TRADING WHILST INSOLVENT - A CASE FOR INDIVIDUAL CREDITOR RIGHTS AGAINST DIRECTORS

JUSTIN DABNER*

The corporate excesses of the 1980s, together with the recession, focussed attention on the ability of creditors of insolvent limited liability companies to recover their losses from directors and related companies. One result of a series of government sponsored enquires and reform proposals has been the replacement of s 592 of the *Corporations Law* with an insolvent trading provision and the enactment of special provisions dealing with holding company liability for the debts of insolvent subsidiaries. It is argued that whilst these novel provisions admit of some interpretational difficulties, their major deficiency is the inadequacy of the cause of action provided to individual creditors. The restriction, essentially, of standing to a liquidator suing on behalf of the company was a response to the reform recommendations which have assumed that such a feature furthers the principle of parity in winding up. However, it is argued that the furtherance of this principle in this manner will not necessarily achieve the optimum result in all circumstances and a case can be made for the provision of equal standing to creditors either in a personal or derivative capacity.

* Senior Lecturer, Faculty of Law, University of Tasmania.

I. INTRODUCTION

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

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,[2] 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.

It is proposed in this article, first, to examine the details of the reports motivating this legislation and then to examine the actual reforms relating to the defaulting officer provisions.[3] Essentially, the defaulting officer provisions have been recast as a duty to prevent a company from engaging in insolvent trading. Furthermore, provision is made for a cause of action against holding companies where subsidiaries have been allowed to trade whilst insolvent, although notably this provision does not go as far as the recommendations proposed.

It will be observed that whilst these reforms have generally been well received there has been some comment to the effect that certain deficiencies of the former

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1 For example, see A Herzberg, "Insolvent Trading - Civil Liability of Company Officers Under Insolvent Trading Provisions" (1991) 9 *Company and Securities Law Journal* 285 and see his earlier article "Current Developments Legal and Administrative" (1985) 3 *Company and Securities Law Journal* 202. Also see K Mangioni, "Directors' Personal Liablity: Section 592 of the *Corporations Law* and Related Matters" (1991) 27 *Butterworths Corporation Law Bulletin* [507]. Also note P Vickery, "Section 556: No Rest for the Sleepy" (1990) 64 *Law Institute Journal* 1181; J Hill, "The Liability of Passive Directors: *Morley v Statewide Tobacco Services Ltd* (1992) 14 *Sydney Law Review* 504; R Baxt, "Company - Liability of Directors for the Debts of the Company" (1988) 62 *Australian Law Journal* 643; "Limited Liability for Directors who do not Authorise the Incurring of Debts" (1988) 16 *Australian Business Law Review* 390; A Herzberg, "*Metal Manufacturers v Lewis*" (1987) 5 *Company and Securities Law Journal* 200 and "The Metal Manufacturers Case and the Australian Law Reform Commission's Insolvent Trading Recommendations" (1989) 7 *Company and Securities Law Journal* 177; GR Kennett, "Companies - Liability of Director to a Third Person" (1989) 63 *Australian Law Journal* 502; and JG Starke, "Companies - Liability of Individual Connected with Company" (1991) 65 *Australian Law Journal* 300.

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

3 In addition to the various reform committees considered below, the Companies and Securities Law Review Committee has also recommended the establishment of a statutory derivative action encompassing creditors as potential applicants. (Companies and Securities Law Review Committee, *Report No 12: Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action*, November 1990. Also see Companies and Securities Law Review Committee, *Discussion Paper No 11: Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action*, July 1990.) One of the features of this proposal is that no distinction is drawn between creditors of the company concerned and those of related companies and, in fact, creditors of related companies have standing and may share in any recoveries if so ordered. The proposal, therefore, clearly recognises commercial realities and the status of a group as a legal entity. The recommendations of the Committee are yet to be responded to by the Government although the Companies and Securities Advisory Committee in its *Report on a Statutory Derivative Action*, July 1993, rejected the extension of the action to encompass creditors as potential applicants: p 14.

provisions have been perpetuated and that the group company proposals are misguided. It will be argued that although the reforms satisfy the need to repair the defaulting officer provisions, restrictions placed on the cause of action available to individual creditors are unsound. It will be argued that a mandatory collective regime fails to appreciate the disparity characterised by creditor interests and is falsely based on the premise that all creditors are equal. Furthermore, once it is recognised that the creditor recovery legislation is essentially about ensuring a legitimate transfer of risk and what is legitimate may, at least to some extent, depend on the circumstances of a particular creditor, the case for individual rights of some form is overwhelming.

II. THE COMMONWEALTH LAW REFORM COMMISSION DISCUSSION PAPER ON INSOLVENCY PROPOSALS

A. Background to the Proposals

During August 1987 the Commonwealth Law Reform Commission (the Commission) issued for discussion a number of proposals being considered for the reform of insolvency law.[4] In the Discussion Paper the Commission identified some of the deficiencies in the defaulting officer provisions. In particular, the Discussion Paper identified the length of recovery proceedings, the fact that the law favoured creditors with resources enabling them to take action and that the provisions encouraged a multiplicity of actions if all creditors were to be compensated with the likelihood that the first creditors to take action would exhaust the assets of the errant directors. Accordingly, the Commission stated that there was an urgent need for reforms which would promote the principle of equal sharing in an insolvency.

B. Outline of the Proposals - a Duty to Prevent Insolvent Trading

(i) The Duty

The proposed legislation was to repeal the fraudulent and reckless trading provisions and in their place impose on directors a duty to prevent their company from engaging in insolvent trading.[5] Breach of this duty would only give rise to a civil liability and this would be in favour of the company, notwithstanding that the breach of duty would adversely affect creditors. Thus only the liquidator or a creditor with leave could bring proceedings and only then on behalf of the company.

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4 Australian Law Reform Commission, *General Insolvency Inquiry, Discussion Paper No 32*, August 1987. See generally chapter 6.

5 In contrast to the repealed legislation, the precondition for the application of the provisions was that the company go into an insolvent winding up and not simply one of the wide range of situations of insolvency administration specified in the *Companies Code*, s 553, (*Corporations Law*, s 589). This was intended to encourage directors to buy their way out of liability, with perceived benefits for creditors.

Insolvent trading was characterised as the incurring of debts in circumstances where there were reasonable grounds for suspecting that a company was unable to pay its debts, after taking into account contingent and prospective liabilities, and where the company was subsequently wound up in insolvency. The Commission argued that the use of the term "suspect" rather than "expect" would impose a higher standard of care on directors.[6]

To overcome the difficulties of proof which have plagued provisions of this nature there would be a presumption of an inability to pay debts where it was shown that either liabilities exceeded assets or adequate accounting records were not kept or were not available in circumstances where the company was unlikely to pay its creditors more than 50 cents in the dollar. Once established, circumstances of insolvency would be presumed to continue to exist.

(ii) The Defences

Directors would be able to avail themselves of a number of defences including:

(i) that the director 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, inter alia, that either:
   (a) another person, who it was believed on reasonable grounds was competent and reliable, was entrusted with responsibility to ensure that the company did not engage in insolvent trading; or
   (b) the director was not able, for good reasons, for example illness, to participate in the management of the company;

(ii) that the director took steps to minimise a possible loss for creditors, for example, by endeavouring to either prevent the insolvent trading or to place the company under a form of administration in insolvency; and

(iii) the relief provided for by s 535 of the *Companies Code*[7] would be available to directors who could establish that they acted honestly and ought to be excused for their breach of duty.

(iii) Extent of Liability

Where a director was found liable, his liability was to be measured by the loss or damage sustained by the creditors, taking into account any benefit to the company from incurring the debts and whether any of the creditors continued to trade with the company in the knowledge of its circumstances, with the court having a broad discretion in this regard. Any sum recovered was to be applied for the benefit of all unsecured creditors.

The Commission emphasised that the liability would be civil only, taking the view that criminal liability in this area was in appropriate and provided no

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6 On the other hand, the requirement that the director suspect that the company "is unable to pay" rather than "will not be able to pay" was intended to have the effect that a director would not have to take into account such matters as general forecasting data which arguably he was required to do by the existing legislation.

7 *Corporations Law*, s 1318.

additional benefit. In particular, it questioned the deterrent capacity of a criminal sanction stating that in fact to the extent that it might discourage an attempt to trade out of difficulties in circumstances where the directors were prepared to make good any loss to creditors, a criminal sanction actually deterred such behaviour. Furthermore, criminal prosecutions for insolvent trading were seen as a waste of public resources in circumstances where penalties were likely to be light given the limited culpability of the conduct at issue.

