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Abstract
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These inadequacies were not lost on the Government and whilst the introduction of the National companies scheme in 1990 did not effect any reforms to the defaulting officer provisions, as they have commonly become known, over a six year period a series of committees was established to examine both the adequacy of the laws relating to insolvency and the regulation of directors. Subsequently the Corporate Law Reform Act 1992 enacted, amongst other reforms, significant changes to the defaulting officer provisions. These amendments took effect from 24 June, 1993.

Keywords
corporate law, insolvency, liability of directors, Australia, New Zealand, South Africa, Corporate Law Reform Act 1992

ARTICLES

INSOLVENT TRADING - RECENT DEVELOPMENTS IN AUSTRALIA, NEW ZEALAND AND SOUTH AFRICA

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Introduction - Corporate Law Reform Act 1992 (Aust)

During the 1980's much was written about the inadequacies of the Australian fraudulent and reckless[1] trading provisions contained in sections 556 and 557 of the *Companies Code* and later sections 592 and 593 of the *Corporations Law*.[2]

These inadequacies were not lost on the Government and whilst the introduction of the National companies scheme in 1990 did not effect any reforms to the defaulting officer provisions,[3] as they have commonly become known, over a six year period a series of committees was established to examine both the adequacy of the laws relating to insolvency and the regulation of directors.[4] Subsequently the *Corporate Law Reform Act 1992* enacted, amongst other reforms, significant changes to the defaulting officer provisions. These amendments took effect from 24 June, 1993.

The duty

Section 592 was amended to apply only to debts incurred prior to the commencement of the new insolvent trading provisions contained in section

1 This description is adopted for ease of reference. The provision was not couched in terms of recklessness but rather in terms of the incurring of debts in the absence of the existence of reasonable grounds to expect that they would be paid. Arguably this is akin to recklessness or, possibly, negligence.

2 For example see Herzberg, 'Insolvent Trading', (1991) 9 C and SLJ 285 and see his earlier article at (1985) 3 CandSLJ 202. Also see Mangioni, 'Directors' personal liability: S.592 of the Corporations Law and related matters', (1991) 27 BCLB para 507. Also note Vickery (1990) 64 LIJ 1181; Hill (1992) 14 Syd LR 504; Baxt (1988) 62 ALJ 643; (1988) 16 ABLR 390; Herzberg (1987) 5 CandSLJ 200 and (1989) 7 CandSLJ 177, Kennett (1989) 63 ALJ 502; and Starke (1991) 65 ALJ 300.

3 The only change is the deletion of s 557(9), made redundant by s 589(6).

4 Commonwealth of Australia, Law Reform Commission, General Insolvency Inquiry, Discussion Paper No 32, AGPS Canberra August 1987; Commonwealth of Australia, Law Reform Commission, General Insolvency Inquiry, Report No 45, AGPS Canberra January 1989 (Harmer Report); Commonwealth of Australia, Parliament, Joint Select Committee on the Corporations Legislation, AGPS Canberra April 1989 (Edwards Committee); and Commonwealth of Australia, Parliament, Senate Standing Committee on Legal and Constitutional Affairs, Company Directors' Duties Report on the Social and Fiduciary Duties and Obligations of Company Directors, AGPS Canberra November 1991.

588G to section 588X. Section 588G specifies that a director contravenes the section if his insolvent company incurs a debt at a time when there are reasonable grounds for suspecting that the company is insolvent and the director is aware of this or ought reasonably to be aware of it. Breach of this duty may result in the director being ordered to compensate the company and may also result in a civil penalty or criminal sanction although criminal and civil sanctions are separated, with criminal liability being retained for cases where actual dishonesty is involved.

The defences

The defences are set out in section 588H. They include that the director:

(i) had reasonable grounds to expect (not suspect) that the company would have been able to pay its debts. This would be established if the director showed that another person, who it was believed on reasonable grounds was competent and reliable, was entrusted with the responsibility of providing the director with sufficient information to enable the director to comply with the duty and apparently discharged that responsibility,

(ii) took all reasonable steps to prevent the company incurring the debt, for example, by endeavouring to have the company placed under a form of administration in insolvency, and

(iii) was not able, for good reasons, for example illness, to participate in the management of the company.

The presumptions

The legislation embraces a number of presumptions designed to assist in proving the action.[5] First there is a presumption of continued insolvency for a period of up to 12 months from the date that insolvency is first established up to the date of the winding up where this period does not exceed 12 months. Also, section 558E(8) has the effect that where insolvency is proved for the purposes of one form of recovery proceedings against a company then it would be presumed to exist in relation to any other forms of recovery proceedings.

Furthermore, section 588E(4) provides that a presumption of insolvency will arise where a company has failed to keep adequate accounting records as required by section 289. Notably the presumption will not arise if it can be shown that the contravention was due to the destruction of the records outside the directors' control.

5 These presumptions do not operate in relation to criminal charges.

Duty to be enforced by Australian Securities Commission or liquidator

Section 588J to section 588U inclusive contain the mechanical provisions supporting the duty against insolvent trading. The fundamental principle is that amounts recovered from directors are to be paid to the company for distribution to unsecured creditors.

Section 588J provides that the court may make an order for the payment to a company of compensation where there has been an application for a civil penalty order made against a director for breach of the duty against insolvent trading. Applications for civil penalty orders are made pursuant to Part 9.4B. Section 1317EB authorises the ASC to make such applications. Such proceedings are civil in nature.[6]

Similarly section 588K provides that the court may order a person, convicted under section 1317FA of Part 9.4B of contravening the duty against insolvent trading, to pay compensation to the company. Under section 1317FA a director would be guilty of a criminal offence if he knowingly allowed the company to trade whilst insolvent for a dishonest purpose.

Section 588M provides the liquidator with an avenue to directly proceed against a director in breach of his duty against insolvent trading. Such proceedings must be commenced within a period of six years. Provisions exist preventing any double recovery and providing that certificates evidencing a contravention of a civil penalty provision or a criminal offence shall be conclusive evidence of the matters contained therein.

Creditors have a secondary action

Section 588R to section 588U inclusive provide the circumstances in which a creditor may sue a director under section 588M for allowing a company to trade whilst insolvent. Section 588R provides that a creditor may commence such proceedings with the written consent of the liquidator whilst the other sections set out a procedure for a creditor to follow where the liquidator does not commence an action, nor provides consent to an action by the creditor. Essentially the creditor may serve on the liquidator a notice of his intention to commence proceedings requiring the liquidator to, within three months, either provide his consent or a statement of reasons why the proceedings should not be commenced. Where consent is not forthcoming the creditor may commence proceedings after the three month period with the leave of the court. Any statement of reasons opposing the proceedings provided by the liquidator must be considered by the court when determining whether to grant leave.

6 Section 1317ED.

Application and quantum of compensation

Section 588Y provides that compensation recovered from directors arising from an action by the ASC or a liquidator is first to be applied to the payment of unsecured creditors. However any creditor who was aware that the company was or would become insolvent at the time the particular debt was incurred is postponed in priority to all other unsecured creditors, except where the compensation was forthcoming due to an application against the director by a creditor. Any compensation ordered upon an action by a creditor is owed to the creditor bringing the proceedings.[7]

In calculating the compensation payable by a defaulting director regard is to be had to the loss or damage suffered by the creditors.[8]

Group companies - duty imposed on holding companies

In a departure from the recommendations of the *Law Reform Commission*,[9] by virtue of section 588V to section 588X inclusive, holding companies are to be liable for insolvent trading by subsidiaries.[10] These provisions provide that where a holding company permits one of its subsidiaries to trade whilst insolvent then the subsidiary's liquidator may recover from the holding company an amount equal to the loss or damage suffered by the unsecured creditors of the subsidiary. The provisions essentially mirror those applying to individual directors who have allowed their company to trade whilst insolvent. Similar offences are also provided.

