

# AVENUES OF RECOVERY FOR A CREDITOR

## Consequences of Incorporation

Separate legal entity doctrine	
<b>Intro</b>	Australian courts have followed the UK decision in <a href="#">Salomon</a> and have recognised the strong legal personality of a company where the co is to be treated as a separate legal entity.
<b>Strong legal personality</b>	<p>As long as requirements of incorporation are met, a company is a <u>separate legal entity</u> and can contract with the human that controls it (<a href="#">Salomon</a>; <a href="#">Lee</a>; <a href="#">Macaura</a>)</p> <ul style="list-style-type: none"> <li>Even if the company only has one member (<a href="#">Salomon</a>)</li> <li><a href="#">Salomon</a>: S was chairman, managing director and had 99% shareholding and was permitted to contract with his company and obtain an advantageous bargain for himself</li> </ul>
<b>Powers</b>	<p>Corporations are given the legal capacity and powers of an individual (<a href="#">s 124</a>)</p> <ul style="list-style-type: none"> <li>Contract <ul style="list-style-type: none"> <li><a href="#">Lee</a>: L could enter a valid contract of employment with a company completely controlled by him</li> </ul> </li> <li>Hold property <ul style="list-style-type: none"> <li>A company's property is not property of its members (<a href="#">Macaura</a>)</li> <li><a href="#">Macaura</a>: M could not enter into a valid contract of insurance in respect of property which he does not own (timber was held by the company)</li> </ul> </li> <li>Assume liabilities and obligations (through contract)</li> <li>Sue or be sued</li> </ul>
Corporate veil	
<b>Limited liability</b>	<p>Liability of shareholders is limited to the amount they agreed to their investment in the company (<a href="#">ss 514-529</a>)</p> <ul style="list-style-type: none"> <li>AKA owner shielding</li> <li>See e.g. <a href="#">James Hardie</a> where court was extremely reluctant to disregard the form of the company despite the woeful circumstances of the claimant (asbestos victim)</li> </ul>

## Lifting the Corporate Veil

If the company has no money and claimants/ASIC want to get money from directors/owners

**Intro:** "Australian courts have followed the UK decision in [Salomon](#), recognising the strong legal personality of a company as a separate legal entity. In order for [xxx] to lift the corporate veil, one of the exceptions to strong legal personality must apply. A useful approach is to look first to statutory mechanisms, directors duties and then to general law exceptions ([Prest v Petrodel](#))."

### 1. Statutory exceptions: [588G](#) (Director) + [588V](#) (Holding Company)

<b>Intro</b>	<i>"The Corps Act has statutory exceptions to the limited liability principle when a company has engaged in insolvent trading. In this case, a claim may be brought directly against</i> <ul style="list-style-type: none"><li><i>[xxx] as a director under 588G or</i></li><li><i>[xxx] as a holding company under 588V</i></li></ul>	
<b>Application</b>		
<b>WHO can you claim against</b>	<b>Director</b> (s 588G(1)(a))	Duly appointed; de facto; shadow directors (s 9) NB: must be a director at the time of incurring the debt
	<b>Holding Company</b> (s 588V(1)(a))  Definitions (ss 9 'holding company'; 46 'subsidiary'; 47 'control')	S 46(a)(i) Controls the composition of the <b>board</b> ; OR <ul style="list-style-type: none"><li>Power to appoint/remove all or the majority of the board (s 47)</li><li>Courts have interpreted narrowly to only mean <u>legal</u> power as distinguished from practical control</li><li>E.g. Can only be appointed director if the HC decides so (47(a)) or if being a director of the HC means necessarily that you are a director of the subsidiary (47(b))</li></ul>
		S 46(a)(ii) >50% total <b>votes</b> ; OR
		S 46(a)(iii) >50% total <b>shares</b> <ul style="list-style-type: none"><li>Last two are usually satisfied together because of 250E (1 share=1 vote)</li></ul>
		NB: If any of the company's subsidiaries have their own subsidiaries, then the company is a HC for all of them (s 46(b))