C. Group Company Proposals

(i) Proposals Based on New Zealand Precedents

The Discussion Paper also advanced proposals in relation to group companies based on the New Zealand legislation which:

(i) empowers a court to order a past or current related company to contribute, by way of payment to the liquidator, to the debts of a company in liquidation; and

(ii) provides that where two or more related companies are being wound up, the court may order that their assets be pooled in such a manner that they are wound up together as one company.[8]

Applications can be made under both provisions by the liquidator, and additionally under the former by a creditor or contributory of the company being wound up. The court has a wide power to make such orders as it thinks fit, the overriding consideration being that it be "just an equitable" and, in the case of the second provision, that the interests of minority shareholders be considered.[9]

In the Discussion Paper, the first provision appeared as s D15 of the draft legislation with some minor changes whilst the second appeared as s PR3.[10]

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8 Contained in the *Companies Act* 1955, ss 315A, 315B. These provisions were inserted into the *Companies Act* 1955 by the *Companies Amendment Act* 1980 on the recommendation of the McArthur Committee, *Final Report of the Special Committee to Review the Companies Act*, New Zealand, 1973 at [405]. The United Kingdom Cork Committee, *Report on Insolvency Law and Practice*, 1982 (Cmnd 8558) criticised the New Zealand provisions for their lack of specificity, referring to them as the "discretionary solution" at [1947]-[1950]. See also the New Zealand Law Reform Commission, *Company Law Reform and Restatement, Report No 9*, June 1989 at [681] and s 212 of the draft legislation. The recommendations were not disturbed by the revised report: New Zealand Law Reform Commission, *Company Law Reform Transition and Revision*, Report No 16, September 1990 recommended the retention of these provisions, although in a more concise form, and they were included as s 235 of the *Companies Bill* 1990. After some debate (the Bill drew considerable criticism and was referred to the Justice and Law Reform Select Committee which reported back in December 1992) the Bill was revised and passed through Parliament during late 1993. The legislation will come into force on 1 July 1994. See s 271.

9 The legislation contains guidelines for determining what is "just and equitable". In relation to s 315A orders, the court is to have regard to: (i) the extent to which the related company took part in the management of the company being wound up; (ii) the conduct of the related company towards the creditors of the company being wound up; (iii) the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related company; and (iv) such other matters as the court thinks fit (s 315C(1)). In relation to s 315B orders, the court is to have regard to similar factors and also the extent to which the business of the companies have been intermingled (s 315C(2)).

10 The Discussion Paper also canvassed the problems associated with cross-frontier insolvency, including those arising from the insolvent winding up of multinational companies. The Commission's proposals included that

(ii) Section D15 - Contribution Orders

In relation to s D15, the Discussion Paper envisaged its application in two circumstances:

(i) where the related company has been acting as a "director" of the other company and causing it to incur debts and liabilities; and

(ii) where creditors of the other company have legitimately taken into consideration the assets of the related company in making commercial decisions about dealings with the other company only to find the related company to rapidly distance itself from the financial problems of the other company.

(iii) Section PR3 - Pooling Orders

Similarly, the Discussion Paper envisaged the application of s PR3 in two situations:

(i) where it would appear justifiable to make one company liable for the debts of a related company having regard to certain criteria; and

(ii) where because the business of the companies has been intermingled, administrative convenience dictated their joint winding up.

The Discussion Paper acknowledged the possible need to adjust the rights of the creditors of the various companies by stating that the court need not order an equal distribution of assets should it cause injustice.

D. Reactions to the Proposals

These proposals met a mixed response. For example, Farrar[11] applauded the removal of the criminal sanctions in the absence of fraud and the restriction of locus standi to enforce the duty to the liquidator or a creditor in the form of a derivative action. However, he itemised a number of potential difficulties and anomalies:

(i) it was anomalous that directors were to have a duty not to engage their company in insolvent trading whereas no such duty is imposed on natural persons;[12]

(ii) the duty would be one "to prevent" which is a very onerous obligation, particularly bearing in mind that a director's role is to act as part of a collegiate body; and

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Australia promote multilateral international treaties as regards the adoption of common basic elements of insolvency law and also promote the reciprocal recognition of insolvency laws. Furthermore, the Australian companies legislation ought to be amended to contain a provision enabling the administration of an insolvent company being conducted overseas to be recognised and enforced in Australia. Australia should also seek to encourage other countries to adopt a similar provision: note 4 *supra* at [663]-[664]. See chapter 19 generally.

11 JH Farrar, "The Obligations of a Company's Director to its Creditors", unpublished, New Zealand, 1987. Also see JH Farrer, "Responsibility of Directors and Shareholders for a Company's Debts" (1984) 4 *Canterbury Law Review* 12 at 32-33

12 Natural persons also cannot claim the privilege of limited liability in respect of an insolvent enterprise in which they are personally engaged.

(iii) the word "suspect" was likely to present interpretational difficulties.

Adler provided a further commentary. He argued that the current law was sufficient to protect creditors and simply needed to be administered more strongly. Any extension of the current obligations on directors was only potentially damaging to the economy. The proposals were an attempt "to catch a few bad fish with a very big net" and would simply have the effect of discouraging honest and competent directors and impeding business development. He concluded by encouraging opposition to the proposals and pressing for legislation which recognised the right of directors to accept legitimate business risks, including the right to nurse businesses back to health.[13]

These comments are considered below in the context of the Commission's ultimate recommendations.

III. THE COMMISSION'S REPORT

A. Duty to Prevent Insolvent Trading Recommended

The ultimate recommendations of the Commission, published late in 1988,[14] deviated little from the proposals contained in the Discussion Paper. Directors were to be liable to their company for insolvent trading, upon an action by a liquidator or a creditor with the liquidator's leave. Central to the proposal was the promotion of the principle of equal sharing in an insolvency and the focusing of attention on directors' responsibilities for the overall financial management of the company and not the incurring of particular debts.

The Report acknowledged that the presumptions had drawn criticism and some minor modifications were inserted, although not meeting all these criticisms.[15] Similarly, criticisms of the defences were noted and the format of the defences were re-organised. The "reasonable grounds to expect payment" defence was amended so that it was necessary for the director to expect that the company would be able to pay the debt from its own resources. This was to overcome the decision in *Deputy Commissioner for Corporate Affairs v Caratti*,[16] the effect of which was to enable directors to avoid liability on the basis of an alleged expectation of funds from a source which they controlled. However, the Commission refused to accept the criticism that the standard contained in the defence should be the same as that contained in the substantive provision, namely "suspect" rather than "expect". The Commission stated that the intention was that a vigorous standard apply to directors such that if they even suspect that the company may be trading while insolvent they should examine its affairs to ensure that there are reasonable grounds to expect that it will be able to pay its debts. Furthermore, this defence

13 "Creditor Idea Damaging, says Adler" [1988] 4(6) *Company Director* 20.

14 Australian Law Reform Commission, *General Insolvency Inquiry, Report No 45*, January 1989 (Harmer Report).

15 *Ibid* at [290]-[[301].

16 (1980) 5 ACLR 119.

could no longer be established by pointing to illness or the like; rather, this was now to be viewed as a separate defence in its own right in place of the reference to the general defence contained in s 535 of the *Companies Code.*

In relation to the proposed defence that a competent and reliable person had been entrusted with responsibility for the company, the Commission indicated that it had reconsidered this defence and now viewed the duty as imposed on directors alone. Thus, the proposed defence would now require that the director believe, on a reasonable basis, that a competent and reliable person had the responsibility of providing the director with sufficient information to enable the director to comply with the duty and apparently discharge that responsibility.

Whilst the Commission maintained its position that individual creditors not be able to bring an action against directors except by way of derivative action, a further recommendation was made that the court be given a discretion to distribute the proceeds of such an action in favour of those creditors who had financed the action.

B. Group Companies

Again the proposals contained in the Discussion Paper were put as recommendations with only minor amendments.[17] The Commission observed, however, that the proposal that companies contribute to an insolvent liquidation of a related company in circumstances where these companies had effectively directed the insolvent company or the companies had effectively represented themselves to creditors as a single entity, was the subject of criticism. It had been argued that the provision:

(i) infringed the fundamental principle of separateness;
(ii) jeopardised the feasibility of large projects which were often predicated on the ability of a parent company to secure limited recourse finance;
(iii) generated uncertainty in commercial dealings especially in the context of the provision of finance to subsidiary companies; and
(iv) would render it difficult for auditors and company directors to produce accounts representing a true and fair view of a parent company.

The Commission was not however, impressed by these arguments, claiming that the discretion vested in the courts by the provision and the commercial reality, that groups of companies are often viewed by the business world as a single entity, justified the introduction of the provision.

Similarly, the proposal in relation to asset pooling on insolvent liquidation was also affirmed by the Commission, although with an amendment requiring the court to have regard to the extent to which creditors of any of the companies might be advantaged or disadvantaged by the making of a pooling order.

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17 Note 4 *supra* at [222]-[336].

C. Comments on these Recommendations

(i) No Cause of Action for Individual Creditors

Arguably the most significant feature of these recommendations is the vesting of standing solely in liquidators, except by leave of the court. The effect of this is likely to be that individual creditors would be completely precluded from recovering losses from company directors. Whilst it is generally conceded that this may possibly generate a harsh result in specific cases, it is typically justified as being more just overall, as recoveries would go to increase the pool of assets available to all creditors.[18] This restriction of standing to the liquidator and away from individual creditors has also been supported on the basis that, as liquidators have complete access to the company's records and the power to gain information from the company's officers and employees, they are in a better position to establish a case.[19] Furthermore, as in practice, a creditor who initiates proceedings is also typically the creditor who initiates the winding-up of the company and so bears significant legal costs in recovering the debt, this is further grounds for limiting standing.[20]

These justifications are explored further below, where it is argued that there are grounds to doubt whether justice will, in fact, be enhanced by denying individual creditors a cause of action.