Notably the provisions deal only with the holding company/subsidiary company relationship rather than generally with related companies. According to the *Explanatory Memorandum* the provisions impose a specific test to which the directors of a parent company may address their minds.[11]

Notably there is no procedure for creditors to instigate proceedings against the holding company.

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7 Notably the recommendation of the Law Reform Commission that any creditor action only be derivative in nature was not taken up.

8 The recommendation of the Law Reform Commission that regard be had to the extent to which the financial position of the company was prejudicially affected by reason of the breach of duty was not taken up.

9 Adoption of the New Zealand group company provisions, referred to below, relating to the pooling of assets of insolvent companies in liquidation and the imposition of liability on related companies for the debts or liabilities of an insolvent company, was recommended. The Explanatory Memorandum stated that the basis for the legislative departure from the Law Reform Commission proposal was the concern that the wide discretion proposed to be given to the courts would create uncertainty in commercial dealings.

10 See Austin, 'The Corporate Law Reform Bill - its effect on liability of holding companies for debts of insolvent subsidiaries', [1992] 6 BCLB para 103.

11 At para 1125.

The overseas experience

South African developments provide a useful comparison to the creditor recovery regime adopted in Australia. It will be observed that the United Kingdom *Jenkins Committee* recommendation on reckless trading,[12] whilst not adopted in either the United Kingdom or Australia, was embraced in South Africa. The history of the resulting legislation will be examined.

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

It will be argued that whilst the Australian legislation has much to recommend it over these alternative approaches these overseas experiences point to a number of issues that require further consideration in the Australian context. In particular there are the issues of whether individual creditors ought to be provided with a cause of action in their own right and whether specific regimes ought to be established to cater for particular categories of companies.

South Africa

Reckless trading

Whilst until 1973 the South African legislation simply repeated the United Kingdom position,[13] in that year the *Companies Act 1973* amended the fraudulent trading provision[14] in accordance with the recommendations of the *Jenkins Committee* that the civil sanction contained in the United Kingdom provision should be extended so as to apply to reckless as well as to fraudulent trading.[15] Although this recommendation was never adopted in the United Kingdom the South African *Van Wyk de Vries Commission of*

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12 Report of the Company Law Committee, London June 1962 (Cmnd 1749).

13 Section 184 and s 185 of the Companies Act 1926 provided a summary action against defaulting officers and, since 1939, personal liability for fraudulent trading respectively.

14 The fraudulent trading provision was first enacted by s 75(1) of the Companies Act 1928 (UK) on the recommendation of the Greene Committee (Cmnd 2657). It was the first provision providing a cause of action against directors of insolvent companies. This provision was subsequently adopted in Australia (In 1931 the Queensland Companies Act became the first Australian legislation to contain a fraudulent trading provision by virtue of S.284. The other States quickly followed: South Australia (1934-35) s 290, Victoria (1938) s 275, New South Wales (1936) s 307, Western Australia (1943) s 281, Tasmania (1959) s 237) South Africa (s 185 of the Companies Act 1926, inserted in 1939) and New Zealand (s 320 of the Companies Act 1955).

15 Paragraph 497, Report of the Company Law Committee, London June 1962 (Cmnd 1749).

Enquiry,[16] whilst acknowledging the far reaching implications of importing into the provision the concept of recklessness, concluded that its introduction was justified.

The 1973 legislation extended both the offence and civil liability to reckless trading.[17] This was effected simply by inserting the words "recklessly or" before "with intent to defraud" in the section. Thus section 424 (1) reads:

> 424 (1) When it appears, whether it be in a winding-up, judicial management or otherwise, that any business of the company was or is being carried on *recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose*, the Court may, on the application of the Master, the liquidator, the judicial manager any creditor or member or contributory of the company, declare that any person who was knowingly a party to the carrying on of the business in the manner aforesaid, shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Court may direct. [Emphasis added]

Judicial interpretation of the defaulting officer legislation

Generally - a liberal interpretation

A feature of the interpretation of the provision by the South African judiciary has been its liberal nature. In particular, the South African courts appear not to have been influenced by the amalgamation of civil and criminal sanctions within the section.[18]

Application to a single reckless or fraudulent transaction

An illustration of this liberal approach to the interpretation of the provision is provided by *Gordon NO and Rennie NO v Standard Merchant Bank Ltd and Others*.[19] It had been argued that as the provision imposes a criminal sanction then the rule of statutory interpretation that it must be restrictively interpreted should be applied. However this argument was rejected on the basis that the rule only applies where the language is obscure or ambiguous and, in any event, had today lost much of its force. The standard approach now is to interpret the language according to its plain and rational meaning and to promote its object.

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16 Commission of Enquiry into the Companies Act, Main Report, 1970.

17 Sub-section (3) renders it an offence to recklessly trade.

18 See Williams R.C., 'Liability for Reckless Trading by Companies: The South African Experience' 33 ICLQ 684 (July 1984). Williams comments that the interpretation of the provision has not been influenced by its so-called 'punitive' nature, as has occurred in the United Kingdom, with the result that the provision has, in general, been interpreted liberally. For a detailed statement of the elements of a s 424(1) action see *Ozinsky NO v Lloyd and Others* 1992 (3) SA 396 (C) at 411- 14.

19 1984 (2) SA 519(C). Also see *Bowman NO v Sacks* 1986 (4) SA 459 (WLD), 465.

After noting the extension in the scope of the provision brought about by the 1973 amendments, the Court indicated that it would interpret the section broadly in order to promote the remedy it afforded.[20] Accordingly the Court interpreted section 424(1) in such a way as to include a single reckless or fraudulent transaction within its ambit.[21]

Passivity no defence

A further example of the liberal approach adopted by the South African judiciary is illustrated by the treatment of passive directors. Whilst the use of the term 'knowingly' in section 424 might have provided the passive director with a defence this term has been read down to merely require knowledge of the facts from which the conclusion is objectively drawn that the business of the company was carried on recklessly or fraudulently. It is not necessary to show that the person had actual knowledge of the legal consequence of those facts.[22]

Passivity will therefore seldom provide an answer to a section 424 application with the result that non-executive directors are in a particularly vulnerable position. In fact the Court in *Howard v Herrigel and Anor NNO* stated that a supine attitude by a director might be sufficient to render him liable irrespective of his non-executive status as a director. Whether the enquiry was one in relation to negligence, recklessness or fraud the legal rules were the same for all directors.[23]

Notably the Court also observed that section 424 enabled a director to be declared liable for debts or other liabilities of the company without proof of a causal connection between the fraudulent or reckless conduct and the relevant debts or liabilities.[24]

Application to operating companies

A final example is the application of the provision to operating companies. The section applies when the relevant circumstances come to light 'whether it be in a winding-up, judicial management or otherwise'. The *Jenkins Committee* had recommended that the criminal penalty apply to fraudulent trading generally whether or not the company had been or was in the course of winding-up.[25] On the face of it, it is contentious whether the effect of the

20 Ibid.

21 This decision is even more remarkable when contrasted with the reluctance of earlier courts to decide the matter (See for example, *S v Harper* 1981 (2) SA 638(D), *Fisheries Development Corporation of SA Ltd v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd and Others* 1980 (4) SA 156(W) and *Joh-Air (Pty) Ltd v Rudman* 1980 (2) SA 420 (T).) and when it is appreciated that it was contrary to the views expressed in the leading South African text on company law (Henochsberg, Henochsberg on the Companies Act (4th edition) Meskin Butterworths Durban 1985 (op cit., f n.4)).