<p><b>Debt</b> (s 588V/G(1)(a))</p>	<p><b>A debt is incurred (contractual claim)</b></p> <ul style="list-style-type: none"> <li>When a binding <u>contractual</u> obligation to pay money is voluntary incurred (<i>Hawkins v Bank of China</i>) <ul style="list-style-type: none"> <li><u>Not tort</u> claims</li> <li>Includes conditional obligations, as long as it is ultimately binding (<i>Hawkins v Bank of China</i>) - e.g. a guarantee in Hawkins</li> </ul> </li> <li>Must be a certain sum which is due rather than merely a claim for compensation that requires calculation by a court (<i>Box Valley v Kidd</i> (2006) NSWCA)</li> <li><b>S 588G(1A)</b> specifies a range of 'deemed debts' such as declaration of a dividend, reduction of share capital, share buy-back etc</li> </ul> <p><b>Timing:</b> At the time the relevant contract is entered into</p> <ul style="list-style-type: none"> <li>The non-enforcement of payment does not delay the timing of the debt (<i>Southern Cross Interiors v Deputy Commissioner of Taxation</i>)</li> </ul>
<p><b>Insolvent</b> (s 588V/G(1)(b))</p>	<p><b>At that time, the company is insolvent or becomes insolvent by incurring that debt</b></p> <ul style="list-style-type: none"> <li><b>S 95A:</b> Insolvent if the company is unable to pay their debts when they become due and payable</li> <li>Look for financial difficulties</li> </ul> <p>Usually will involve a <b>cash flow test</b> (see <i>Bank of Australia v Hall</i>)</p> <ul style="list-style-type: none"> <li>Not a balance sheet assets/liabilities test</li> <li>Do the facts indicate ability of Co to pay claims <u>when they fall due for payment</u> <ul style="list-style-type: none"> <li>So it is fine to incur a debt now, even if you cannot pay it, IF when the debt becomes due you can</li> </ul> </li> </ul> <p>However, courts will look to the <u>commercial reality</u> of the company's financial position and whether a company is practically able to pay its debts (<i>Powell v Fryer</i>; <i>Rees v Bank of NSW</i>)</p> <ul style="list-style-type: none"> <li>Use this where the company has insufficient cash but could still pay debts through e.g. asset sales or borrowed funds <ul style="list-style-type: none"> <li><b>International Cat Manufacturing:</b> Another business was supporting the company financially</li> </ul> </li> </ul> <ul style="list-style-type: none"> <li>Generally cannot rely on the non-enforcement of repayment by creditors (<i>Powell v Fryer</i>)</li> <li>Not appropriate to base an assessment on the prospect that the company might make more <u>profits in the future</u>, have to look at the particular time the debt is due (<i>Powell v Fryer</i>)</li> <li>May not be insolvent if there is evidence of an agreement (express/implied) of an extension of the payment date, course of conduct giving rise to an estoppel preventing the creditor from relying upon the stipulated time for payment, or well-established industry practice where debts are payable at a different time than what was stipulated (<i>Southern Cross Interiors v Deputy Commissioner of Taxation NSWSC</i>)</li> </ul>
<p><b>Suspecting insolvency</b> (s 588V/G(1)(c))</p>	<p>At that time, there are <u>reasonable grounds for suspecting</u> the company was insolvent or would become insolvent by incurring that debt</p> <ul style="list-style-type: none"> <li>Objective test looking at an ordinary hypothetical director of reasonable competence and diligence (<i>ASIC v Plymin</i>) who is at least able to understand the company's financial position (<i>CBA v Friedrich</i>; <i>ASIC v Plymin</i>)</li> <li>Can look at facts peculiar to the company (<i>Metropolitan Fire Systems v Miller</i>)</li> </ul> <p>Relevant factors to look at (none are necessarily determinative on their own) from <i>ASIC v Plymin</i> (2003) VSC per <i>Mandie J</i></p> <ul style="list-style-type: none"> <li>Continuing losses</li> <li>Overdue losses</li> <li>Poor relationship with the bank</li> <li>No access to alternative finance</li> <li>Inability to raise further equity capital</li> <li>Solicitor's letters, judgments or warrants issued against the company</li> <li>Inability to produce timely and accurate financial information to display the company's trading performance and financial position and make reliable forecasts</li> </ul>
<p><b>Awareness</b></p>	<p><b>Subjective</b></p> <ul style="list-style-type: none"> <li><u>Director</u> is aware at the time that there were reasonable grounds for suspecting (<b>s 588G(2)(a)</b>) <ul style="list-style-type: none"> <li>Look at their special expertise, aptitude, education, experience (e.g. accounting skills)</li> <li>Relevant to <u>criminal liability</u> for dishonest contravention (see below)</li> </ul> </li> <li><u>HC</u> (or at least one of the HC's directors) is aware at the time that there were reasonable grounds for suspecting (<b>s 588V(1)(d)(i)</b>)</li> </ul> <p><b>OR, Objective</b></p> <ul style="list-style-type: none"> <li><u>Director</u>: A reasonable person in a like position in a company in the company's circumstances would be aware (<b>s 588G(2)(b)</b>)</li> <li><u>HC</u>: A HC (or at least one of the HC's directors) would be aware, having regard to the <u>nature and extent of the HC's control over the company's affairs and to any other relevant circumstances</u> (<b>s 588V(1)(d)(ii)</b>) <ul style="list-style-type: none"> <li>Does not seem to posit a model holding company or a model director of a holding company</li> <li>Look at the holding company in its actual circumstances and determine what a reasonable person would expect as to the holding company's awareness</li> </ul> </li> <li>State that since 588V/G(1)(c) is satisfied, it is likely that this will be satisfied</li> </ul>