(ii) General Endorsement by Commentators

Most commentators generally endorsed these recommendations whilst noting some areas of likely interpretational difficulties and, in the case of Farrar and Adler,[21] expressing some concerns at the severity of the obligations to be imposed on directors.

Trethowan for example, applauded the recommendations, although with the observation that the problem of making non-participating directors liable may be frustrated by the vagueness of the defence available to directors who can establish a "sufficient cause" for neglecting their duties.[22] She also observed that, given the various regimes that impact on the liability of directors to creditors, there is a potential for recourse to these other regimes to undermine the principles underlying these recommendations.[23]

Similarly, Herzberg generally endorsed these proposals, although with the suggestion that the focusing on debts incurred and not management's failure to initiate prompt liquidation, was a design flaw which would limit the remedy to trade creditors. He suggested that the aim of insolvent trading provisions should be

18 For example see I Trethowan, "Directors' Personal Liability to Creditors for Company Debts" (1992) 20 *Australian Business Law Review* 41 at 70. Also see JH Farrar (1984), note 11 *supra*.

19 A Herzberg (1991), note 1 *supra* at 289.

20 *Ibid* at 291.

21 Note 13 *supra*.

22 I Trethowan, note 18 *supra* at 70.

23 *Ibid* at 76-7. This criticism could be readily addressed by legislation prohibiting reliance on these other recovery regimes.

to ensure that management promptly ceases trading when it becomes apparent that the company cannot trade its way out of financial difficulties.[24] In this respect the new, more specific, defences were, in his view, particularly satisfactory being more attuned to the purpose of the insolvent trading provision to encourage prompt action.[25]

(iii) Other Observations on the Proposals

Whilst there appears to be considerable support for these recommendations, it is notable that subsequent judicial decisions have repaired many of the problems in s 592 with respect to the meaning of the term "debt"[26] and the breadth of the defences.[27]

Furthermore, the problems identified with creditors proving their cause of action under s 592 are, to some extent, ameliorated by the availability of discovery[28] and the right of inspection provided by s 486 and, in any event, could be remedied by the provision of further presumptions. There is also some evidence to suggest that s 592 does secure the result that management is obliged to promptly secure insolvency administration.[29] Arguably, the removal of one category of potential applicants who could enforce the provision, namely creditors, in favour of a collective recovery regime essentially enforceable only by the liquidator, may only serve to limit its effectiveness. The fact that, as acknowledged by Herzberg, some creditors might also achieve a windfall gain under these provisions, can also be attributed to the collective nature of the recovery regime.[30]

In relation to the group company proposals, it is arguable that they suffer from a number of deficiencies that have been identified in relation to the New Zealand legislation.[31] Furthermore, although the proposals adopted the definition of "related company" contained in the *Corporations Law* ss 46-50, this definition is arguably too narrow. In particular, the definition is couched in terms of 50 per cent share capital being held by another company and those related to it. The

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24 A Hertzberg (1991), note 1 *supra* at 286. Also see generally A Herzberg (1989), note 1 *supra*.

25 *Ibid* at 308. Whilst Herzberg also supported the presumptions, he expressed regret that the Commission did not simply recommend that the company be presumed to be insolvent within a specified period of time prior to the commencement of winding-up: *ibid* at 307. Furthermore, he observed that the fact that any recoveries were to be distributed equally between the unsecured creditors may give some creditors the benefit of a windfall gain, namely those creditors whose unpaid debts were incurred prior to the company engaging in insolvent trading: *ibid* at 309.

26 For example see *Hawkins v Bank of China* (1992) 10 ACLC 588.

27 See *Group Four Industries Pty Ltd v Bronson* (1992) 8 ACSR 463 and *Morley v Statewide Tobacco Services* (1990) 8 ACLC 827; (1992) 8 ACSR 305. For a similar conclusion see RJ Burrell and SS Long, "Apathetic Directors Beware - Recent Case Developments" (1991) 21 *QLSJ* 5 at 13.

28 But see *EL Bell Packaging Pty Ltd v Allied Seafoods Ltd* (1990) ACLC 1135. Distinguished in *Southern Star Group Pty Ltd v Taylor* (1991) 9 ACLC 386.

29 See the discussion below.

30 See the discussion below.

31 These deficiencies were identified by the Cork Committee, note 8 *supra* at [1950] - [1952], as their reason for not recommending provisions of this nature, in particular the wider ramifications of such legislation in relation to directors' duties. Furthermore, the Committee criticised the New Zealand provisions for their lack of specificity, referring to them as the "discretionary solution".

fascination with 50 per cent share holding is to be questioned. It is well documented that a 50 per cent share holding or voting power is not required for control, assuming that that is the essential feature sought to be defined.[32]

IV. REPORT OF THE JOINT SELECT COMMITTEE ON THE CORPORATIONS LEGISLATION

When the Commonwealth Government introduced the *Corporations Law* into Parliament during 1988 it generated considerable controversy with the result that the bills were referred by the Senate to a Joint Select Committee. The Committee's Report was tabled in April 1989. Included in its recommendations was that the reforms proposed by the Law Reform Commission[33] receive early attention and that the necessary amendments be enacted as soon as possible.[34]

V. REPORT OF THE SENATE STANDING COMMITTEE ON LEGAL AND CONSTITUTIONAL AFFAIRS

During May 1988 the Senate referred to the Standing Committee on Legal and Constitutional Affairs a consideration of the social and fiduciary duties and responsibilities of company directors. The Committee's report was published during November 1991.[35] This report comprehensively examined the responsibilities and liabilities of corporate officials and contained a number of recommendations. Whilst these recommendations did not deal directly with the

32 AA Berle and GC Means, *The Modern Corporation and Private Property*, Harcourt, Brace World, (revised ed, 1968) p 75. Also see the South African Van Wyk de Vries Commission of Enquiry into the Companies Act, Main Report, 1970 at [46.01]-[46.33], in particular [46.17]; R Baxt and D Harding, "Duties of Directors and Majority Shareholders in Groups of Companies - Tensions between Commercial Convenience and Legal Obligations", 9 *Commercial Law Association Bulletin* 127 and CM Schmitthoff, "The Wholly Owned and the Controlled Subsidiary" (1978) *Journal of Business Law* 218 at 227. CM Schmitthoff argues that the threshold of control is often less than 50 per cent, observing that the city code on takeovers and mergers had adopted a 30 per cent threshold figure. Furthermore he acknowledges the need for provisions relating to warehousing by associates. Indeed the Cork Committee, *ibid*, cited the difficulty in defining the relevant relationship as a factor against adopting these reforms. The definition subsequently enacted by the United Kingdom legislation stated a 33 per cent threshold. See *Insolvency Act* 1986, *s* 435. Also see the *Companies Act* 1989, ss 52 and 53 (the definition of "group") and the pre-1989, s 736 definitions of "holding" and "subsidiary company" of the *Companies Act* 1985. The new ss 736, 736A and 736B were inserted by the *Companies Act* 1989 and essentially, have an application to the requirement to consolidate accounts. The existing s 736 definitions were, however, retained for most other purposes. The differences in these definitions are discussed by S Sugar, "Statutory Interpretation and the Definition of Subsidiary" (1989) 139 *New LJ* 377. In particular the new definition is not premised on ownership of equity capital, unlike the former provision, thereby recognizing that it is voting rights, and not share ownership per se, that is the hallmark of control.

33 Australian Law Reform Commission Report No 45, *General Insolvency Inquiry* 1988 (The Harmer Report).

34 Commonwealth of Australia, Parliament, Joint Select Committee on the Corporations Legislation, April 1989 (Edwards Committee).

35 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties Report on the Social and Fiduciary Duties and Obligations of Company Directors*, November 1991.

issue of the liability of corporate officials to creditors, some did touch incidentally on this issue.

These recommendations included that the companies legislation ought to permit all creditors to share equally in sums recovered from directors. In this regard, the development of the common law 'duty to creditors' was examined with the conclusion being drawn that it did not extend a direct remedy to creditors. This was considered more appropriate than a situation where the proceeds of such actions would accrue only to those creditors with sufficient resources to fund an action.[36]

In addition to the direct implications of the recommendations dealing with the issue of the liability of corporate officials to creditors, the general thrust of the recommendations in proposing a tightening of the regulation of officials carried with it certain implications. In particular the recommendations that directors be required to attend board meetings, that their duties be non-delegable, that they comply with objective standards, that they be encouraged to undertake professional development courses and that they comply with a code of ethics were significant as indicative of the attitude of the legislature towards directors.[37] In particular, to the extent that directors had, in the past, been able to avoid liability to creditors under the reckless trading provision by deferring to others or claiming some special dispensation personal to them, the indication was that this would no longer be tolerated.[38]

VI. *CORPORATE LAW REFORM ACT* 1992

During 1992 the Government issued a draft bill proposing substantial amendments to the law relating to, amongst other things, the duties and liabilities of corporate officials, the giving of financial benefits to related parties of public companies and corporate insolvency. This draft bill generated enormous community concern primarily at the complexity of the proposed financial benefits provisions and the onerous nature of the new obligations to be imposed on corporate officials. Notably, the provisions relating to corporate insolvency received little attention.