22 *Howard v Herrigel and Anor NNO* 1991(2) SA 660 (AD). Also see Luiz, 'Extending the liability of directors', (1988) 105 SALJ 788 and *S v Parsons* 1980 2 SA 397(D).

23 Ibid at 661.

24 Ibid.

25 Paragraphs 497 to 500.

terminology used in section 424(1) is to extend the application of the provision to companies other than those in the course of being wound-up or whether, as *Williams*[26] observes, the argument may still be open that the words 'or otherwise' should be interpreted ejusdem generis with the preceding words.

However the judiciary has given support to the view that the words 'or otherwise' will not be interpreted narrowly. In *Gordon NO and Rennie NO v Standard Merchant Bank Ltd and Others,*[27] De Kock J, referred to how the 1973 amendments extended the section making it applicable to circumstances other than those where the company is in the process of being wound up. Furthermore, in *Food and Nutritional Products (Pty) Ltd v Newman,*[28] Schabort J. referred to how 'operating companies have been included in the spectre of the provision' by virtue of the 1973 amendments.

Individual creditors as beneficiaries of awards

One of the most significant issues to have been considered by the judiciary has been the issue as to the beneficiaries of any compensation orders. Although creditors have locus standi the provision does not expressly provide that applicants are to necessarily be the beneficiaries of any orders. The caselaw on provisions akin to the South African provisions has been divided on who are to be the beneficiaries in such circumstances.[29] The traditional view is that it is the company, although notably the view of the leading South African text on company law favours creditors as beneficiaries.[30]

The alternative view gives rise to the unusual result that should an applicant successfully pursue a claim under section 424(1) then the court could order payment of all recklessly incurred debts to the respective creditors should they be joined as parties to the action.[31] Issues of standing aside, their causes of action would stand or fall together. In this respect, a creditor claiming payment of a debt under the provision might be met with the argument that proof that the particular debt was recklessly incurred is insufficient as the section requires proof that the 'business' of the company was recklessly carried on.[32] The result of an acceptance of this argument

26 Above 18.

27 Above 19.

28 1986 (3) SA 460(W).

29 See *Re William C Leitch Bros Ltd (No 2)* (1932) All ER 897 and *Re Klintworth Homes Pty Ltd* [1977] 2 NSWLR 904. Contrast *Hardie v Hanson* (1960-61) 105 CLR 451, *Re Cyona Distributors Ltd* (1967) 1 All ER 281, *Re Maney and Sons Ltd* [1969] NZLR 116 (North P) and *Re Gerald Cooper Chemicals Ltd* [1978] 2 All ER 49.

30 See pp 749-50, Henochsberg on the Companies Act (4th edition) Butterworths, Durban 1985.

31 On the principles applicable to the joinder of parties to an action, generally see Halsbury's Laws of England, Volume 37 (4th edition), Butterworths, London 1982 at paragraph 215 and following.

32 Notwithstanding the affirmative view of the South African judiciary referred to in the previous section the caselaw generally is divided as to whether a single transaction can constitute the carrying on of a business. See *Re Gerald Cooper Chemicals Ltd* [1978] 2 All ER 49, *Re Murray Watson Ltd* (Unreported 6 April 1977; referred to in *Re Gerald Cooper Chemicals Ltd* [1978] 2 All ER 49), *In re Sarflax Ltd* [1979] 2 WLR 202, *Flavel v Semmens* (1987-88) 12 ACLR 178, *Re Lake Tekapo Motor Inn Limited (in liq)* [1988] NZ Recent Law 193 and *Re Nimbus Trawling Co Ltd* (1983) 1 NZCLC 98,762.

would be to significantly increase the burden of proof imposed on applicants as they would need to prove that the debts of the company generally were recklessly incurred in order to recover the deby owed to them. However, as observed above, South African courts have taken the view that a single transaction can constitute carrying on business.

Recent decisions would appear to have embraced the view that the applicant may be the beneficiary of any damages award. In *Bowman NO v Sacks*[33] the Court observed that the wording of the provision allowed the Court to order a director liable to a particular creditor although conceding that it might sometimes be more appropriate to order payment to the advantage of all creditors. The object of section 424 was not, in the Court's view, to alter priorities amongst creditors except where called for by equitable considerations.[34]

The matter was further explored in *Ex Parte Lebowa Development Corporation Ltd*[35] where the Court acknowledged that section 424 might provide a creditor with a cause of action against corporate officials in addition to any action at common law, thereby implying that the creditor would be the beneficiary of any successful action. This conclusion is supported by the Court's further comment that the declaration under section 424 might also benefit the company in various ways, for example a successful applicant might forgo his claim against the company.[36]

Thus, it would appear that the South African courts are prepared to countenance a creditor applicant as the beneficiary of a damages award[37] although always with an eye to exercising their discretion as necessary to maintain an equitable and sensible result.

The meaning of 'recklessly'

Arguably the most important issue considered by the judiciary concerning this provision is as to the meaning of the term 'recklessly'. The *Van Wyk de Vries Commission*, in the course of recommending the reckless trading amendments, stated that recklessness was a 'wide concept'[38] which would include both the carrying on of business in insolvent circumstances and the carrying on of business while the liabilities exceeded the value of assets or, in other words, the contracting of debts without a reasonable expectation of paying them. The Commission conceded that the wide nature of this concept

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33 1986(4) SA 459 (WLD).

34 Ibid at 464.

35 1989(3) SA 71 (TPD).

36 Ibid.

37 Also see *Pressma Services (Pty) Ltd v Schuttler* 1990 (2) SA 411 (CPD) where a creditor was held not to have lost the right to proceed under s 424 notwithstanding the sanctioning and implementation of a compromise.

38 Para 44.24.

would have far reaching implications but that faith could be had in the courts.

An objective test - gross negligence

The leading decision on the meaning of the word 'recklessly' is *S v Goertz*[39] where Fagan J stated an objective test, namely that it was necessary to show that the director acted recklessly judged by the standards of reasonable businessmen. Proof of gross negligence was sufficient although he left open the question as to whether lesser negligence could amount to recklessness.[40]

This view was affirmed in *Ex Parte Lebowa Development Corporation Ltd*[41] and also in *S v Parsons,*[42] where Leon J stated that the word 'recklessly' applies to gross negligence without the need for conscious disregard of the consequences. Further, in the *Fisheries case,*[43] Margo J stated that gross negligence is required as an element of the word 'recklessly' and the tests as to what will amount to such gross negligence and therefore 'recklessness' will vary greatly from case to case.

In the course of his judgment Margo J referred to an article by *Hyman*[44] where he points out that had the legislature intended mere negligence to be sufficient for liability under section 424(1) or section 424(3) it would have used the term 'negligently' and not 'recklessly'. *Hyman's* view is that recklessness is a concept to be placed somewhere between mere carelessness and dishonesty, in other words 'gross negligence', without necessarily appreciating or being aware of the consequences. His Lordship agreed with the view expressed by *Hyman*[45] that if 'gross negligence' is required as an element of recklessness the tests will vary greatly from case to case and no precise definition of gross negligence is possible.

Thus this decision appears to answer in the negative the question left open in *S v Goertz* whether any negligence less than gross negligence could amount to 'recklessness'. It also emphasises the aspect of the earlier decisions that it is irrelevant in establishing gross negligence that the wrongdoer was unaware of, or did not appreciate, the consequences of his acts.[46] For instance, it may be sufficient for a finding that the business had been carried

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39 1980 (1) SA 269 (C).

40 Ibid at 272.

41 1989 (3) SA 71(TPD).

42 1980 (2) SA 397 (D).

