Director Restriction: An Alternative to Disqualification for Corporate Insolvency

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Provisions that allow for the disqualification of directors who are involved in multiple corporate failures have been adopted by legislatures in many jurisdictions. Imposing restrictions on directors is more easily justified where the director has broken the law. However, it is arguable that creditors need to be protected not only from fraudulent or dishonest directors but also from incompetent directors. It makes little difference to creditors whether their bills are not paid because of illegality or ineptitude.. A way needs to be found to reconcile the need to protect future creditors, on the one hand, and the rights of persons to manage companies in the absence of wrongdoing, on the other. This article proposes the introduction of a new regulatory tool – "restricted directorships" – which has the potential to limit the harm that persons who are involved in multiple corporate failures can cause.

I. INTRODUCTION

Provisions that allow for the disqualification from managing corporations of directors who are involved in multiple corporate failures have been adopted by legislatures in many jurisdictions.[1] It is generally accepted that such provisions are protective, in that once disqualified, an individual's ability to cause harm to others through future corporate failures is limited.[2] Scholars[3] have recognised that underlying the disqualification power is a tension between the right of companies to manage their own internal affairs, including the appointment of directors of their choosing, and the government's obligation to protect "the public". In the case of involvement in corporate insolvency as the justification for disqualification,[4] "the public" is future creditors who may be affected by the improper behaviour of the disqualified director.

Imposing restrictions on directors to protect the public is more easily justified where the director has broken the law. Terms of imprisonment are accepted as an outcome for criminal breaches of the *Corporations Act 2001* (Cth) (*Corporations Act*).[5] However, it is arguable that creditors need to be protected not only from fraudulent or dishonest directors who should forfeit their right to manage a

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[1] See the discussion at Part III(A).

[2] Jean Jacques du Plessis and Jeanne Nel de Koker, "Analyses, Perspectives and Jurisdictional Overview" in Jean Jacques du Plessis and Jeanne Nel de Koker (eds), *Disqualification of Company Directors: A Comparative Analysis of the Law in the UK, Australia, South Africa, the US and Germany* (Routledge, 2017) 1, 5; Julie Cassidy, "Disqualification of Directors under the Corporations Law" (1995) 13 C&SLJ 221, 222; Jassmine Girgis, "Corporate Directors' Disqualification: The New Canadian Regime" (2009) 46 *Alberta Law Review* 677, 679; Karsten Engsig Sørensen, "Disqualifying Directors in the EU" in Hanne S Birkmose, Mette Neville and Karsten Engsig Sørensen (eds), *Boards of Directors in European Companies: Reshaping and Harmonising Their Organisation and Duties* (Kluwer, 2013) 327; National Audit Office, *The Insolvency Service Executive Agency: Company Director Disqualification: Report by the Comptroller and Auditor General for Northern Ireland*, House of Commons Paper No 907 (1993) 4.

[3] These are considered in Part II.

[4] The other grounds for disqualification are noted in Part III(B).

[5] *Corporations Act 2001* (Cth) Sch 3.

company, but also from incompetent directors. It makes little difference to creditors whether their bills are not paid because of illegality or ineptitude.

This article argues that Australia's present insolvency disqualification regime is failing to protect the public for a number of reasons.[6] The first reason is that the present grounds for disqualification do not appear to capture incompetence rather than malfeasance, even though the provisions do not require significant breaches of the law to be established as a precondition to the imposition of an order.[7] Despite not being required, the Australian Securities and Investments Commission's (ASIC) media releases show that those who it disqualifies are in fact accused of very significant breaches of the law. For example, on 19 February 2018, ASIC announced that it had disqualified Mr Peter Kalos from being a director for five years. In relation to nine failed companies, ASIC found that Kalos had, among other things, improperly used his position, failed to exercise his duties with due care and diligence, failed to monitor the companies' operations and financial position, and had engaged in insolvent trading and phoenix activity.[8] Where ASIC imposes a disqualification in situations where there is only relatively minor wrongdoing, such as a failure to keep books and records, ASIC's decision may well be appealed,[9] thus reducing the attractiveness of this enforcement mechanism from ASIC's perspective.

There is a second, but no less significant, reason that Australia's present insolvency disqualification regime is failing. In circumstances where an individual has been involved in multiple corporate failures, the imposition of the order is reliant upon ASIC taking some action. The regulator may impose disqualification orders administratively[10], or it may apply to the court for a disqualification order.[11] In either case, if ASIC takes no action, a disqualification order will not be imposed. This is in contrast to several other non-insolvency grounds for disqualification where the imposition is automatic.[12]

This suggests that a way needs to be found to reconcile the need to protect future creditors, on the one hand, and the rights of persons to manage companies in the absence of wrongdoing, on the other. This article proposes the introduction of a new regulatory tool – "restricted directorships" – which has the potential to limit the harm that persons who are involved in multiple corporate failures can cause. The proposed restricted directorship regime would constitute a midpoint or a compromise between an unlimited number of directorships and complete disqualification from managing corporations.