Subsequently, the financial benefits provisions were redrafted and the bill was introduced into and passed through parliament during November and December.

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36 Other relevant recommendations included: (i) criminal liability ought not apply in the absence of criminality; (ii) the administrative bodies charged with enforcing the companies legislation should receive adequate funding; and (iii) civil penalties ought be provided in the legislation for breaches by directors where no criminality was involved and in appropriate circumstances, people suffering loss as a result of a breach ought to be able to bring a claim for damages in the proceedings taken, to recover the penalty.

37 Also see *Government Response to the Report of the Senate Standing Committee on Legal and Constitutional Affairs on "The Social and Fiduciary Duties and Obligations of Company Directors"*, Senate Hansard, 28 November 1991.

38 Such an attitude was also clearly apparent in the general thrust of the recommendations of the Australian Law Reform Commission, note 33 *supra*.

The reforms enacted by this Act, which impact on the capacity for creditors of insolvent companies to recover their debts, are considered below.

A. Insolvent Trading

(i) The Duty

Section 592 was amended to apply only to debts incurred prior to the commencement of the new insolvent trading provisions contained in ss 588G to 588X. These provisions essentially enact the insolvent trading provision recommended by the Law Reform Commission,[39] although in a substantially different format to the proposed draft legislation. Section 588G specifies that a director contravenes the section if the 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.[40]

(ii) The Defences

The defences are set out in s 588H. Notably, the defence that the director had reasonable grounds to expect that the company was solvent and could pay its debts does not require that the expectation be that the debts could be paid from the company's own resources. That is, the limitation recognised by the Law Reform Commission as arising from the decision in *Deputy Commissioner for Corporate Affairs v Caratti*,[41] has not been provided for.[42]

(iii) The Presumptions

Whereas the legislation embraces the recommendation that there be 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, otherwise the presumptions enacted by the legislation substantially differ from those recommended. First, there is no presumption of insolvency where liabilities exceed assets, although s 558E(8) would have the effect that, where insolvency is proved for the purposes of one form

39 *Ibid.*

40 The Explanatory Memorandum to the Act refers to the criticisms of the existing provisions and states that the new provisions address these criticisms in the following ways: criminal and civil sanctions are separated with criminal liability being retained for cases where actual dishonesty is involved; directors are under a positive duty to ensure that their company does not incur a debt whilst it is insolvent; a liquidator has the primary right to sue a director for the benefit of all unsecured creditors; the duty is expressed in such a way that a director cannot rely on his or her lack of involvement in the company as a defence; and a series of rebuttable presumptions assists the liquidator in establishing the insolvency of the company: *Explanatory Memorandum, Corporate Law Reform Act* 1992.

41 (1980) 5 ACLR 119. See discussion above, p 7.

42 See the definition of "solvent" in s 95A(1).

of recovery proceedings against a company, it would be presumed to exist in relation to any other forms of recovery proceedings.

Furthermore, s 588E(4) provides that a presumption of insolvency will arise where a company has failed to keep adequate accounting records as required by s 289. Notably, there is no additional requirement that the company be unlikely to pay its unsecured creditors more than fifty cents in the dollar, although 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.

These presumptions do not operate in relation to criminal charges.

(iv) Duty to be Enforced by Australian Securities Commission (ASC) or Liquidator in Favour of the Company

Sections 588J to 588U inclusive contain the mechanical provisions supporting the duty against insolvent trading.

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 essentially authorises the ASC to make such applications. Such proceedings are civil in nature.[43]

Similarly, s 588K provides that the court may order a person, convicted under s 1317FA of Part 9.4B of contravening the duty against insolvent trading, to pay compensation to the company. Under s 1317FA a director would be guilty of a criminal offence if the director 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 their 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.

(v) Creditors have a Secondary Action

Sections 588R to 588U inclusive provide the circumstances in which a creditor may sue a director under s 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. The other sections set out a procedure for a creditor to follow where the liquidator neither commences an action, nor provides consent to an action by the creditor. The creditor may serve on the liquidator a notice of his intention to commence proceedings requiring the liquidator to, within three months, either provide consent or a statement of reasons why the proceedings

43 Section 1317ED.

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.

(vi) Application and Quantum of Compensation

Section 588Y provides that compensation recovered from directors pursuant to these provisions 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.

Where proceedings are taken by a creditor under s 588R then it would appear that any liability is owed to the creditor directly and, in contrast to the recommendations of the reform bodies, this is not a derivative action.

Finally, it is also of note that, in calculating the compensation payable by a defaulting director, regard is to be had to the loss or damage suffered by the creditors. 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, however, taken up.

B. Group Companies - Duty Imposed on Holding Companies

Neither the recommendation of the Law Reform Commission relating to the pooling of assets of insolvent companies in liquidation nor that proposing the imposition of liability on related companies for the debts or liabilities of an insolvent company were adopted. However, by virtue of ss 588V to 588X inclusive, holding companies are to be liable for insolvent trading by subsidiaries. It would appear 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.[44] However, the provisions enacted are more specific than those proposed by the Law Reform Commission and 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 relationship between the holding and subsidiary companies rather than with related companies generally. According to

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44 See RP Austin, "The Corporate Law Reform Bill - its Effect on Liability of Holding Companies for Debts of Insolvent Subsidiaries" (1992) 6(7) *Butterworths Company Law Bulletin* at [103].

the Explanatory Memorandum, the provisions impose a specific test to which the directors of a parent company may address their minds.[45]

Where the duty against insolvent trading is breached, the holding company will be liable if there were reasonable grounds at the time for suspecting that the subsidiary was insolvent or would become insolvent and either the holding company or one or more of its directors were aware of these grounds or, having regard to the nature and extent of the holding company's control over the subsidiary's affairs, it was reasonable to expect that a company in the holding company's circumstances or one or more of its directors would have been aware of those grounds.

The provisions are not civil penalty provisions nor may their contravention give rise to a criminal offence.

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

C. Commentary on the Reforms

(i) General Endorsement

Following the release of the *Corporate Law Reform Act* as an Exposure Draft in February 1992, the Government was inundated with submissions and the Exposure Draft was widely debated.[46] This debate primarily focused on the onerous nature of the changes to directors' responsibilities and the complexity of the new related party dealings regime. Essentially, the arguments were that the existing obligations on directors were sufficient and simply needed better enforcing and that the black letter law format of the related party provisions should give way to a drafting format that specified general principles and left it to the courts to provide the details.[47]

This debate effectively ignored the proposed insolvency amendments except that, to the extent that they were part of the increased obligations imposed on directors, it was argued that they would contribute to deterring qualified and desirable people from being directors, generate mistrust between directors and cause them to focus on defensive practices and their own potential liabilities rather than on more legitimate concerns. Ultimately, economic growth would be retarded and administrative costs would soar.[48]

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45 Note 40 *supra* at [1125].

46 See the discussion on the history of the Bill in the Second Reading Speech, Australia, House of Representatives 1992, Debates, vol HR 15 (3 November 1992).

47 For example see: Submission on Corporate Law Reform Bill 1992, Business Council of Australia, May 1992; Joint Submission by the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants, reported in M Lawson, "Accountants Call for Redrafting of Bill", *Australian Financial Review*, May 27 1992, p 25.

48 For example see: B Pheasant, "BCA Opts for Tougher Prosecution" *Australian Financial Review*, May 11 1992, p 3; "Corporate Law Reform Bill 1992 - Debate in the Press" (1992) 7 *Butterworths Company Law Bulletin* [117]; R Baxt, "Reforming the Law on Directors' Duties" (1992) 10 *Company and Securities Law Journal* 205.

As part of the Government's consultative process the Joint Statutory Committee on Corporations and Securities conducted a series of public hearings in relation to the draft bill. The evidence gathered generally supported the introduction of the insolvency provisions although the adequacy of the definition of insolvency was questioned.[49]

(ii) Doubts over the Adequacy of the Threshold of "Suspicion"

During the debate in both Houses the Opposition expressed its concern with the lowering of the threshold in the insolvent trading provision to one of the mere "suspicion" of insolvent trading. This was seen as very onerous and effectively requiring directors to resign upon a suspicion.[50]

Certainly on the face of it, this appears to be a major extension in the scope of potential liability. Notably, other commentators have questioned the use of the term "suspect"[51] and the desirability of the change,[52] especially in relation to group company liability.[53]

There is merit in these criticisms of the adoption of this new threshold. Its precise scope is unclear and arguably too onerous, especially when viewed in conjunction with the other extensions to the application of the defaulting officer provisions. Arguably, it shifts the balance too far towards protecting creditors by promoting a risk-adverse culture in directors performing a risk-taking function. Certainly directors ought to be encouraged to contemplate the expected or probable outcomes of their decisions. However, to extend liability to them for failing to appreciate or act on a concern as to a *possible* outcome is, in the context of a risk-taking venture, an obtuse responsibility.