43 Above 21.

44 Hyman 'Directors' Liability for Company's Debts', 1980 SA Co Law J E-1.

45 Ibid at 170.

46 These decisions have since been followed in *S v Harper and Anor* 1981 (2) SA 638 (D) and *Anderson and Ors v Dickson and Anor* NNO 1985 (1) SA 93 (N). Furthermore they are consistent with the *Van Wyk de Vries* Commission conception of the term (at para 44.25).

on recklessly that the company was merely undercapitalised.[47]

Rationale for objective test of recklessness

Avoiding difficulties with the onus of proof

The South African courts have, therefore, deviated from the ordinary meaning of 'recklessness'. The emphasis has been on the objective concept of negligence rather than the traditional meaning, namely, the existence of a subjective foresight as to the probability or possibility of harm resulting from conduct but, nevertheless, a persistence in that conduct.

It has been suggested that the reason for this deviation from the normal meaning of the term was the desire of the courts to remove all subjective features from the criterion for liability. This was a result of a reaction against the deficiencies which plague the fraudulent trading provision, in particular the difficulty of proving that the defendant subjectively was fraudulent.[48]

Williams argues that this argument is premised on a misconception as the weakness of the fraudulent trading provision is not so much the subjective nature of the criterion for liability but rather the difficulty of proving the element of fraud. In fact he is of the view that by making the test for recklessness wholly objective this may limit rather than enhance the operation of the section. This is because the objective standard applied must of necessity be very low due to the use of the amorphous term 'reasonable businessmen'. The combination of this low norm with the requirement that 'recklessness' connotes not merely a deviation but a gross deviation from the norm (ie gross negligence is required) will considerably undermine the effectiveness of the remedy. Furthermore, it will necessitate the courts making difficult value judgments on business decisions to determine which risks a company may justifiably take.

A further rationale - a wide definition of 'fraud'

There is possibly a further reason why the courts have adopted a negligence based concept of recklessness. In the *Fisheries* case, Margo J made the observation that:

> In *Dorklerk Investments (Pty) Ltd v Bhyat* 1980 (1) SA 443 (W) Phillips AJ, interpreting section 424(1), referred to English cases as bearing on the meaning of carrying on business with intent to defraud creditors or for any fraudulent purpose. On these authorities, if a company continues to carry on business and to incur debts at a time when there is to the knowledge of the directors no reasonable prospect of the creditors ever receiving payment, it is,

47 See *Ex Parte De Villiers NO: In Re MSL Publications (Pty) Ltd (In Liquidation)* 1990 (4) SA 59 (WLD).

48 Referred to by Williams R.C. (above 18).

> in general, a proper inference that the company is carrying on business with intent to defraud. Phillips AJ held at 444H that the word 'recklessly' in section 424(1) must connote something different. I assume that he meant something less, although he did not in the circumstances find it necessary to define the difference.[49]

On this analysis of the judgment of Phillips AJ, his Lordship was resurrecting a meaning of fraud first postulated by Maugham J in *In re William Leitch Brothers (No 1).*[50] This view, which seemingly did not require proof of dishonesty, was rescinded by the same judge in *In re Patrick and Lyon*[51] when he stated the need for the element of 'dishonesty' which is still required in the United Kingdom today. However it is arguable, in any event, that Margo J. incorrectly stated the position reached by Phillips AJ because Phillips AJ did in fact refer to the relevant passage from the judgment of Maughan J in *In re Patrick and Lyon* and it was at that stage that he made the comment that 'the word *recklessly* must connote something different'.[52]

Nevertheless the view of Margo J was affirmed by Milne J in *S v Harper and Another* where his Lordship added that if, in the particular circumstances it was for some reason not permissible to infer an intent to defraud, such conduct would almost invariably be reckless.[53]

This view was also affirmed by Booysen J in *Anderson and Others v Dickson and Another NNO*[54] and repeated in the leading South African text on company law.[55] The difficulty of differentiating between the two concepts was even recognised by the *Van Wyk de Vries Commission* by its statement that '[t]he dividing line between recklessness and fraud in business matters seems to be tenuous'.[56]

Thus it would appear then that the South African courts have included the normal concept of 'recklessness' within the definition of fraudulent trading.[57] As a result, in order to give the new reckless trading remedy any application it was necessary to depart from the normal meaning of reckless and embrace the concept of negligence. Further, in recognition of the fact that recklessness and negligence cannot be equated, the courts were forced to draw the distinction between gross and mere negligence.

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49 Above 169.

50 [1932] 2 Ch 71 at 77. Also see *R v Wax* 1957 (1) SA 399 (C) and *S v Harper and Anor* 1981 (2) SA 638 (D).

51 [1933] Ch 786.

52 On the other hand Phillips A.J. did refer to *Re Gerald Cooper Chemicals Ltd* [1978] 2 All ER 49, a case which would tend to support the interpretation of Margo J. as to the meaning of the judgment in *Dorklerk Investments.*

53 Above. Similarly in *Orkin Bros Ltd v Bell* 1921 TPD 92 directors who had acted with "reckless indifference" were held to have committed a fraud.

54 Above 46.

55 Henochsberg on the Companies Act (4th edition) Butterworths, Durban 1985 at 747.

56 Para 44.25.

57 See Ford, 84.

If Williams is correct in his view that the reckless trading remedy has little scope then this is for the very reason that the courts anticipated the legislature and gave the fraudulent trading remedy an extended scope. Williams' fears are encapsulated in the comment that:

> ... a person can then escape liability if he in fact foresaw the possibility of the harm in question - that the company would not be able to repay the debt - but an objective reasonable businessman would not have done so.[58]

This is possibly correct in the context of the reckless trading provision although given the broad application of the fraudulent trading provision then a remedy may, nevertheless, be available in such circumstances.[59]

Common law assimilation

The judicial development in Australia, New Zealand and the United Kingdom of a duty owed to creditors by directors of insolvent companies has been acknowledged elsewhere.[60] There are indications that the South African judiciary may be prepared to embrace a similar development.

Trading whilst insolvent a fraud

In *Ex Parte De Villiers NO: In Re MSL Publications (Pty) Ltd (In Liquidation)*[61] the Court ventured certain motherhood observations to the effect that the benefits of limited liability are not for those who knowingly try to pass the commercial risks of their ventures on to their trade creditors by, for instance, under-capitalising a company and trading with the funds provided by these creditors.

In *Ex Parte Lebowa Development Corporation Ltd*[62] such a practice of trading whilst insolvent was described as a 'social evil'.[63] The cost of acquiring the privilege of limited liability is the provision of capital by which to conduct the business. Moreover corporate officials are not permitted to expose the assets of any other persons (including the claims of creditors) to the risks of their business in the absence of consent. The conduct of an official who exposes the claim of a creditor to foreseeable loss through the risks attendant upon the company's own business is culpable because such conduct departs from the standards of a reasonable man.

58 Above 692. Contrast the findings and view expressed by Williams GL in "Directors' Liability for Fraudulent Trading", (1984) 11 NZULR 189 at 195.

59 There are indications that a subjective element may be creeping into the test of reckless trading. See *Cronje NO v Stone and Anor 1985* (3) 597 (T).

60 Dabner, "Directors' Duties - The Schizoid Company", (1988) 6 CandSLJ 105. See *Walker v Wimborne* (1976) 137 CLR 7; (1976) 40 ALJR 446; *Nicholson and Ors v Permakraft* (NZ) Ltd (in liq) (1985) 3 ACLC 453 and *Winkworth v Edward Baron Development Co Ltd and Ors* [1987] 1 All ER 114. Discussed in, for example, Sealy, "Directors' duties - an unnecessary gloss", [1988] Cambridge LJ 175.

61 Above 47.

62 Above 35. Also see *Singer NO v M J Greeff Electrical Contractors (Pty) Ltd* 1990 (1) SA 530 (W) at 538G-H.

63 Above 35, 76.

Where a company is insolvent the incurring of further liabilities exposes the creditors to the risk of loss and a director who permits this to happen commits fraud, the fraud being the dishonest exposure of the creditor's economic interest to unauthorised risk. An honest belief that the creditor will not be prejudiced is of no avail, the potential prejudice in exposing him to the risk being sufficient to establish fraud.

