

# Directors' Duties and Phoenix Companies

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## Introduction

Despite the fact that the Australian economy generally continues to experience growth, significant attention continues to be given to the responsibilities and duties of directors of companies, particularly those duties arising during insolvency. Corporate financial failures can occur even in prosperous times and there has been an increasing use of Royal and Special Commissions and more extensive use by the Australian Securities and Investments Commission (**ASIC**) and the Australian Prudential Regulation Authority (**APRA**) of their investigative powers. There can be no doubt that there is a greater focus on directors' conduct generally. One of the areas in which additional resources are being invested by the Federal Government to curb fraudulent activity by directors is that of phoenix activity.

This paper addresses both the identity and impact of phoenix companies in Australia and then reviews the most relevant directors' duties before turning to the remedies available when a breach of those duties occurs.

## 1. What is a phoenix company?

Phoenix activity is typically associated with directors who transfer the assets of an indebted company into a new company of which they are also directors. The director then places the initial company into administration or liquidation with no assets to pay creditors, meanwhile continuing the business using the new company structure. The term "phoenix company" is widely used by lawyers and other professionals.

On a basic level, a phoenix company is a limited liability company:

*"housing individuals, or the directors by name or otherwise, who abuse the corporate form by dissolving one company and creating another to avoid the payment of debt."*<sup>1</sup>

The 2005 Corporate Insolvency Reform Report<sup>2</sup> described the phoenix company phenomenon as being:

*"where business operations are transferred from one company to another to avoid having to meet liabilities to unsecured creditors (particularly revenue authorities and employees)".*

ASIC defines phoenix activities as those when a company:

- fails and is unable to pay its debts; and/or
- acts in a manner which intentionally denies unsecured creditors equal access to the available assets in order to meet and pay debts; and
- within 12 months of closing another business commences which may use some or all of the assets of the former business, and is controlled by parties related to either the management or directors of the previous company.<sup>3</sup>

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<sup>1</sup> N Couburn, *"The Phoenix Re-examined"* (1998) 8 AJCL 321 at 322.

<sup>2</sup> Insolvency Reform package released by the Treasury dated 12 October 2005.

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## 2. What is the impact of phoenix companies in Australia?

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Phoenix activities have a widespread effect on the Australian economy, but the failure of creditors to report it to the authorities means that it often remains undetected. Research carried out by the Australian Securities Commission<sup>4</sup> in the 1990s indicated that:

- the highest estimate of annual losses to the Australian economy as a result of phoenix activities was \$1.3 billion, representing 0.28% of GDP;
- 18% of small to medium sized entities had experienced phoenix activities;
- 80% of respondents who had experienced phoenix activities did not report it to the authorities;
- 45% of phoenix activities appeared to be in the building/construction industry;
- only 38% of phoenix company groups had a secured creditor; and
- 82% of respondents were prepared to continue providing credit to companies who appeared to be in financial difficulties.

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## 3. Breach of duty

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In the event that a director is involved in phoenix activities, he or she is likely to breach a number of directors' duties which stem from the general law and statute.

The general law duty of care, skill and diligence arises from the law of negligence and the relationship between the director and the company. A fiduciary relationship arises when a person undertakes to act on behalf of another in the exercise of a power or discretion which affects the interests of that other person. The equitable duties of a director stem from the fiduciary relationship between a director and the company.

As well as the general law duties of directors based on their fiduciary relationship with the company and their general duty of care, directors have certain statutory duties under the *Corporations Act 2001* (Cth) (the **Act**). Generally, these statutory duties are in addition to, not in derogation of, general law duties.

It is important to note that the duties imposed on directors (including de facto and shadow directors)<sup>5</sup> are also, in certain instances, imposed on other categories of people. For example:

- the duties of care and diligence and good faith are imposed on 'officers'; and
- the duties not to make improper use of position and information are imposed on officers and on employees.

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<sup>3</sup> ASC research paper, *Phoenix Companies and Insolvent Trading*, No. 95/01 (July 1996) p1.

<sup>4</sup> ASC research paper, *Phoenix Companies and Insolvent Trading*, No. 95/01 (July 1996) pp2-5.

<sup>5</sup> That is, 'directors who are not properly appointed or persons in accordance with whose instructions or wishes a company's board is accustomed to act'.

'Officers' include company secretaries, people who make (or participate in making) decisions which affect the whole or a substantial part of the company's business, and people who have the capacity to affect significantly the company's financial standing.

In relation to phoenix activities, the particular duties a director or officer is likely to contravene include the duty of good faith and the duties in relation to proper use of information and position.

### 3.1 Duty of good faith

There is a statutory and fiduciary duty of good faith on the part of a director.

#### 3.1.1 General law

Directors are required to act in good faith and exercise their discretion bona fide in the interests of the company and act honestly in what they consider to be the interests of the company.