## Defences: Directors (588H) + Holding Companies (588X)

<b>Reasonable expectation of solvency</b>	<p><b>S 588H/X(2):</b> Director had reasonable grounds to expect, and did expect, that the company was solvent at the time and would remain solvent even if it incurred the debt</p> <ul style="list-style-type: none"> <li>Expectation requires something <u>more than mere hope</u> and implies a <u>measure of confidence</u> in the company's solvency (<a href="#">Metropolitan Fire Systems v Miller</a>)</li> <li>If it is <u>probable or certain</u> how the asset can be turned into cash to pay all debts present and to be incurred in the short term (<a href="#">Hall v Poolman</a>)</li> <li>Directors who are passive and remain ignorant of their company's financial affairs without asking for figures or information on a regular basis will not succeed under this defence (<a href="#">Tobacco Services Ltd v Morley</a>)</li> </ul>
<b>Reasonable reliance on 3rd party information</b>	<p><b>588H/X(3)</b> Reasonable grounds to believe and did believe (subjective+objective), that a <u>competent and reliable</u> person gave you adequate information <u>about whether the company was solvent and would remain solvent</u></p> <ul style="list-style-type: none"> <li>Responsibility <ul style="list-style-type: none"> <li>Director must prove that a reliable person was <u>responsible</u> for providing information about the company's solvency (<a href="#">Williams v Scholz</a>)</li> <li>Inability to verify specific tasks entrusted to the person is fatal to the defence</li> <li><a href="#">Re McLellan</a>: could not show that the accountant was specifically engaged for the purpose of providing advice as to solvency</li> </ul> </li> <li>Reasonable grounds for believing the person was <ul style="list-style-type: none"> <li>Competent</li> <li>Reliable (i.e. trustworthy) <ul style="list-style-type: none"> <li>■ Distrust is fatal to this defence (<a href="#">Williams v Scholz</a>)</li> </ul> </li> </ul> </li> </ul>
	<p>The director expected <u>on the basis of the information</u> that the company would remain solvent</p> <ul style="list-style-type: none"> <li>Subjective test - no requirement of reasonable grounds here</li> </ul>
<b>Non-participation in management</b>	<p><b>588H/X(4):</b> Because of <u>illness</u> or for some other <u>good reason</u>, the director did not take part at that time in the management of the company</p> <ul style="list-style-type: none"> <li>Interpreted narrowly and only a serious justification will suffice (e.g. Serious illness that prevents tending to company affairs or passing away of a close relative)</li> </ul>
<b>Taking all reasonable steps</b>	<p><b>588H/X(5):</b> <u>Directors/Holding Companies</u> can escape liability if they take all reasonable steps to prevent the incurring of the debt</p> <p>All reasonable steps for <u>directors</u> was held to require (<a href="#">ASIC v Plymin per Mandie J</a>)</p> <ol style="list-style-type: none"> <li>Prevent the incurring of the debt (e.g. persuade fellow directors)</li> <li>And failing that, resign immediately or wind up the company</li> </ol>
<b>Note</b>	NB: For holding company liability - the holding company and all of its directors must all satisfy the defence to avoid liability