In reaching this conclusion the Court referred to the unacceptably high proportion of companies being wound up in insolvency and the need to reduce this practice by the more widespread enforcement of the common law and statutory remedies.

This decision, whilst not expressly cited, would appear to have been endorsed by the decision in *Ex Parte De Villiers and Another MNO: In Re Carbon Developments (PTY) LTD (in liquidation)*[64] where the Court expressed the view that if corporate officers knowingly placed at risk the interests of creditors by, for example, persuading them to provide further credit when the company was knowingly insolvent, then this would amount to fraud.

On the other hand the decision in *Ozinsky NO v Lloyd and Others*[65] suggests a judicial retreat from this strict position. In that case the Court expressed the view that fraudulent misrepresentation required conscious deceit. As there was no general rule requiring pre-contractual disclosure of all material facts then non-disclosure would only amount to fraudulent misrepresentation when there was a duty to disclose which was consciously breached. It was not true to say that in the case of insolvent companies there was such a duty of disclosure. The statements made by the Court in *Ex Parte Lebowa* were too strict. Trading in insolvent circumstances, except on a cash basis, is not per se dishonest and unlawful. To stigmatise such trading as a social evil was unnecessary and unrealistic as the reality was that most private companies had nominal paid up capital and rather relied upon shareholders loans. If these loans were taken into account many commercially active private companies would be technically insolvent. It was not the case that when these companies accepted credit that they implicitly represented that the value of their assets exceeded their liabilities, but simply that they would be able to pay the debt in terms of the undertaking. In any event, to impose on directors a duty to disclose the insolvency of a company to potential creditors was impractical.

Thus, while there would appear to be some support for a common law duty to creditors of some form with its origins in the principles of deceit, clearly this is in the stage of evolution and it is difficult to precisely identify the current state of the law. Essentially the issue would appear to be over whether fraud requires a subjective element or can be established by breach of an objective test. Thus it has similarities to the dispute between the

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64 1992 (2) SA 95 (W).

65 1992 (3) SA 396 (C).

United Kingdom courts as to the requirements for fraudulent trading. Certainly there would appear to be an assimilation between the position expressed in *Ex Parte Lebowa* and the common law requirement in Australia, New Zealand and the United Kingdom that directors of companies approaching insolvency have a duty to act in the best interests of creditors. Importantly, in contrast to the position in these jurisdictions, the principle expressed in that case would not appear to confine standing to the liquidator but rather the individual creditors whose interests are harmed may take action.

It is notable that the development of this common law duty in Australia, New Zealand and the United Kingdom is often cited as evidence that the statutory provisions were inadequate.[66] A similar comment might, therefore, be made in relation to the South African reckless trading provision. On the other hand, what we may be witnessing in the recent judicial reconsideration of this principle is a resistance to the judicial exuberance for change that characterised the development of the duty to creditors in Australia and New Zealand. Certainly the position stated in *Ex Parte Lebowa* had been arrived at without any reference to these developments overseas and little authority was cited.[67] On the other hand, proponents of this principle may gain some solace from the fact that, as will be observed below, a similar principle has also been expressed by the New Zealand Law Reform Commission.

New Zealand

General provisions and a small company regime

The New Zealand legislature has also been active in enacting defaulting officer provisions. Initially the United Kingdom approach was adopted and the equivalent provisions repeated in the *Companies Act 1933*. The fraudulent trading provision was also to appear in the *Companies Act 1955* as section 320.

However by virtue of the *Companies Amendment Act 1980* a major departure was effected. Amendments were made to the fraudulent trading provision which drew upon both the Australian and South African innovations.

66 For example, see Grantham who concedes the need for creditor protection but questions whether this radical development is appropriate: "The judicial extension of directors' duties to creditors" [1981] Jnl of Bus L 1.

67 Some reliance was placed on *Orkin Bros Ltd v Bell* 1921 TPD 92 where the Court held that there was an implied representation when directors of limited companies ordered goods that they believed that the company would probably be able to pay and if they know this not to be the case they commit a fraud. Also see *Brenes and Co v Downie* 1914 SC 97 and *Ruto Flour Mills (Pty) Ltd v Moriates* 1957 (3) SA 113 (T).

These general defaulting officer provisions have also been supplemented by a special winding-up provision only applicable to private companies registered under a unique part of the New Zealand companies legislation. This provision features its own creditor recovery mechanism. It is proposed to examine both these small companies provisions and the special features of the New Zealand defaulting officer regime.

The private company regime

The legislation generally

The New Zealand *Companies Act 1903* inserted a part into the legislation dealing solely with private companies.[68] Where a company is registered under this part, a number of specific provisions, which basically recognise that the company is akin to a partnership, apply to it. For example, the company must consist of not fewer than 2 and not more than 25 members, all the share capital is to be subscribed for in the Memorandum and the company is prohibited from issuing any prospectus inviting subscriptions for shares in its capital. At the same time the company is granted certain privileges, for example there is no prohibition on loans to directors and company affairs can be conducted without a formal meeting.[69]

Winding-up provisions

Most significantly, the private company provisions contain a number of special provisions which apply on the winding-up of such a company. For present purposes the most important of these provisions is section 364 of the *Companies Act 1955* which first appeared as section 170. Section 170(1) provided that:

> If it appears to the Court on the winding-up of a private company that any member of such company acting in its affairs has, prior to such winding-up, knowingly done or omitted any act, or been party or privy to any act or omission, which, if such member were a sole trader and had been adjudged bankrupt, would render him liable to the penalty imposed by S.138 of the *Bankruptcy Act 1908*, the Court may, if it finds that such act or omission has in fact prejudiced the creditors or any creditor of the company order any such member to pay to the liquidator of the company such sum in addition to the amount for which he may be liable under the constitution of the company as to the Court may seem just.

The provision further provided that the Court could order that such sums be paid to particular creditors and that the powers contained in the

68 The notion of private companies as defined in this part is different from the generally accepted notion of a small company with its constitution prohibiting capital invitations being made to the public and restricting the right to transfer shares. Rather, a company registered under this part is a private company.

69 Part VIII *Companies Act 1955*.

section were in addition to any other powers which the Court had on winding-up.[70]

The significance of this provision is plain from a perusal of the various offences contained in section 138 of the *Bankruptcy Act 1908*. These included not having had at the time when any of the debts were contracted any reasonable or probable expectation of being able to pay the same as well as all the other debts and having acted with intent to defraud creditors.

Section 138 of the *Bankruptcy Act 1908* was substantially amended by virtue of the enactment of the *Insolvency Act 1967*. The relevant offences are now contained in section 126, section 127 and section 128 of the *Insolvency Act*. The reckless trading offence, for want of a better description, is now couched in subjective terms in that the Crown must prove that the bankrupt did not expect to be able to pay his debts although the section provides that it will be sufficient to show that he had no reasonable grounds for expecting that he would be able to pay the debts. The new offence specifically includes within the meaning of debts, future and contingent debts.[71]

The effect of these provisions was thus to operate as fraudulent and reckless trading provisions some thirty and sixty years respectively prior to the enactment of these provisions in other jurisdictions. The major limitation of course was that the provisions only applied to companies registered as private companies. However given that reckless and fraudulent trading provisions were, initially at least, mainly directed at small private companies, and when the popularity of private company registrations in New Zealand is appreciated,[72] then this limitation is of less significance.