This, of course, assumes that the judiciary will interpret "suspect" in such a way as to lower the threshold for liability. Certainly the case law on the s 592 test would suggest that this is likely to occur. The cases draw a distinction between "suspect" and "expect". The latter is considered synonymous with "predict" or "anticipate"[54] whereas the former is concerned with possibilities.[55]

Certainly it is arguable that one of the implications of the new insolvent trading provisions will be to encourage boards of companies experiencing financial difficulties to more quickly resolve to appoint an administrator rather than to attempt to trade through such difficulties.[56] On the other hand, it is arguable that this incentive has already existed in recent times since the ASC has become more

49 Joint Statutory Committee on Corporations and Securities, *Summary of Evidence Presented to the Committee on the Draft Corporate Law Reform Bill 1992*, June 1992.

50 Australia, House of Representatives 1992, Debates, vol HR 16 (10 November 1992) p 3035 and Australia, House of Representatives 1992, Debates, vol HR 21 (17 December 1992), p 5300.

51 JH Farrar (1989), note 11 *supra* at 32-3.

52 Note 13 *supra*.

53 RP Austin, note 44 *supra* at [103].

54 See *3M Australia Pty Ltd v Kemish* (1986) 4 ACLC 185, per Foster J.

55 See *Dunn v Shapowloff* [1978] 2 NSWLR 235, per Reynolds JA.

56 See DG Lovell, "Corporate Law Reform Bill 1992: Amendments to Chapter 5 of the Corporations Law - External Administration" (1992) 26 *Butterworths Company Law Bulletin* [456].

vigilant in enforcing the defaulting officer provisions. This is well illustrated by the collapses of Compass Airlines. The much publicised ASC actions against the directors after the first collapse was arguably designed to send a message to the business community.[57] It appears that this message was at least heard by their successors who were reported to have arranged for a "friendly creditor" to put the company into administration at an early stage so as to avoid potential personal liability.[58]

(iii) Other Concerns

Herzberg has applauded the features of the new insolvent trading provision, especially the limitation of standing to liquidators, arguing that it was very difficult for a creditor to adduce evidence to prove a case under the former provisions and, accordingly, creditors owed only small amounts were unlikely to proceed.[59] Furthermore, a multiplicity of actions were required if all creditors were to recover with the likelihood that the first creditors to take action would exhaust the assets of the directors, thereby offending the principle of equal sharing in an insolvency.

On the other hand, he argues that the new approach perpetuates deficiencies in emphasising the incurring of debts whilst insolvent rather than imposing a duty on directors of insolvent companies to initiate winding up proceedings as soon as possible. Furthermore, the retention of the phrase "incurs a debt" produces anomalous consequences, such as saving directors from potential liability for amounts due by their insolvent company to tort creditors, and achieves the result that trade creditors are advantaged at the expense of other types of creditors, particularly finance creditors. He is also in favour of one general presumption, rather than a number of limited presumptions, to the effect that the company be presumed to be insolvent within a specified time prior to the commencement of winding up.

It is difficult to accept the criticism that the provisions provide insufficient incentive for directors to place their insolvent company into administration. Certainly this view is not shared by Lovell[60] and, as observed above, there is evidence to suggest that sufficient incentive does in fact exist, particularly when the more vigilant approach of the Australian Securities Commission is taken into account.

The criticism of the expression "incurs a debt" has some merit although recent decisions have cast doubt on the earlier restrictive interpretations of the phrase.[61] Furthermore, it is by no means clear that directors should be made personally liable for the tortious liability of their insolvent companies. Ultimately it may depend on the circumstances, namely whether the corporation is effectively being used to

57 I Ries, "Compass Claim puts the Regulator on a New Course", *Australian Financial Review*, March 20, 1992, p 64.

58 "Compass Airlines: Its Finally All Over", *Australian Financial Review*, 12 March 1993, p 3.

59 A Herzberg (1991), note 24 *supra*.

60 See DG Lovell, note 56 *supra*.

61 See *Hawkins v Bank of China* (1992) 10 ACLC 588.

shield directors from their own negligence or default, but the imposition on directors of liability for debts voluntarily incurred by their insolvent company may be more readily acceptable than the imposition on them of liability for involuntary and potentially substantial liabilities.

The general presumption argued for by Herzberg is also subject to the same criticism in that such a significant reversal of the onus of proof arguably shifts the law too far against directors. The recent decision in *Re MMC Pty Ltd (in liq)*[62] illustrates that individual creditors have the power to inspect the books of a company for the purposes of a s 592 action. Thus, avenues do exist to gather the necessary evidence.[63]

Finally, the criticism that the former provisions promoted a multiplicity of actions and offended the principle of equal sharing in insolvency is further explored below, where it is argued that there is some justification for providing creditors with a less restricted cause of action in their own right and the equal sharing principle may require qualification in this context.

(iv) Group Company Provisions

It has been questioned whether the high standard imposed by the requirement that a holding company will be liable for the insolvent trading of a subsidiary if there were "reasonable grounds for suspecting" that the subsidiary was insolvent, should be applied to directors of a holding company in relation to the activities of a subsidiary. This test places directors of a holding company under the same broader duties as the directors of a subsidiary itself. The result will be to require a vigorous monitoring by a holding company of its subsidiaries.[64]

Certainly it is likely that actions under s 588X may be preferred to those against the directors of failed subsidiaries under s 588G due to the "deeper pockets" of the holding company. If this is the case then it is inappropriate that directors of subsidiaries will be allowed to escape the civil consequences of their actions in such circumstances.[65]

Finally there may be significant international repercussions for Australia from the unilateral enactment of this provision. It is possible that foreign companies

62 (1992) 6 ACSR 741.

63 For a similar conclusion see TN Antrobus, "A Creditor's Right Under the *Corporations Law* s 486 to Inspect, for Purposes of a s 592 Action, the Books of a Company in Liquidation" (1992) 10 *Company and Securities Law Journal* 346.

64 RP Austin, note 44 *supra* at [103]. He also argues that it is not clear whether the defence, that it was reasonably believed that a "competent and reliable person" had the responsibility of providing sufficient information to enable compliance with the duty and apparently discharged that responsibility, requires that the person be competent in financial management only or whether the person relied upon needs to have business skills as well. Further, what about people employed by this competent and reliable person? Can the directors of the holding company rely on this person to employ appropriate individuals or must they satisfy themselves as to the competence and the ongoing due performance of each individual employed?

65 *Ibid.* Ultimately, whilst the provision may have merit in imposing liability on the holding company where it is the principal operating entity, it is doubtful whether the imposition of absolute liability on the holding company is justified, where the holding company is a non-operating company and not involved in the day to day operations of its subsidiary.

may adopt the view that, given the potential exposure of a holding company to liability for the debts of its Australian subsidiaries, it may be safer to operate subsidiaries in other countries where the risk is lower.[66] Certainly this argument has force whatever the form of the group company liability regime implemented. Ultimately it is a matter of balancing the potential costs to Australia of multinational companies closing their Australian operations with the ongoing costs associated with permitting the status quo to continue.

(v) Related Party Provisions

It was observed above that the new related party provisions may provide some incidental protection for creditors, particularly creditors of group companies, although providing no direct cause of action. It has been argued by Lipton that these provisions ought specifically recognise the interests of creditors and any contravention should render directors personally liable at the suit of a liquidator.[67]

Lipton's arguments are now more significant because his analysis was with respect to the original exposure draft provisions pursuant to which liquidators, and in some cases even creditors, had a direct cause of action against defaulting directors.[68] With the redrafting of these provisions prior to enactment, breach of the prohibition against providing financial benefits to a related party, contained in s 243H, now renders a defaulting director liable at the suit of the ASC only.[69] Whilst any compensation is payable to the company's liquidator, creditors have no right to pursue such an action.[70]

If these provisions were extended to provide creditors with a cause of action then they would contain other limitations which need to be addressed. The fact that defaulting conduct can be ratified by the members is inconsistent with the principle that recognises that where a company is close to insolvency the members can no longer ratify a breach of duty which prejudices the interests of creditors.[71] Furthermore the restriction on the application of the provisions to public companies only is illogical from the perspective of protecting creditors.

Ultimately, Lipton proposes that a liquidator of a public or private company ought to be empowered to recover from directors where a company's assets have been loaned or transferred to an associated entity or person. Individual creditors would not have standing except by way of a derivative action or where a particular interest which ought to be recognised separately from the interests of other creditors could be demonstrated. He justifies this proposal on the basis that

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66 RP Austin, note 44 *supra* at [103].

67 P Lipton, "Loans and Benefits to Directors: The Corporate Law Reform Bill Response to the Abuses of the 1980s" (1992) 12 *BCLB* at [210].

68 Pursuant to ss 243ZE, 1317EB and 1317EA.

69 A number of the provisions provided that any person who suffered loss as a result of defaulting conduct could proceed against the directors, for example, ss 243TA, 243PA and 243BA.