## Consequences

<b>Director (588G)</b>	<p><b>Compensation</b></p> <ul style="list-style-type: none"> <li><u>Court ss 588J and 588K</u></li> <li><u>Liquidator s 588M(2)</u></li> <li><u>Creditor s 588M(3)</u> (with consent of the liquidator (588R) or leave of the court - see <a href="#">Aris v Express Interiors</a>) <ul style="list-style-type: none"> <li>Loss or damage must have been suffered (<a href="#">s 588M(1)(b)</a>)</li> <li>Creditor must be wholly or partly UNSECURED (<a href="#">s 588M(1)(c)</a>)</li> <li>Company is being wound up (<a href="#">s 588M(1)(d)</a>)</li> </ul> </li> </ul> <p>NB: If creditor is not owed a substantial amount, may say that in practice there is little incentive to take action</p> <p><b>Civil penalty</b></p> <ul style="list-style-type: none"> <li>Section 588G(2) is a civil penalty provision (<a href="#">1317E</a>) and so the director may be liable to pay a fine to the regulator of up to \$200k (<a href="#">s 1317G</a>)</li> </ul> <p><b>Criminal liability for dishonest contravention (<a href="#">s 588G(3)</a>)</b></p> <ul style="list-style-type: none"> <li>If failure to prevent incurring a debt was dishonest (i.e. had <u>actual knowledge</u> that the company is in financial difficulties and <u>deliberately</u> acts)</li> <li>ASIC can bring criminal proceedings and the director may be liable to pay up to 2,000 penalty units and/or 5 years imprisonment</li> </ul>
<b>Holding Company (588V)</b>	<p><b>Compensation</b></p> <ul style="list-style-type: none"> <li>Under <a href="#">s 588W</a>, the LIQUIDATOR (see <a href="#">s 471A</a> and <a href="#">477</a>) may recover loss from a HC if <ul style="list-style-type: none"> <li>The claimant has suffered loss or damage; is wholly or partly unsecured; and the company is being wound up (<a href="#">s 588W(1)</a>)</li> </ul> </li> </ul>
<b>Priority for claimants</b>	<b>S 588Y</b> provides that for any means of recovery, unsecured creditors take priority over secured creditors

## Relief from civil penalties for DIRECTORS

<b>Reasonable time to repair is given</b>	<p>Director must be allowed a reasonable time to assess whether the company's difficulty is temporary and remediable or endemic and fatal (<a href="#">Hall v Poolman</a>)</p> <ul style="list-style-type: none"> <li>• Are not expected to abandon substantial trading as soon as any liquidity shortage occurs</li> <li>• <a href="#">Hall v Poolman</a>: was reasonable for three months to try and resolve the ATO dispute and attempt to save the business, but after that it was clear the ATO was unlikely to resolve the dispute and so they became liable - gained <u>partial</u> relief</li> </ul>
<b>Full relief from civil penalties</b>	<p>In <a href="#">Re McLellan</a>, the court held that a director can be <u>fully relieved</u> of liability for <u>civil penalties</u> under s 1317S if the director had acted reasonably in allowing the business to continue trading for a limited time while he/she tried to restore profitability</p> <p>Considerations:</p> <ul style="list-style-type: none"> <li>• Diligence, honesty and fairness</li> <li>• Whether the director profited personally</li> <li>• Whether the director heeded professional advice</li> <li>• Whether the director was taking active steps to repair profitability</li> </ul> <p><a href="#">Schohlz</a>: knowledge of deteriorating financial conditions, suspicions of mismanagement but failure to take remedial steps</p> <p><a href="#">Re McLellan</a>: Director took active steps to try and fix the business (sought advice from a specialist accountant; tried to expand sales)</p>