Significant features of S.364

Section 364 contains a number of significant features:

(i) It is not limited in its application to officers of the company, but applies to 'any member of the company acting in its affairs'.[73]

(ii) Such a person must have 'knowingly done or omitted any act or been party or privy to any act or omission' amounting to a bankruptcy offence. This is a broad head of liability in that it encompasses a

70 Subsections (2) and (3). Apart from the addition of two inconsequential sub-sections which appeared in the 1933 version of the provision (Ss 302(4) and (5)) this section has remained unchanged.

71 Ss126(1)(a) and (2).

72 There had been 86,252 registrations as at 1972. See the McArthur Committee Report, para 450.

73 In *In re JE Hurdley and Son Ltd (In Liq)* [1941] NZLR 686, 711 their Honours assumed that the word "member" included a director, although Fair J. reserved his opinion, although conceding that the term probably did include directors.

failure to act which the member was simply privy to, although the term 'knowingly' may impose a constraint on the scope of the offence.[74]

(iii) The act or omission must have 'in fact prejudiced the creditors'. Thus the focus is on creditors' rights. Notably the court is expressly authorised to direct the payment of compensation to creditors.

(iv) The court has a very wide discretion as to the quantum of the orders it can make. However it is suggested that a responsible exercise of this discretion would result in the court only ordering personal liability for a debt where it is specifically shown to have been contracted in the specified circumstances.

The provision was considered in *In re JE Hurdley and Son Ltd (In Liq)*[75] where the New Zealand Court of Appeal dismissed actions against certain directors of an insolvent company on a number of grounds. During the course of the decision a number of instructive observations were made in relation to the provision.

A new cause of action?

One issue was whether the provision created a new cause of action. Whilst Ostler J expressed some doubts as to whether the provision created a new cause of action, because nearly all the paragraphs of section 138 of the *Bankruptcy Act* referred to fraudulent and tortious acts or omissions for which an action already lay, he and the other members of the Court concluded that a new cause of action was provided. However because section 170 provided that the powers conferred by the section were to be in addition to any other powers the Court had on a winding-up, it followed that the provision providing a summary procedure to determine actions based on misfeasance against the company[76] and section 170 had to be read together and the 'real effect of section 170 is to extend the words 'misfeasance or breach or trust' as used in [the misfeasance provision] by including therein the acts and omissions referred to in section 170'.[77]

Compensatory or penal in nature?

Another issue was whether the provision was compensatory or penal in nature? Whilst Myers CJ held that the provision was penal in nature, the other two members of the Court of Appeal did not agree. Their Honours observed that section 170 applied only where it could be proved that a creditor had been prejudiced by one or more of the acts detailed in section

74 But see the discussion below.

75 [1941] NZLR 686, 711.

76 Commonly referred to as the "misfeasance provision".

77 Id 740.

138. This observation supported the view that the section was not directed towards punishing members but to compensating creditors. The real and only object of the section was to mitigate or make good losses suffered by creditors.

The meaning of 'knowingly'

As to the term 'knowingly', the Court unanimously held that it did not import any notion of mens rea into the provision. The object of using the term was solely to protect members of the company who had not taken an active part in its management. All that the term required was that the member of the company must know that a particular act was done or omitted to be done. In the context of the reckless trading offence, the member must know that the particular debts were incurred, but it is not necessary that he know at that time that there was no reasonable expectation of the company paying them. The test was broader, namely whether a reasonable man, at the time that the debt was incurred, and with the knowledge of the directors as to the affairs of the company would have known that the company was insolvent and that there was no reasonable chance of it being able to pay the debt.[78]

It may be that the remedial effect of the provisions has, in fact, been lessened by virtue of the changes to the bankruptcy offences effected by the *Insolvency Act 1967.* Now the reckless trading offence is couched in subjective terms, thereby importing a mens rea.

Cause of action for creditors?

Their Honours would seem to have taken the view that a creditor could not itself take action under section 170, although Fair J expressly stated that he reserved his opinion on this point. If the provision is truly to be read with the misfeasance provision then it would appear that standing under that provision would be determinative of the issue. Under the provision then existing creditors did have standing.

General fraudulent/reckless trading provisions

The McArthur Committee recommendations and amendments

The first general fraudulent trading provision appeared as section 268 in the 1933 Act. This provision remained unchanged as section 320 of the 1955 Act until 1980 when amendments were introduced in response to the recommendations of the McArthur Committee. The general theme of the Committee's report, widely regarded as too conservative,[79] was a move to align New Zealand company law with that of Australia and away from the United Kingdom.

78 Id 743.

79 See Russell, "The Companies Amendment Act 1980" [1981] NZLJ 71.

The recommendations

The McArthur Committee was particularly concerned at the rapid growth in the number of private company registrations together with the low level of capital with which these companies were being established. It reported that there was a danger of abuse through the incorporation with limited liability of very small undercapitalised businesses and that there was some evidence to connect company failures with companies with a small capital base. Accordingly the recommendations in relation to private companies included a requirement that private limited companies incorporate with a subscribed capital of not less than $2,000.[80]

In a more general context the Committee also recommended that the defaulting officer provisions be entirely re-enacted along the lines of the legislation then existing in most Australian States, that is section 367A to section 367C and section 374A to section 374H of the Uniform Companies Acts.[81]

The amendments

In the result the $2,000 minimum capital requirement for private companies was not enacted but otherwise the recommendations were generally adopted.[82] In relation to the defaulting officer provisions amendments included:

(i) The separation of the fraudulent trading offence, formerly contained in section 320(3), from the provision creating the civil liability, and the extension of its application to circumstances not necessarily discovered upon a winding up,[83] and

(ii) The inclusion of two reckless trading provisions within section 320 enabling the Court to make relevant orders where it appeared in the course of the winding up of a company that:

> Any person was, while an officer of the company, knowingly a party to the contracting of a debt by the company and did not, at the time the debt was contracted, honestly believe on reasonable grounds that the company would be able to pay the debt when it fell due for payment as well as all its other debts (including future and contingent debts)

80 At paras 459-470.

81 At paras 328-329.

82 Certain group company provisions had also been recommended. The resultant amendments are considered in detail below. A provision was also enacted giving the Court the power to order that any security or charge created by a company, subsequently unable to meet all its debts, in favour of a related person or company, was void as against the liquidator. The purpose of this provision was to catch persons who have gained some undue advantage through abuse of a special position in relation to the company (S 311B).

83 S 461D.

or

> Any person was while an officer of the company, knowingly a party to the carrying on of any business of the company in a reckless manner.

The reckless trading provision

Of these amendments the enactment of the reckless trading provision was the most significant. The provision effectively repeats the then existing Australian provision with the addition of an additional limb apparently copied from the South African legislation.

The second limb is directed at a course of conduct in its application and hence is possibly more suitable for actions on behalf of the company, whereas it would appear that the first limb, being directed at the incurring of a particular debt, is better designed to cater for actions by individual creditors. It is argued below that this distinction may explain the need for the enactment of the two limbs.[84]

The amendments substantially widen the scope of section 320. The scope of the fraudulent trading provision must now be very limited although it has been suggested that it is still important in respect of frauds committed by third parties or where the company has been defrauding particular creditors, such as the Revenue.[85]

Whilst the interpretation of the first limb clearly calls upon the earlier Australian caselaw,[86] the second limb of the provision has also been considered in a number of cases. A test for recklessness has been established to the effect of whether something in the financial position of the company would have drawn the attention of an ordinary prudent director to the real possibility, not so slight as to be a negligible risk, that his continuing to carry on the business of the company would cause loss to the creditors?[87] This test would appear to be essentially a restatement of the 'gross negligence' test established by the South African Courts.

In this context one particular issue that has generated difficulty is the relevance of a failure by the directors concerned to maintain proper accounts. In a number of decisions the absence of adequate accounting records has assisted the courts in a finding of recklessness.[88] However in *Re Pacific Wools Ltd* [89] careless accounting actually protected a director from

84 For a general discussion of this provision see Farrar, "The Responsibility of Directors and Shareholders for a Company's Debt", (1989) 4 Cant LR 12 at 20-25.