70 Naturally, if such a breach also occasions the breach of the director's fiduciary duties, then a liquidator has the right at common law to bring an action in the name of the company.

71 P Lipton, note 67 *supra* at 138.

directors who engineer such transactions will often be deserving of the imposition of personal liability having carried out the transaction with the intention of frustrating creditors and, sometimes, benefiting themselves. A specific statutory right conferred on liquidators would serve as a guide to directors as to what is a permissible transaction. The absence of such a provision in fact misleads directors by only emphasising the interests of the members when, at common law, the directors may also be required to take into account the interests of creditors when undertaking such transactions. The fact that the common law position is not clear, nor generally appreciated by directors, provides further support for the introduction of a specific statutory provision.

As observed above, the changes to the draft provisions considered by Lipton have rendered creditors' interests even less protected. However where minority share holdings exist, then to the extent that the members' consent to an uncommercial transaction may not be forthcoming,[72] creditors remain incidentally protected. On the other hand, where wholly owned group companies are concerned, there would appear to be nothing to prevent member-ratified asset transfers which have the effect of frustrating creditors in circumstances where neither the insolvent trading nor related party provisions will apply.[73]

VII. INDIVIDUAL OR COLLECTIVE RIGHTS?

A. The Pursuit of Fairness?

(i) Rights of Individual Creditors Curtailed

It is suggested that the greatest failing of the new insolvent trading and group company provisions is that they, at least in one major respect, restrict the rights of individual creditors. This arises as a result of the fundamental change in the provisions from the former insolvent trading provisions to the effect that individual creditors are not provided with primary standing in their own right but rather standing is reserved to the liquidator and, only with the leave of the liquidator or the court, to a creditor. In the case of the group company provisions creditors have been denied standing completely.

Admittedly, this restriction on the standing of creditors to sue is less severe (at least in the non-group company case) than that proposed by the reform bodies, who would have required that any action by a creditor be solely in the nature of a derivative action (although with a power in the court, at its discretion, to give priority in the distribution of any recoveries to the creditor who brought the successful action). Nevertheless, both the restrictions on standing, implemented

72 The consent of a majority of disinterested shareholders is required under s 243ZF.

73 For example, the subsidiary may be rendered insolvent after the debts are incurred and so the insolvent trading provisions have no application. On the other hand, possibly the voidable transactions provisions contained in ss 588FA to 588FJ inclusive may enable a liquidator to claw back any unfair preferences provided to related creditor companies or the benefits of any uncommercial transactions given in circumstances of insolvency.

and proposed, share a common philosophical underpinning, namely that they are premised on the principle of fairness and more specifically, that there ought to be parity in the treatment of unsecured creditors upon winding up.

It is suggested, however, that it is far from certain that reliance on the principle of equal sharing in a winding up as a justification for the removal or restriction of individual creditor rights against company officials will achieve the optimum result in all circumstances. Situations can arise where a company is not put into liquidation. For example, the company may be hopelessly insolvent such that an applicant creditor would not even recover their legal costs, or a liquidator their fees. In such circumstances there will be no liquidator to proceed against the directors, nor may creditors secure standing under s 588R. Whilst the ASC could proceed against directors under the civil penalty provisions, any successful action would require the payment of the compensation to the company and there is no certainty that it will flow through to the unsecured creditors.[74] In any event it is hardly appropriate that whether creditors recover ought depend upon the whims and resource levels of the ASC.

In other situations the creditors might enter into a compromise with a company in lieu of commencing liquidation proceedings. Again, a dissenting creditor would either have to rely on the ASC or, if its debt is large enough, upset the compromise by commencing its own liquidation proceedings.

Whilst it is true that the provision of an unfettered cause of action to creditors might generate a multiplicity of actions and favour some creditors over others, the availability of self-help remedies is more in tune with a laissez faire commercial philosophy. If provisions were enacted enabling matters proved in one set of proceedings to be presumed to be the case in another action by a different creditor then, in fact, the body of creditors might actually benefit from an individual creditor's recovery.[75] To the extent that the company's funds are not used in prosecuting such proceedings then the position of the body of creditors may be further enhanced.

The restriction on the cause of action available to creditors also ignores the reality that most actions never proceed to a court hearing but are settled. The utility of the defaulting officer provisions as creditor bargaining tools has been recognised.[76] If individual creditors can induce payment from directors upon the threat of such proceedings without plunging the company into liquidation then again, in many instances, the body of creditors might ultimately benefit from the continuance of the company.

Although the liquidator can be said to act on behalf of the creditors, it will seldom be the case that he or she will have their unanimous support to the commencement or settlement of an action. Whilst, on one hand, there is some merit

74 Whilst s 588Y requires that any compensation be applied to pay unsecured creditors before secured creditors, there is nothing to prevent the compensation being dissipated in an attempt to restart the company, for example, by the purchase of stock, marketing or employment of a corporate trouble-shooter.

75 Compare s 588Q.

76 LCB Gower, *Gower's Principles of Modern Company Law*, Steven & Sons (4th ed, 1979) pp 115-16.

in maintaining an orderly democratic approach to a liquidation, ultimately it is the interests of the individual creditors that are at stake and they may wish to be the masters of their own destiny. Whilst some creditors may prefer a limited but immediate payout from the corporate funds rather than investing in potentially protracted legal proceedings against the directors, others may wish to wage such proceedings in the expectation of greater rewards. Similarly, the decision to settle or discontinue an action lies with the liquidator and creditors have no say in the decision, even though it directly impacts on their interests.

Whilst the procedure exists to grant creditors leave to pursue an action, this does not extend to taking over actions already commenced. Also, it is unclear as to whether creditors might be able to secure a cause of action where a liquidator has proceeded and subsequently withdrawn its action, been successful or partially successful, or settled the action. Section 588U(b) provides that a creditor may not begin proceedings where the liquidator has already commenced them. Does this prohibition mean that a creditor loses any possible cause of action once a liquidator sues, regardless of the result of the liquidator's action? The existence of s 588N (which proposes a mechanism to prevent double recovery) might suggest that this is not the intention. However, if it is conceivable that a creditor could follow up an action by a liquidator against a director with its own action then this has implications for both the settlement of liquidators' proceedings by directors and the subsequent distribution by liquidators of the proceeds of successful actions.

B. Application of the "Parity in Winding Up" Principle Flawed

It is also suggested that the notion of parity in the sharing of proceeds from an insolvent trading action is flawed in principle. The circumstances of creditors can differ markedly. This is indeed recognised by s 588Y(2) which authorises a court to postpone a creditor's entitlement to share in compensation proceeds where the creditor allowed the company to incur the debt in the knowledge that the company was insolvent. Whilst the court has a discretion whether to apply this provision it is suggested that the provision is too limited. A company may go through many stages as it withers into insolvency and there may be a variety of signals indicating its deteriorating financial health. On the other hand, creditors can differ markedly in levels of sophistication and comprehension and hence the ability to read these signals. Furthermore, some creditors, knowing their debtor company to be in, financial difficulties, may have continued to extend additional credit to the company in an effort to assist it. Others may have acted in a precipitous fashion in seeking payment[77] and thereby contributed to the decline of the company.

Whilst the provision of an unfettered creditor action will not address the relative merits of whether and to what extent particular creditors ought to recover, this potential variance in the circumstances of creditors illustrates that the parity in winding up principle is questionable as a basis upon which to define recovery allocations.

77 For example stock may have been seized or critical services or supplies cut off.

The principle of equal sharing is a corollary to the collective and mandatory nature of insolvency proceedings.[78] That actions by creditors against insolvent persons be necessarily collective has been justified on the basis that this reduces strategic costs, increases the pool of available assets and generates administrative efficiencies.[79] In subjecting creditors to such a regime it is considered necessary that creditors be treated equally.

Oditah has examined the limits to the principle of equal sharing and has concluded that both the established exceptions and, more significantly, the development of private rights have undermined the principle in practice. This has come about because the principle, which can be restated as equals are to be treated equally, does not address the critical determination of just which creditors are equal.[80] Rather, the status of creditors is determined by their pre-liquidation entitlements. That is, the equal sharing principle does not operate to readjust these pre-existing entitlements nor to define the concept of equality.[81]

Whilst the distinction between secured and unsecured creditors is readily appreciated, it is the variety that exists within these broad categories that is the real issue. Again, categories of secured creditors, such as those with mortgages over real property, those with floating charges and those with specific charges over items of personal property, are well understood. Less well appreciated is the fact that, primarily as a result of attention to self-help remedies, the category of unsecured creditors is not homogeneous. Some unsecured creditors will have obtained personal guarantees against corporate executives, have cross guarantees from other companies, have supplied goods under various retention of title or arrangements (including consignment), have proceeded to a judgment debt against the company and may have available to them the debt collection remedies of the courts, may have entered into individual compromises, may have taken out some form of insurance or simply may have built the risk of non-payment into their pricing structure.

Furthermore, inequalities between unsecured creditors of a particular debtor may exist in other forms. As was acknowledged above, some creditors may have known of the debtor's precarious financial position yet extended credit to it in an attempt to assist it whilst others may have acted precipitously in seeking to recover their debt. Others may have related dealings with the debtor or related companies which impact on their attitude to pursuing any unpaid debts.