The directors are vested with the right and duty of deciding where the company's interests lie and how they are to be served. It should be noted that ignorance of the facts (as opposed to the law) will not ordinarily result in a breach of duty. It has been found that a director who makes a bona fide decision in ignorance of relevant facts will have discharged their duty.

Directors must, however, exercise independent judgment in order to resist a breach of the duty of good faith. To the extent that a director relies upon the knowledge and experience of others in the corporate group, the exercise of independent judgment requires the director to listen to and assess what their colleagues have to say and bring their own mind to bear on the issue using such skill and judgment as they possess.

A director also has a fiduciary duty to act in good faith for the benefit of the company as a whole. This is a subjective duty of good faith imposed on directors. In *Re Smith & Fawcett Ltd*<sup>6</sup> it was held that directors must act

*"bona fide in what they consider - not what the court may consider – is in the interests of the company."*

It is also possible for a director to breach the duty of good faith if the law objectively considers what they are doing is improper, even if they subjectively believe that what they are doing is in the best interests of the company.<sup>7</sup>

#### 3.1.2 Corporations Act

The Act (s181) reflects the common law in requiring a director to exercise their powers and discharge their duties:

- in good faith in the best interests of the company; and
- for a proper purpose.

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<sup>6</sup> [1942] Ch 304 at 306 per Lord Greene MR

<sup>7</sup> Australian Growth Resources Corp Pty Ltd v van Reesema [1988] 13 ACLR 261

## 3.2 Use of position and use of information

### 3.2.1 General law

(a) Proper purpose

A director must exercise the powers conferred on them for the purpose for which they were conferred. The assessment of whether a director has discharged their duty to exercise their powers for a proper purpose involves an examination of the relevant director's motives as well as an examination of the nature of the power in question and the limits for which it may be exercised.

(b) Mixed purposes

Where the relevant decision taken by the directors appears motivated by a number of purposes (ie, where the decision is taken for 'mixed purposes'), Australian courts have developed the so-called 'but for' test. Under this test, an action by directors will constitute a breach of duty if there was present in that action an improper purpose which, although just one of a number of actuating purposes, was causative in the sense that, but for its presence, the action would not have been taken.

(c) Directors' duty to retain their discretion

The courts have found that it is unlawful for a director to bind themselves to act in accordance with the instructions of another person or persons. Accordingly, directors must not place constraints upon the exercise of their directorial discretions so as to ensure that they are not limited from acting in the best interests of the company.

### 3.2.2 Corporations Act

(a) Misuse of position

Section 182(1) provides that a director must not improperly use their position to gain an advantage for themselves or someone else, or to cause detriment to the company. The provision is to be interpreted with a purposive meaning rather than a causative meaning. That is, a director will be in breach of this duty where they engage in conduct with the purpose of obtaining a benefit for anyone or causing a detriment to the company, regardless of what actually occurs in fact.

(b) Misuse of Information

Similarly, s183(1) states that a person who obtains information because they are, or have been, a director of a company must not improperly use the information to gain an advantage for themselves or someone else, or cause detriment to the company. Again, the provision is to be interpreted with a purposive meaning.

Directors and officers of companies have a duty to make proper use of their position and the information they acquire through their position. The case of *Cook v Deeks*<sup>8</sup> is authority for the proposition that directors and officers cannot take advantage of an opportunity or information that belongs to the company without the prior approval of the company.

What is "improper" will be determined by the facts of the case. The case of *Grove v Flavel*<sup>9</sup> held that the particular role and duties of the individual officer had to be examined on a case by case basis rather than by a common, uniform or inflexible standard.

Although "information" is not defined in the Act in relation to the improper use of information, it is clear that it relates to "inside" information. The information itself does not need to be confidential in order for a breach to occur<sup>10</sup>.

Under the above sections, which are civil penalty provisions, the intention of the director or officer is not relevant in determining whether the provision has been contravened.

However, for the purposes of determining if a criminal offence has been committed under s184(2) or (3) of the Act, the dishonest intention of the director or officer will be relevant.

It is also important to note that it is not necessary that the contravention of the provision result in an actual accrual of an advantage or detriment.

An example of a case in which directors breached their duties of proper use of position and information is *Mordecai v Mordecai*<sup>11</sup>. It is authority for the proposition that a director who holds directorships in two competing companies cannot actively solicit the clients of one company for the use of the other without breaching his or her duties to the first company. The court held that a breach of fiduciary duty occurred when two brothers set up a company in order to reduce the potential claim of their dead brother's estranged widow on another company because they had actively solicited the clients of the other company. On the facts the court decided that the brothers had made clear use of information gained in their capacity as directors of the first company and constituted a conflict of interest and improper use of information.