85 Morison, Company Law in New Zealand, Butterworths, Wellington NZ, para 40-55.

86 The leading decision on the interpretation of which was *Dunn v Shapowloff* (1977) 2 ACLR 458; [1978] 2 NSWLR 235 (CA); (1978) 5 ACLR 577 (HC).

87 *Thompson v Innes* (1985) 2 NZCLC 99,463; Re Petherick Exclusive Fashions Ltd (in liquidation) (1987) 3 NZCLC 99,946 and *Re Lake Tekapo Motor Inn Ltd (in liquidation)* [1988] NZ Recent Law 193.

88 *Re Bennett, Keane and White Ltd* (1988) 4 NZCLC 64,317; *Re Electronic Business Systems Ltd* (1990) 3 BCR 685 and *Re Rex Wood Service Centre Ltd* (1986) 3 NZCLC 100,199.

89 (1992) 6 NZCLC 67,824.

liability on the basis that he was oblivious to the company's insolvency and knowledge of the company's financial difficulties was a prerequisite for liability. The earlier authorities were distinguished on the basis that the officers concerned in those cases were at least aware that their respective companies were experiencing financial difficulties although unaware as to the precise extent of these difficulties because of the lack of adequate records.

Ultimately this issue rests on whether the test for recklessness is wholly objective or carries with it subjective elements. In any event, given the interpretation of the first limb of section 320(1) adopted in *Vinyl Processors (New Zealand) Ltd v Cant*[90] to the effect that passivity is no defence, applications in reliance on the second limb ought to be rare.[91]

Comparison with the private company provisions

The reason for this relatively late introduction of a reckless trading provision is probably attributable to the existence of section 364. For example, the Courts in *Hurdleys case* found that there was no intent to defraud but arguably had the action not been statute barred the directors would have been liable for reckless trading under the private company provisions.

The importance of section 364 may now have diminished with the enactment of a reckless trading provision in section 320. Ultimately whether this is in fact the case will depend upon the interpretation of section 320, especially as to the significance of the reference to an 'honest belief' in section 320(1), and whether this provision establishes a different test to that established by the combined effect of section 364 and section 126(1)(a) of the *Insolvency Act*. It may well be that the tests established by each provision have the same application. It would appear that in each case the issue is one of what is objectively reasonable.[92] Thus, in the case of section 320(1), the subjective test (the belief of the officer that the company can meet its debts) must be justified by an objective test (the reasonableness of that belief).[93]

Notably creditors are expressly granted locus standi to proceed against corporate officers under the reckless trading provision in contrast to the private company provision which is silent on this issue.

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90 [1991] 2 NZLR 416.

91 See Watts [1992] NZ Recent Law Review 230.

92 See Russell, "The Companies Amendment Act 1980 - Protecting the Company against its Directors" [1981] NZLJ 131, 133-134 where the author argues that the amendment to S 320 effectively restores the test stated in Re William Leitch Bros Ltd (No. 1) (1932) 2 Ch 171 which was really the type of dealing which the old S.320 was designed to attack, but which was overturned in Re Patrick and Lyon Ltd [1933] Ch 786. Also see Morison (above 85), para 40.55 Fn(d).

93 See Morison (above 85), para 40.55.

Recent New Zealand reforms and proposals

The New Zealand Law Reform Commission solvency test

During 1989 the New Zealand Law Reform Commission recommended substantial changes to the companies legislation including the defaulting officer regime.[94] After public consultation these proposals were modified and a supplementary report issued.[95]

Essentially the Commission proposed replacing the reckless and fraudulent trading provisions with a solvency test. Pursuant to section 105 of the draft legislation a director was to be prohibited from allowing a company to enter into a transaction unless he believed at the time, on reasonable grounds, that the transaction did not involve an unreasonable risk of causing the company to fail the solvency test and that the company would be able to perform its obligations when required.

The Commission also expressed dissatisfaction with the common law development of a duty to creditors.[96] Hence section 103 of the draft legislation provided that whilst directors were permitted to have regard to the interests of creditors when performing their duties this was not to be taken to limit their duties. Furthermore section 131(3) provided that both their fundamental duty to act in good faith and in the best interests of the company and their duty to observe the solvency test were owed solely to the company.

The Commission stated that the solvency test was designed to protect creditors whilst having a more restricted application than the existing provisions which were considered to go too far in undermining the position of the company as a vehicle for the taking of business risk.[97] Whilst defaulting directors would be personally liable to the company, creditors could not claim damages directly, nor mount a derivative action, although they would have standing to restrain a proposed breach of the Act or the company's constitution.[98]

Furthermore, the Commission proposed the abolition of the distinction between private and public companies arguing that the flexibility contained within the draft legislation enabled it to sensibly apply to all forms of corporation and this would remove the need for arbitrary definitions.[99] For

94 Company Law Reform and Restatement, Report No 9, June 1989, Wellington New Zealand.

95 Company Law Reform: Transition and Revision, Report No 16, September 1990, Wellington New Zealand.

96 Report No 9, para 217.

97 Id para 214.

98 Id paras 215 and 219 and see S 126 of the draft legislation.

99 Id paras 229-241.

this reason there was also no need to establish a specific close corporations regime.[100]

Companies Bill 1990 - duty to refrain from reckless trading

The resultant Companies Bill 1990[101] did not embrace the Commission's solvency test but rather restated the duty to refrain from reckless trading,[102] omitting the first limb, together with a provision requiring that directors only agree to the company incurring an obligation where they have reasonable grounds to believe that the company will be able to perform its obligations.[103] Furthermore, the statement of the duty to act in good faith and in the best interests of the company required only that the powers be exercised for a proper purpose and no reference was made to whether the interests of creditors might be taken into account.[104]

Whilst the Bill contained a statement of the solvency test[105] its relevance was essentially as a precondition to corporate distributions[106] to shareholders, the breach of which was to constitute an offence by the directors and entitle the company to recover from the relevant shareholders. Any deficiency was to be made up by the directors where, typically, reasonable grounds for believing that the company would satisfy the solvency test did not exist.[107]

The Law Reform Commission's proposals were clearly directed at denying creditors a cause of action against defaulting directors. Arguably the Bill achieved the same result as the reckless trading provision was cast in the form of a duty owed solely to the company.[108] On the other hand, both section 126 of the draft legislation and section 138 of the Bill entitled creditors to seek an injunction restraining, inter alia, a director from contravening his duties and authorising the Court to grant such consequential relief as it thought fit. Importantly, however, both provided that no order could be made in relation to past conduct.[109]

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100 Id, para 239. Notably this argument was preconditioned on the general statute being highly flexible and it was conceded that in the absence of such flexibility this position would need to be reconsidered.

101 The Companies Bill 1990 establishes a new companies regime separate to the existing legislation. The Companies (Ancillary Provisions) Bill 1991 essentially incorporates many of the features of this new regime into the 1955 Act whilst requiring all existing companies to register under the new regime by 31 December, 1994 from which date the 1955 Act is to be repealed.

102 Fraudulent trading is retained as an offence but not as a head of civil liability: S 326. Personal liability to both a liquidator and a creditor is imposed for acting in breach of a disqualification order (S 328 and S 329) or management prohibition (S 330 and S 331) or for failing to keep proper accounting records (S 172 and S 263).

103 S 113 and S 114. (Subsequently enacted as S 135 and S 136 of the *Companies Act* 1993.) It has been argued that the compromise position that has ben established is both conceptually and practically flawed: Wishart, "Models and theories of director's duties to creditors", (1992) 14 NZULR 323, 324.