The point is that for various legal or other reasons it may be a gross generalisation to treat all unsecured creditors equally. This is the inherent limitation of the equal sharing principle.

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78 F Oditah, "Assets and the Treatment of Claims in Insolvency" (1992) 108 *Law Quaterly Review* 459 at 463.

79 TH Jackson, "Bankruptcy, Non-Bankruptcy Entitlements and Creditor's Bargain" (1982) 91 *Yale Law Journal* 857 at 860-68.

80 F Oditah, note 78 *supra* at 463. Also see TH Jackson, *ibid* and DD Prentice, "The Effect of Insolvency on Pre-Liquidation Transactions" in BG Pettet (ed), *Company Law in Change - Current Legal Problems*, Stevens (1987) p 70.

81 DD Prentice, *ibid.*

As argued above, this limitation afflicts the principle in its application to the distribution of proceeds from actions against defaulting directors. Furthermore, to the extent that the equal sharing principle is a corollary to the recognition of the principle of a collective, mandatory insolvency regime there is no inherent justification for the application of either of these principles to the defaulting officer regime. At issue in the context of the defaulting officer regime is compensation for wrongs inflicted on a creditor or creditors in contrast to an insolvency regime which is directed to the maximisation of returns from, and the efficient administration of, an insolvent's estate. The two "proceedings" are very different. One involves instigating adversarial proceedings, the other is more administrative in nature requiring a forbearance from acting on the part of the creditors. That is, one requires action (and outlaying funds) whereas the other requires inaction. At the very least, this raises doubts as to whether defaulting officer proceedings should be mandatory, yet once voluntary class actions are permitted then the question of whether persons other than the individual or individuals pursuing the action should be permitted to share in any recoveries must, arguably, be answered in the negative.

Jackson has argued that the "creditors bargain" is the most compelling explanation for the mandatory, collective nature of insolvency proceedings. That is, creditors before the event, would agree that such an approach was the best way to enforce their claims in the event of insolvency.[82] However this argument appears to presuppose that all the creditors are equal and is defeated by the fact that, as Oditah illustrates, creditors have devised means to ensure that they are not equal and can therefore enforce their claims outside the insolvency. Jackson anticipates this argument by suggesting that creditors would nevertheless have some incentive to enter into a collective regime due to the costs and uncertainty associated with their individual actions.[83] However, the issue is one of relative benefits and where some creditors have devised more sophisticated mechanisms by which to protect their positions, the benefits of negotiating a collective action may be surpassed. It cannot therefore be assumed that creditors would agree to a collective regime. This is, indeed, evidenced by the fact that when they have turned their minds to the issue before the event they have sought to avoid such a regime.[84]

At the very least, this again raises doubts as to whether the mandatory nature of insolvency proceedings can be sustained, but once a voluntary collective approach is embraced the equal sharing principle must, in fairness, give way to the principle of who bears the risks shares in the returns.[85] Certainly it is argued that the "creditors bargain" analysis cannot support a collective, mandatory approach to

82 TH Jackson, note 79 *supra* at 860.

83 *Ibid* at 863-64.

84 Although see TH Jackson, *ibid* at 866. Prentice also doubts this argument but concedes that it has merit in relation to the residue of unsophisticated creditors who are homogeneous: note 80 *supra*.

85 Probably in proportion.

defaulting officer proceedings.[86] In the absence of such an approach an application of the principle of equal sharing lacks justification.

C. Joinder, Representative and Class Actions

A further argument in support of permitting individual creditors an unfettered cause of action rather than imposing the primacy of a mandatory collective regime is that provision already exists for individual creditors to join their actions and thereby reduce the incidence of costs borne individually and the inconvenience of multiple actions. Arguably, such a voluntary collective regime is fairer, as any recoveries will be enjoyed by those creditors who have sought to enforce their interests and such a regime recognises that, as argued above, not all unsecured creditors are necessarily equal to each other.

The precise rules for collective actions differ depending upon whether the action is maintained in a particular State Supreme Court or the Federal Court.[87] Essentially, however, collective actions may take one of three forms:

(i) *Joinder of Plaintiffs:* all persons who have a common complaint against a defendant may be joined in one action. Typically joinder will only be permitted where each plaintiff has a right arising out of the same transaction or series of transactions and where, if separate trials were held, a common question of law or fact would arise or, in some jurisdictions, where the court gives leave.[88]

(ii) *Representative Actions:* where there are a number of parties to a proceeding, all having the same interest, then they may all be represented by one party.[89] It is necessary that each party have a common interest and grievance, and the relief must be beneficial to all parties who are represented by the party on the record.[90]

(iii) *Class Actions:* under the Federal Court Rules and the rules of some State Supreme Courts representative actions may be brought notwithstanding that the parties do not have identical interests and that individual damages

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86 It is doubtful whether the reduction in strategic costs and increase in the aggregate pool of assets justifications for a mandatory collective approach are relevant to actions against defaulting officers, especially where such officers are solvent. There would, however, certainly be administrative efficiencies in collective actions but possibly this benefit can be provided through the availability of voluntary class actions. Again the concern that no creditor would agree to collective proceedings in the absence of like agreement from all creditors (see TH Jackson, note 79 *supra* at 866) thereby justifying mandatory proceedings, is not an issue.

87 The cross-vesting scheme under the *Corporations Act* and corresponding State legislation is to the effect that the Federal Court and Supreme Courts of the States and Territories are each vested with civil jurisdiction under the *Corporations Law* of all jurisdictions. See each *Corporations ([State]) Act* 1990, Part 9, in particular s 42 and the *Corporations Act* 1989, Part 9, especially s 51.

88 See BC Cairns, *Australian Civil Procedure*, Law Book Company (3rd ed, 1992) pp 237-239 generally and especially p 237. In particular see the Federal Court Rules (SR 1979 No 140 as amended), Order 6, rule 2.

89 *Ibid*, pp 260-63 and the Federal Court Rules, Order 6, rule 13.

90 The classical authority is *Duke of Bedford v Ellis* [1901] AC 1 at 8, per Lord Macnaghten, which was recently affirmed by the New South Wales Court of Appeal in *Esanda Finance Corp Ltd v Carine* (1992) 29 NSWLR 382.

assessments may be required.[91] This is termed a class action. Under the *Federal Court of Australia Act* 1976 it is necessary that there be seven or more people with claims arising in similar circumstances and there must be at least one common substantial issue of law or fact. The Court is empowered to give directions as to the procedure to be adopted generally and, particularly, in relation to individual issues and costs.[92]

In the context of proceedings under the defaulting officer provisions it is unclear as to whether applicant creditors would be able to take advantage of the joinder rules given that it is doubtful as to whether their claims could be said to arise out of the same transaction or series of transactions, notwithstanding that there would almost certainly be some common question of law or fact at issue. The difficulty is that each creditor would be relying on a separate transaction or transactions being the incurring of its particular debt or debts. There is some authority which would suggest that the rules would not extend to allow a joinder of plaintiffs who merely entered into a group of similar transactions.[93] It has been suggested, however, that in such circumstances a court would be likely to give leave for joinder under the second limb of the rule where this limb exists.[94]

Whilst creditors who are able to take advantage of the joinder rules may enjoy a saving as to costs, there are a number of potential difficulties in adopting such a course. In particular, there is no provision for dissension or conflict of interests between the applicants, an applicant is exposed to the risk of increased costs from the failure or insolvency of a co-applicant and the possibility of complications arising from the joinder and a co-applicant may cause embarrassment through non-compliance with directions of the court.[95]

It is also unlikely that creditors would be able to take advantage of the representative procedure given the requirements as to a common interest and relief. The individual circumstances surrounding the incurring of each debt might be such as to render it difficult to satisfy these requirements as each applicant might be seeking an individual assessment of damages.[96]

It is the class action procedure that is likely to provide the greatest assistance to creditors wishing to combine their actions. With the introduction of this procedure into the Federal Court in 1992, it could have been anticipated that, had provision

91 BC Cairns, note 88 *supra*, pp 267-68 and the *Federal Court of Australia Act* 1976, Part IVA.

92 *Federal Court of Australia Act* 1976, Part IVA Division 2, especially ss 33C, 33Q, 33R and 33S.

93 *Payne v Young* (1980) 145 CLR 609, although Murphy J dissented on this issue. Also see *Marino v Esanda Ltd* [1986] VR 735 where actions based on similar contracts were not considered to be actions arising out of the same series of transactions.

94 BC Cairns, note 88 *supra* at 239. There is also some authority for the view that the rule ought to be construed liberally: *Payne v British Time Recorder Co* [1921] 2 KB 1 and *Bendir v Anson* [1936] 3 All ER 326.

95 See the commentary on the Federal Court Rules in *Practice and Procedure High Court and Federal Court of Australia*, Butterworths, (1991) (looseleaf), at [38,780.1].

