knowing 'that the company faces a risk of liquidation ... which is a real and not a remote risk', is acting 'improperly'.[68]

5.54 The interesting feature of Grove v Flavel is that, unlike the other cases discussed in this chapter, the action was not brought by a liquidator in the name of the company under general fiduciary law. The action was a criminal prosecution brought by the South Australian Corporate Affairs Commissioner. The director was charged with making 'improper use of information' under the equivalent of section 229(3) of the Code (Corporations Act, s232(5)). His failure to protect the interests of creditors in a situation of likely insolvency was what made his use of information about the risk of insolvency 'improper'.

5.55 A similar approach was taken in the recent decision of the Supreme Court of Western Australia, Jeffree v National Companies and Securities Commission.[69] A director was charged under section 229(4) (Corporations Act, s232(6)) with making

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66. *(1986) 4 ACLC 654.*
67. *Ibid at 662.*
68. *Ibid at 662-3.*
69. *(1989) 15 ACLR 217.*

'improper use of his position' as a director. He transferred the company's assets and business to a new corporate structure to put them beyond the reach of a prospective creditor. The court held that the director owed fiduciary duties to present and future creditors of the company.[70] It followed Grove v Flavel in holding that the test of 'improper' conduct depended on the duties of the person whose conduct was in question.[71] Thus breach of the duty t creditors resulted in liability under section 229(4).

5.56 In the absence of statutory definition, terms like 'improper' must be construed by the courts. It is open to them to apply high standards and insist on a standard of conduct in line with the reasonable expectations of modern business. Courts have tended not to impose such high standards on directors in the past.

5.57 However, the Committee recommends that **criminal liability under companies legislation not apply in the absence of criminality.** It considers that, where appropriate, civil penalties should be introduced into company law to cover those cases where it is important to sanction misconduct of directors where the conduct falls short of a criminal offence.

**Conclusion**

5.58 Despite the existence of statutory provisions covering much of the same ground, the fiduciary duty created by case law continues to attract litigation. This is because it is broader and more flexible than the duties set out in the companies legislation, both in scope and in the remedies for its breach. With a basis in concepts drawn from trust law, fiduciary duties set high standards of probity which would be difficult to set out in a statute.

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70. *(1989) 15 ACLR 217 at 221-2 per Wallace J; at 227 per Brinsden J; Pidgeon J agreed.*
71. *Ibid at 227 per Brinsden J. Wallace J did not refer to Grove v Flavel but took a similar approach (at 221-2); Pidgeon J agreed.*

5.59 Perhaps more importantly, equitable remedies are potentially much more powerful than those available under the companies legislation. Under the Code or the Corporations Act, the following remedies are available to a creditor:

- criminal liability of the director for breach of sections 229 (Act, s232) (see paragraphs 3.18, 5.52-5.57), 556(1) (Act, s592(1)) (see paragraphs 5.42, 5.43, 5.45, 5.46) or 556(5) (Act, s592(6));

- personal liability of the director for debts to the creditor incurred by the company, under section 556(1) (Act, s592(1)) (see paragraph 5.43); and

- an injunction under section 574 (Act, s1324) to prevent conduct which would amount to a breach of the Code, or to enforce conduct required by the Code. Under section 574(8) (Act, s1324(10)) the court may order the director to pay damages as well as, or instead of, issuing an injunction. (See the general discussion of section 574 at paragraphs 11.33, 11.34.)

5.60 Criminal sanctions against a director do not help a creditor recover his or her money. A restraining injunction is useful only if granted before the wrong conduct takes place. Most creditors (and for that matter most shareholders) do not have sufficient knowledge of what the directors are doing to take action in time. An order making a director personally liable to repay a debt or to pay damages is of limited value if the director has few or no assets.

5.61 The equitable remedies available for breaches of fiduciary duty, on the other hand, can enable the successful

plaintiff to recover specific assets or interests in property.[72] Equitable remedies can also reach an asset which is in the hands of a third party who has not paid for it or who knew of the breach of duty, or profits made by a third party who knowingly assisted the breach of duty. For example, if a director, faced with the imminent liquidation of the company, sold the company's assets at a 'bargain basement' price to a friend who knew what was going on, a court could use the mechanism of a constructuve trust to make the friend transfer the assets to the liquidator.[73]

5.62 For these reasons, equitable remedies will often be more attractive to a creditor than proceedings under the companies legislation. This will be so particularly if the director personally has little in the way of assets.

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72. *Eg, in the* ***Kinsela*** *case (discussed above at paras 5.29-5.33), a lease of the company's business premises which had been granted in breach of duty to two of the directors was held to be voidable. In this way, the liquidator was able to sell the premises unencumbered by the lease.*
73. *See, eg, Austin, RP, 'Constructive Trusts' in Finn, PD (ed),* ***Essays in Equity****, Law Book Co Ltd, Sydney, 1985, pp 196-242.*