## 4. Remedies against Directors

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Specific remedies available against directors who engage in phoenix activity include civil and criminal penalties under the Act, disqualification of rogue directors, access by creditors to directors' personal assets and the prevention and recovery of asset transfers.

### 4.1 General Law

A number of general law remedies are available for breach of fiduciary duty by directors. They include injunctions and declarations; damages and compensation; accounts of profits;

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<sup>8</sup> [1916] 1 AC 554

<sup>9</sup> [1986] 43 SASR 410

<sup>10</sup> *McNamara v Flavel* [1988] 13 ACLR 619

<sup>11</sup> [1988] 12 ACLR 751

rescission; tracing and constructive trusts. Such remedies reflect the fiduciary relationship between a director and a company.

#### 4.2 Corporations Act

(a) Civil penalty provisions

The statutory duties described above relating to good faith, use of position, use of information and below in relation to the prevention of insolvent trading are known as 'civil penalty provisions.' A contravention of these provisions allows a court to award pecuniary penalties of up to \$200,000 and compensation orders where the contravention resulted in a loss to the company.

(b) Criminal offences

A breach of a duty under the Act that constitutes a criminal offence attracts a fine and/or imprisonment:

- (i) Breach of the statutory good faith that is reckless or dishonest is a criminal offence.
- (ii) Breach of the statutory duties relating to use of information and position are criminal offences if the contravener intentionally or recklessly sought to gain an advantage for themselves or someone else, or cause detriment to the company.
- (iii) Breach of the statutory duty regarding prevention of insolvent trading is a criminal offence if it involves actual knowledge of the company's insolvency and dishonesty.

#### 4.3 Disqualification of directors

Section 206D of the Act provides that a director may be disqualified by the court from managing corporations for up to 10 years if they have been involved in the failures of at least two corporations within a 7 year period and poor management or wholly or partly responsible for the insolvency of the corporation. The court must be satisfied that the disqualification is justified. In determining whether the disqualification is justified, the court will consider:

- the person's conduct in relation to the management, business or property of any corporation; and
- any other matters that the court considers appropriate.

Other matters may include:

- the character of the defendant;
- the nature of the offence;
- the structure of the companies concerned and the nature of their business;
- the interests of shareholders, creditors and employees;
- the risk to those persons or to the public of the defendant continuing in his present function;

- his honesty and competence;
- hardship resulting to him, his personal and family business interests; and
- his appreciation that future breaches could result in fresh proceedings for the court to disqualify *Commissioner for Corporate Affairs v Ekamper (1987)*<sup>12</sup>.

In addition, under s206F of the Act, ASIC also has the power to disqualify a person from managing corporations for up to 5 years where the director has been involved in the insolvencies of two or more corporations within a 7 year period and the liquidator of each corporation has lodged a report about the inability of the corporation to pay its debts. ASIC must give the person notice of their intention to disqualify them and an opportunity to be heard. ASIC must be satisfied that the disqualification is justified.

The difficulty with the threshold of requiring involvement in the failures of at least two corporations until the disqualification provisions are triggered is that it does not prevent one phoenix company rising from the ashes.

#### 4.4 Insolvent Trading

In addition to the disqualification provisions, the remedies available for a breach of insolvent trading will often be available to creditors against rogue directors. It is because in many cases phoenix activities will be used where a company is nearing insolvency or is insolvent and the directors are allowing it to incur debts to creditors with the intention of winding up the company before repayment is made.

Section 588G of the Act imposes liability on a director of a company who allows the company to incur a debt at a time when the company is insolvent and at that time that the debt was incurred there existed reasonable grounds for suspecting that the company was, or may become as a result of incurring the debt, insolvent. A company will be insolvent if it is not able to pay all of its debts as they fall due. A director will be liable if at the time the debt was incurred he or she was actually aware of the existence of reasonable grounds to suspect insolvency or a reasonable person in a similar position within a similar company would have been aware. In these circumstances, an individual creditor has a secondary right to bring proceedings for compensation equal to the amount of "loss or damage" caused by the breach under subsection 588M(3) of the Act. In order to secure recovery, a director must have breached s588G(2) or (3) in relation to the incurring of the debt by the company. The amount of "loss or damage" is likely to include the amount of the debt and other consequential losses.

#### 4.5 Piercing the corporate veil

Piercing the corporate veil refers to the process of imposing liability, in disregard of the corporate entity, on a person or entity other than the offending corporation itself.