104 S 109 and S 111.

105 S 4.

106 Widely defined to cover various transactions which have a similar effect of depleting the company's funds, for example a company acquiring its shares (S 51) or redeeming them (S 59 and S 60) or providing financial assistance to assist a purchase of its shares (S 61) and generally see S 2.

107 S 44 and S 48. Thus the Explanatory Note provided (at para. III) that directors would be required to have reasonable grounds for believing that the solvency test would be satisfied in particular cases.

108 S 143(3).

109 S 126(3) and S 138(4) respectively. Cf S 164 of the *Companies Act* 1993.

Furthermore, whilst the Law Reform Commission's proposals expressly rejected the common law developments in favour of creditors' interests, the Bill, by failing to address the concepts of proper purpose and the interests of the company, left the common law intact.

Justice and Law Reform Select Committee - duty to avoid carrying on business in a manner likely to create a substantial risk of serious loss to creditors

The Bill drew considerable criticism and was referred to the Justice and Law Reform Select Committee. The Committee reported back in December 1992. Whilst the Committee's recommendations did not significantly alter the corporate insolvency provisions, the duty against reckless trading was recast as a duty to avoid carrying on business in a manner likely to create a substantial risk of serious loss to creditors although the duty was still owed solely to the company.[110] Furthermore, the duty to act in the best interests of the company was modified to permit directors to recognise the greater interests of a joint venture or corporate group in certain circumstances.[111]

Companies Act 1993

This revised Bill reflecting these recommendations passed through Parliament during late 1993. The legislation comes into force on 1 July 1994.

There is cause to doubt whether the provisions forthcoming from this lengthy reform process will be effective. Certainly there would appear to be an overlap between the reckless trading provision and the duty to refrain from entering into unfulfillable obligations. This could have implications for the ultimate interpretation of both provisions as the courts struggle to reconcile them. Furthermore, there are many interpretational issues inherent in the reckless trading provision. Will a single transaction amount to business being carried on? What degree of likelihood of loss is envisaged by the provision? When is a loss a 'serious loss'? What is a 'substantial risk' of loss, particularly as the very nature of a limited company is that there is some degree of risk taken by anyone who deals with it? Finally, on what basis is the liability of a director in breach of this provision to be quantified?

Ultimately it may be that these provisions are the result of an unhappy compromise and it may have been better for the legislature to have either retained the existing provisions or to have fully embraced the Law Reform Commission's solvency test. Certainly it is arguable that the solvency test more adequately addresses the underlying concern to which these provisions are directed.[112]

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110 Cf S 135 of the *Companies Act* 1993.

111 Cf S 131 of the *Companies Act* 1993.

112 Discussed further in Dabner, "Creditor Protection - A Three Regime Approach", an unpublished paper, Law Faculty, University of Tasmania, Hobart Tasmania Australia 1994.

Conclusion

Whilst the new Australian insolvent trading provision is yet to be tested there are a number of observations that can be drawn from a review of these overseas experiences.

Cause of action for individual creditors

First, it is notable that Australian developments would appear to be part of a trend towards denying or restricting the cause of action available to individual creditors against directors for insolvent trading. Whilst this is premised on a desire to prevent a multiplicity of actions and maintain parity in winding up doubt has been expressed elsewhere by the writer as to the appropriateness of this rationale.[113] On the other hand, some of the problems associated with providing individual creditors with a cause of action are well illustrated in the South African experience. Where a course of conduct on the part of the directors is required to be proved, viz recklessness, this places a substantial onus on the creditor applicant which in turn raises the issue of whether the reckless incurring of a single debt constitutes reckless trading. Furthermore, the court is required to exercise a substantial discretion in such cases in determining the quantum of any damages award.

These difficulties can be avoided if the reckless or insolvent trading provision is drafted in such a way as to focus on the incurring of a particular debt or debts, as was the case with earlier Australian provisions.[114] However these provisions are also not without their difficulties, particularly the substantial onus cast on a liquidator or a major creditor seeking to recover a number of debts from directors who permitted their company to trade, for some time, whilst insolvent. In this regard the New Zealand approach of adopting both types of provisions may have merit.

Of course this presupposes that individual creditors are provided with a cause of action in their own right. At the very least a derivative or representative type action might be provided with priority provided to the applicant creditor as an incentive to bring the action. Surprisingly such a regime does not feature in any of the jurisdictions reviewed.[115]

In any event it must be doubted whether the restriction of primary standing to a liquidator and, hence, the elevation of the event of liquidation to a pre-condition to a cause of action, is desirable. It is not necessarily the case that a hopelessly insolvent company will be put into liquidation if an

113 Dabner, "Trading Whilst Insolvent - A case for Individual Creditor Rights against Directors", to be published in the *UNSWLR 1994*.

114 *S 592 Corporations Law*; S 556 Companies Code; S 303 and S 304(1A) and later S 374C and S 374D Uniform Companies Acts.

115 The Australian insolvent trading provision arguably does not provide sufficient incentive to creditors to bring derivative actions.

applicant creditor will be at risk of even recovering the costs of appointing a liquidator. Certainly this is an issue with small companies.

Objective and subjective elements

Notably all insolvent trading type provisions have contained a form of combined objective and subjective test. In this regard the South African provision is somewhat of an enigma. The interpretation of this provision in terms of gross negligence probably means that it has been interpreted in such a way as to contain the least subjective element notwithstanding its express reference to recklessness. On the other hand, typically, although not necessarily, gross negligence would involve a degree of negligence that was apparent to, or ought to have been reasonably apparent to, the perpetrator. It is suggested that the difficulties that were observed as having arisen from the adoption of the term 'reckless' in the legislation detract from the attractiveness of this form of provision.

The disparate nature of companies

Finally there would appear to be some evidence to suggest a need to dichotomise between the various types of companies for the purpose of establishing an insolvent trading regime. Certainly the unique problems presented by group companies require special consideration.[116] It must be doubted, however, whether the approach to group companies recently adopted in Australia adds very much given that the general legislation would be applied in the context of a broad definition of 'director'.[117]

Whether the application of the insolvent trading provision regime in relation to small companies is desirable must also be doubtful given the expense and trouble of such actions relative to the quantum of the amounts likely to be at issue. Possibly a special regime that focuses on preventative measures may be a more appropriate response to insolvent trading at this level.[118] Without purporting to endorse the actual provisions, notably the New Zealand experience provides some precedent for the existence of a special small companies insolvent trading regime.

116 Discussed further in Dabner, "Creditor Protection - A Three Regime Approach", an unpublished paper, Law Faculty, University of Tasmania, Hobart Tasmania Australia 1994.

117 See the extended Australian definition of director contained in S.60 of the Corporations Law. In particular, the definition includes a person in accordance with whose instructions the directors are accustomed to act. "Person" is defined to include a company (see S.10 to S.17). On the other hand, whilst there is no doubt that the definition of "director" is very broad it does not mean that its application to holding companies is free from doubt. The definition does not state the frequency with which instructions or directions must be provided. Whilst it would appear reasonable to assume that the requirement is satisfied if it can be shown that when a parent gives instructions or directions they are generally complied with, on the other hand, as has been acknowledged by the Cork Committee, it is often impossible to determine whether instructions had been given or other means used to secure the compliance of a subsidiary. Notably the Committee, therefore, recommended that the parent company should be presumed, in the absence of evidence to the contrary, to be a party to decisions by the directors of the subsidiary wherever the parent had been responsible for the appointment of the directors or where the boards of the two companies consisted substantially of the same persons (at para 1937). No legislation, however, was forthcoming.

118 Discussed further in Dabner, "Creditor Protection - A Three Regime Approach", an unpublished paper, Law Faculty, University of Tasmania, Hobart Tasmania Australia 1994.