### 3. General law exceptions

Intro	Court will not allow the company to be used as a cloak to conceal a sham or fraud ( <i>Horne</i> ). In these limited instances, the court will treat the manager/controller and the company as the same legal person
a. Sham	
What constitutes a sham?	Intention to deceive ( <i>Sharment, Lewis</i> ) or for a legally effective transaction not to have the apparent legal consequences ( <i>Equuscorp</i> )
Avoiding a legal obligation	Company incorporated for the purpose of <u>avoid an existing obligation</u> of the controller ( <i>Horne, Jones, Prest</i> ) <ul style="list-style-type: none"> <li>E.g. avoiding a non compete clause (<i>Horne</i>), avoiding a sale of land contract (<i>Jones</i>)</li> <li>D: If the company was established before the obligation was incurred (e.g. <i>Prest: Case with the husband and the wife? Had already been established?</i>)</li> <li>DOes it have to be the sole reason? Or one of the reasons?</li> </ul>
Fraudulent existence	If the overriding rationale for the existence of the company was fraud, the court will treat the company as indistinct from the owner ( <i>Re Darby</i> ) <ul style="list-style-type: none"> <li>E.g. selling worthless mining rights to unsuspecting investors (<i>Re Darby</i>)</li> </ul>
b. Agency(?)	
Intro	Where the company is an agent of the controller the court may pierce the corporate veil (recognised in <i>Salomon's case</i> )
Atkinson J's 6 questions ( <i>SSK</i> )	Summary <ol style="list-style-type: none"> <li>Were the <u>profits</u> treated as the profits of the parent company?</li> <li>Were the persons conducting the business <u>appointed</u> by the parent company?</li> <li>Was the parent company the <u>head and the brain</u> of the trading venture?</li> <li>Did the parent company <u>govern</u> the adventure, decide what should be done and what capital should be embarked on the venture</li> <li>Did the parent company make the profits by <u>its skill and direction</u>?</li> <li>Was the parent company in <u>effectual and constant control</u>?</li> </ol> <p>Are these all necessary factors - or mere indicia?</p>
Domination	Domination or extreme form of influence of a company by the owner to the extent that a company cannot do anything on its own and has no independent will ( <i>SSK</i> )
	Ownership (Q 2 and 6) <ul style="list-style-type: none"> <li>E.g. <i>SSK</i> owned 99% of shares and remaining 1% was held by directors of the parent company</li> <li>However, 100% ownership alone is not determinative of domination (<i>Salomon's case</i>)</li> </ul>
	Separate existence (Q 3, 4 and 5) <ul style="list-style-type: none"> <li>If a subsidiary has no separate existence (including no employees except a manager), this points to domination (<i>SSK</i>)</li> </ul>
	Treatment of profits (Q 1) <ul style="list-style-type: none"> <li>Independent bank account? <ul style="list-style-type: none"> <li>Waste had no independent bank account (<i>SSK</i>)</li> </ul> </li> <li>Profit sharing? <ul style="list-style-type: none"> <li>Profits were taken by the parent directly, not paid as a dividend (<i>SSK</i>)</li> </ul> </li> <li>Keeping of financial records? <ul style="list-style-type: none"> <li>Parent kept all the books and financial records of Waste (<i>SSK</i>)</li> <li>Manager of the subsidiary had no knowledge of, or access to the financial records of the subsidiary (<i>SSK</i>)</li> </ul> </li> </ul>
Questionable precedential value	England <ul style="list-style-type: none"> <li>Criticised and rejected by English courts</li> <li>Control by a parent company over a subsidiary is typical (<i>James Hardie per Rogers AJA</i>)</li> <li>Complete domination and control of a principal is not part of ordinary rules of agency which is instead based on knowledge and consent</li> </ul> Australia <ul style="list-style-type: none"> <li>Not affirmed in Australia therefore not clear how much weight will be given to this unusual category</li> </ul> <p>[write a pre-prepared answer here]</p> <p>This exception at general law has questionable precedential value in Australia. It has been criticised by English courts who have argued that the exception would be too far reaching since control by a parent over a subsidiary is typical (<i>James Hardie per Rogers AJA</i>). It is also doubtful that conventional principles of agency, based on knowledge and consent, apply in the cases of domination and control.</p>