In the context of phoenix activity, the court may be prepared in certain circumstances to pierce the corporate veil and look through the façade to the individuals exercising real and actual control. There does not appear to be a broad principle of indicating the

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<sup>12</sup> 12 ACLR s19.

circumstances in which a court should lift the corporate veil. In *Briggs v James Hardie & Co Pty*<sup>13</sup> Rogers AJA stated:

*"[T]here is no common, unifying principle, which underlies the occasional decision of the courts to pierce the corporate veil."*

However, there are a number of cases involving phoenix activity where the courts have been prepared to pierce the corporate veil to achieve justice. For example, in *Janet v Kelly McKenzie*<sup>14</sup> the Hong Kong Court of Appeal found that two sisters, who were the controlling shareholders and directors of two companies, Linkwaters Investment Limited (**Linkwaters**) and Kelly McKenzie Ltd (**Kelly McKenzie**) had a clear intention to evade liability to pay a judgment debt in circumstances where they controlled both companies.

#### 4.6 Asset transfers

In certain circumstances, the Act allows for the prevention and recovery of asset transfers where there is evidence that corporate assets have been transferred to an associated company or where an uncommercial transaction has been entered into by the company. Where directors are in the process of transferring corporate assets out of a rogue company to another associated company ASIC can obtain injunctive relief under s1324 of the Act to stop this transfer and preserve the company's assets.

Another useful tool in the Act is the power under s588FB which gives the liquidator the power to challenge "uncommercial transactions". Broadly, an uncommercial transaction is one that a reasonable person in the company's circumstances would not have entered into having regard to the benefits and detriments to the company of entering into the transaction and respective benefits to other parties to the transaction.

Section 588FB allows the liquidator to recover assets transferred to a phoenix company for the benefit of creditors. However, too often, the liquidator is prevented from bringing such a claim in circumstances where there are insufficient assets to fund the proceedings. The recent Corporate Insolvency Reform Report stated that:

*"[A] regulatory gap arises because the remuneration and expenses of liquidators are ordinarily funded from the assets of the company in liquidation. Liquidators are not under an obligation to incur any expense unless there is sufficient available property to fund it. As a result, where a company is left with few or no assets, the liquidator is likely to perform only a perfunctory investigation."*

## 5. Phoenix crackdown by ASIC

In October 2005, ASIC was allocated \$23 million over four years by the Federal Government to establish the Assetless Administration Fund. It finances preliminary investigations and reports by liquidators into the failure of companies with few or no assets, where it appears that enforcement action may result from the investigation and report. A particular focus of the Assetless Administration Fund is to curb fraudulent phoenix activity.

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<sup>13</sup> (1989) 16 NSWLR 549.

<sup>14</sup> (2004) HKCA 209.

In January 2007, ASIC reported that the increase of its focus on misconduct by officers of assetless companies that have gone into administration or liquidation and left behind unpaid creditors has resulted in the removal of 40 directors.<sup>15</sup> ASIC reported in the same article that in 2006 it approved 158 applications from liquidators with a funding commitment of \$1,363,916. It has also commenced a surveillance initiative to ensure that company officers banned from managing companies comply with their disqualification. Criminal proceedings may follow in circumstances where the disqualification is breached.

## 6. Other proposals for Law Reform

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Further law reform is required to better protect creditors from the activities of rogue directors. In addition to the assetless administration fund, the Victorian Law Reform Commission (**VLRC**) has recommended two further reforms which are the introduction of a Mareva injunction and a business name register.

In the VLRC's report<sup>16</sup> there was a recommendation for a system for the preservation of corporate assets to prevent the transfer of these assets in order to facilitate the establishment of a phoenix company. The VLRC recommended the introduction of a statutory process similar to a Mareva injunction that would enable the courts to freeze the assets of a director which are assets on which the corporation has a just claim. If this were to materialise, this would greatly assist the prevention of phoenix companies by preventing the transfer of corporate assets to unassociated companies.

Secondly, the VLRC recommended that a business name register should be maintained by ASIC so that rogue directors are unable to use a business name similar to that of a failed company they were previously associated with. ASIC currently maintains the National Names Index which lists all company names reserved or in use within Australia. In the event that a National Business Name Register were maintained, this might increase the chance of preventing rogue directors from engaging in phoenix activities. A more effective system would be if more thorough checks were made by ASIC when a request to reserve a business name is made and establishing a National Business Names Index could be the way forward.

Finally, it is arguable that the law should be amended to provide that where a liquidator takes a bona fide action against directors to recover property of the corporation or to secure compensation the court should not make an order for costs or an undertaking as to damages against the liquidator personally.

## 7. Conclusion

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The task of curbing fraudulent phoenix activity is a difficult one. It is hoped that the introduction of the assetless administration fund will go some way to addressing the

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<sup>15</sup> [www.asic.gov.au](http://www.asic.gov.au) "Phoenix crackdown reaps results", 8 January 2007

<sup>16</sup> The VLRC, *Curbing the Phoenix company: First Report on the law relating to directors and managers of insolvent corporations* (1994), [4.1.44].

problem. The message to rogue directors must be that the Federal Government and ASIC are taking phoenix activity seriously and any director who breaches his or her duties in this regard should expect their actions to be investigated and punished accordingly.

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