96 See BC Cairns, note 88 *supra*, pp 261-63 and 267. This would be especially applicable if individual creditors could pursue an action under the insolvent trading provision given that damages are to be quantified by reference to the loss suffered by the creditors (s 588M). Under ss 592 and 593, whilst liability is prima facie defined in terms of the unpaid debts, the court has a general discretion (see chapter 6, section 2.2) and there is always the possibility that cross-claims and set offs can impact on the quantum of liability.

for unfettered individual causes of action by creditors been retained in the insolvent trading provision, groups of 7 or more creditors could have voluntarily brought collective proceedings. Certainly their claims would have arisen out of "similar or related circumstances" and have given rise to "a substantial common issue of law or fact."[97] Even with the fetters that are now imposed it is conceivable that such class actions could be commenced in the appropriate circumstances.

Thus with the recent broadening of the joinder rules in some jurisdictions[98] and the provision for class actions the facility does exist for creditors to pursue collective actions under the defaulting officer provisions where individual actions are available. Of course, whilst this facility would satisfy some of the objections raised to the existence of individual actions[99] it does not satisfy the concern as to the unfairness of some creditors recovering and not others. However, as was argued above, the validity of this argument must be doubted given the dipartite nature of creditor interests. Furthermore, by providing a voluntary collective regime this assists in addressing this disparity. Creditors who have not protected their interests in some other way can fall back on the defaulting officer provisions. This enables them to more readily take charge of their own interests, without the need to rely on the existence of a liquidator and his predispositions. Furthermore, the company's funds would not be risked on the actions to the jeopardy of non-involved creditors and, possibly, shareholders.

This is not to say that collective proceedings are not without their limitations. Some of these were recognised earlier in the discussion on mandatory collective regimes and also on the joinder of actions. In particular there is a loss of control and the exposure to the vagaries of the other members of the class and, especially, the representative member. On the other hand, the power of the court to provide directions ought go some way to alleviate concerns as to the potential implications of conflicts between class members. Certainly it is argued that the provision of unfettered individual rights with facility for voluntary collective actions provides a more satisfactory compromise of the various issues than an approach which imposes a mandatory collective regime.

D. The Concept of Even Handedness

There is a further concept which may support the removal or restriction of an individual right of action against defaulting directors. This is the concept of even handedness which requires that an insolvent company treat all creditors equally and that creditors desist from seeking advantage in the teeth of a company's pending insolvency.[100]

97 Thereby satisfying s 33C of the *Federal Court of Australia Act* 1976.

98 By granting the Court a discretion to permit joinder of actions where the rules would not otherwise have permitted it. See the discussion above and, in particular, BC Cairns, note 88 *supra*, p 238.

99 Especially as to excessive costs and the inconvenience and time consuming nature of a multiplicity of actions.

100 See DD Prentice, note 80 *supra* at 79, citing RC Clark, "The Duties of the Corporate Debtor to its Creditors" (1977) 90 *Harvard Law Review* 505 at 512.

Prentice has examined this concept and concluded that it has no legal persona as payments induced by creditor pressure do not constitute an improper preference and, hence, are not prohibited.[101] Furthermore, he acknowledges the benefits of payments secured by permitting individuals to litigate, namely publicity as to the company's poor credit and provision of a bargaining weapon to other creditors in a similar position to the judgment creditor.[102] For these reasons, and consistently with the sentiments advanced in relation to the parity principle, it is argued that this concept should not be extended to justify removal or restriction of individual rights.

E. The Transfer of Risk

In reviewing this new creditor recovery regime it is apposite to identify the underlying theme sought to be given legislative expression. It is notable that a creditor recovery regime typically comes in to play when the imited liability company becomes insolvent. However, it is not insolvency per se that entitles an unpaid creditor to recover from corporate controllers, as that would clearly infringe too greatly on the limited liability principle. Indeed, inherent in the provision of the privilege of limited liability is the notion that creditors must be prepared to accept some risk of non-payment. However, the critical issue is what level of risk is acceptable.

It must be acknowledged, therefore, that the legal fictions of incorporation and limited liability are essentially concerned with the transfer or sharing of risk. Creditors are to share some of the risks associated with a business as an encouragement to those considering risking funds on a venture which capitalist society perceives as potentially of benefit to the community at large. However, the community must pay a premium for the opportunity to savour this benefit. This premium is reflected in the price of goods and services that creditors of corporations charge the community in general for it is in this way that these creditors are compensated by the community for the losses they bear upon corporate insolvency.[103]

These legal fictions do not, however, endorse an unabated transfer of risk. A balance is to be struck. Some risks must still be borne by the incorporators. This is embodied in the requirement that capital be imparted to the venture. How much capital ought be invested is, however, the perennial and most difficult question.

This question is sought to be answered by the defaulting officer legislation. This legislation seeks to define what risks the creditors of a corporation have not agreed to accept in their dealings with it.[104] Certain breaches of fiduciary and statutory

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101 *Ibid* at 79. He leaves it open as to whether such a principle ought be adopted.

102 *Ibid* at 80.

103 In fact Farrar has argued that, accordingly, creditors need no remedies as they are unlikely to pursue them in any event, having built the risk of potential loss into their pricing structure: JH Farrar (1984), note 11 *supra* at 31-2 and the authorities there cited. Whilst it is no doubt true that certain business risks are compensated for as a product of the creditors' bargain this argument begs the question because it fails to acknowledge the existence of unacceptable risks and the need to protect creditors from such risks.

104 Support for this view is provided by J Farrar, *ibid*.

duties and the perpetration of fraud are not risks that the creditors, and through them, the community are prepared to bear. Most importantly creditors are also not to bear the risk of the company contracting a debt in circumstances where an inability to pay is evident, or ought be evident, to corporate management but is unbeknown to the creditor.

In other words creditors and, indeed, the community are not to shoulder the burden or cost associated with incorporation and limited liability where the capital of the company is deficient in the sense that the company is insolvent. In such circumstances a company is risking its creditors' funds on the venture but, in the absence of the incorporators paying for the privilege of limited liability in the form of adequate venture capital, this is not a risk that the creditors ought properly to accept.

However, as was argued above, not all creditors are homogeneous in terms of the level of risk they are prepared to accept. Some may have built into their pricing structure the possibility of loss arising from insolvent trading by their creditors or have taken out insurance. Others may have required some form of security, have negotiated personal guarantees from directors or may seek to rely on retention of title clauses included in their contractual documentation. Thus, whether a particular creditor is motivated to rely on the insolvent trading provision will depend upon its particular circumstances as to the risk of non-payment it was prepared to accept. This, then, provides further support for the view that reliance on the parity principle may not be appropriate as a basis for denying individual creditors an unfettered cause of action in favour of a mandatory, collective regime.

F. A Compromise?

A possible compromise is that creditors might be given primary standing to sue, with the proceeds of a successful action available to benefit all creditors, but with the applicant creditor awarded costs.[105] The effect would be to reward a creditor for bringing litigation which could benefit other creditors whilst not at the same time infringing the equal sharing principle.[106] This position can be justified by the argument that the vigilant should be treated differently from other creditors and, at least, allowed their legal costs.[107] Of course this argument can be extended further to support a damages award in favour of the judgment creditor personally on the basis that it was not equal with other creditors but, rather, more deserving.[108]

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105 A similar compromise is proposed by Prentice although in a different context: note 80 *supra* at 80.

106 *Ibid* at 81.

107 *Ibid* at 82.

108 Similar to the Australian Law Reform Commission recommendation, note 14 *supra*, that the applicant creditor was to potentially receive both his or her costs and damages at the court's discretion, a point which was not taken up by the legislature.

VIII. CONCLUSION

It was observed above that, after some deliberation, the Government's response to the limitations of the existing creditor recovery regime has been the replacement of the incurring unpayable debts and fraudulent trading provisions with an insolvent trading provision, predicated on the need to reform certain deficiencies in these former provisions. It is ironic that this has occurred at the same time as the judiciary has re-interpreted the existing provisions in such a way as to remedy many of these defects.

Whilst there is some merit in this new legislative approach to the issue of the improper use of the corporate form to defeat creditors, there is also merit in the retention of the existing law where it has become familiar to and understood by, the commercial sector. Although this legislation essentially addresses the defects of its predecessor, the problem with any new legislation is that it will almost certainly contain interpretational issues which will initially generate uncertainty and ultimately require resolution. As was observed, this legislation is no exception.

In addition to these interpretational issues, a number of design issues have also been identified, as has a concern that the obligations imposed by the legislation are possibly too harsh. Furthermore, there appear to be major doubts as to the appropriateness of the manner in which the provisions apply to group companies.

There is also some irony in the fact that the issues which the judiciary have not addressed or not had within their power to address, in particular the liability of group companies and their controllers in the international context, have not been addressed by the legislation notwithstanding that these issues have been the subject of reform recommendations. This is a significant failing of the legislation.

However, the greatest irony and limitation of the legislation is that, whilst it has been criticised for imposing heavy burdens on directors, the legislation in fact deprives creditors of their pre-existing unfettered personal cause of action. It was argued that there are grounds to support the provision of an unfettered cause of action for individual creditors within the defaulting officer regime. At the very least, this action, could be in the nature of a derivative action, coupled with a facility to enable the court to reward the particular creditor who brought the action.