Under the proposal, an individual's right to be a director would be restricted where they have been involved in multiple corporate failures. Wrongdoing on the part of the director would not need to be established. In recognition of this, restricted directors would still have the ability to manage a small number of companies; but given the fact that limited liability companies can cause considerable losses to innocent creditors, and that these directors have a track record of causing such losses, their rights to manage large numbers of companies simultaneously would be curtailed. The restriction proposal comes

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[6] For a discussion of the failure of the disqualification regime to deal with phoenix activity, see Helen Anderson et al, "Quantifying Phoenix Activity: Incidence, Cost, Enforcement" (Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, October 2015); Helen Anderson et al, "Phoenix Activity: Recommendations on Detection, Disruption and Enforcement" (Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, February 2017) (Phoenix Activity Report Recommendations); Jasper Hedges et al, "The Potential Economic Gains from Increasing Public Law Enforcement against Illegal Phoenix Activity" (2018) 44(1) *Monash University Law Review* 267.

[7] In the context of multiple corporate insolvencies ASIC and the courts may disqualify directors in certain circumstance where the disqualification is justified. See *Corporations Act 2001* (Cth) ss 206F(1)(a)(ii), 206F(1)(c), 206D(1)(b)(ii); and Part III(B).

[8] Australian Securities and Investment Commission (ASIC), "ASIC Disqualifies Director from Managing Companies for Maximum Period of Five Years" (Media Release, No 18-046MR, 19 February 2018) <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-046mr-asic-disqualifies-director-from-managing-companies-for-maximum-period-of-five-years/>.

[9] See n 98 and accompanying text.

[10] *Corporations Act 2001* (Cth) s 206F.

[11] *Corporations Act 2001* (Cth) s 206D.

[12] For example, under *Corporations Act 2001* (Cth) s 206B(1), a person is automatically disqualified from managing corporations if they are convicted of certain criminal offences and s 206B(3) automatically disqualifies a person from managing corporations if he or she is an undischarged bankrupt.

with an additional attribute to overcome the present limitations with disqualifications by ASIC or the court: the proposed restriction would be imposed automatically. The regulator would not need to form any view about the conduct of the director nor take any action for the restriction to be imposed.

This article proceeds as follows. Part II examines the legitimacy of imposing restrictions on directors in situations where malfeasance has not been established. First we consider the debate between the view that the holding of a directorship is a right that should not be restricted in the absence of wrongdoing, and the view that it is a privilege, that is capable of being restricted when to do so is in the public interest. The arguments in favour of creditor self-protection against the need for state intervention to protect vulnerable creditor groups who cannot self-protect are examined. This discussion acknowledges the Federal Government's National Innovation and Science Agenda that supports entrepreneurship and directors being given multiple chances. Part III examines the history of the director disqualification regime in the United Kingdom and the debate in that jurisdiction about the efficacy of providing disqualification for incompetence. Part IV sets out the current disqualification regime in Australia and recognises its limitations, in particular in relation to incompetent, rather than dishonest, directors. Here, phoenix activity is highlighted as an example of *repeated* instances of corporate failures that cause losses. The significant cost of these successive failures to revenue authorities and the Fair Entitlements Guarantee (FEG) scheme is outlined.

Part V then sets out the details of the proposed regime. It starts by describing what it is and how it would operate. It then looks at international precedents for restrictions on directorships. Part VI concludes the article by recommending the Government consider the advantages of this new form of limit on directorships, both for its own good and for the good of the marketplace more generally.

II. The Legitimacy of Restricting Directorships in the Absence of Malfeasance

There is a tension in corporate law between the rights of companies to manage their internal affairs, including the right of shareholders to appoint directors of their choosing, and the state's obligation to protect stakeholders, including creditors of insolvent companies, from the actions of directors that cause harm. Scholars who espouse a contractarian view believe that a corporation is in effect a nexus of what are essentially private contracts between private individuals, rather than an entity created by the state, and as such the corporation's internal governance arrangements should be free from state interference.[13] Progressive scholars, on the other hand, maintain that corporate law has characteristics that are usually associated with public law; that corporations are creatures of the state; and that therefore, the state has a legitimate role in their regulation.[14]

A related tension arises between the rights of individuals to hold directorships and the right of the public, including future creditors, to protection from potential losses that may flow from the mismanagement of companies by those individuals. In the latter, the interests of the state are those of a creditor through unremitted taxes, increased reliance on government safety net schemes, and the consequential economic damage that insolvency brings to taxation revenue and employment.

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[13] Scholars who subscribe to the contractarian, or a nexus of contracts theory of the firm maintain that the state should not intervene to protect third parties, including creditors. These scholars' views about the nature of corporations and role of corporate law developed from the law and economics scholarship that was prominent in the United States in the 1980s. See Christine Parker, *The Open Corporation* (CUP, 2002) 3. The Law and Economic scholarship drew on the 1930s work of Berle and Means on public companies and the separation of ownership and control: Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (Transaction Publishers, 1st ed, 1932); and on work undertaken by Coase during the same period, on the costs of market transactions and the prospects of reducing those costs through firm organisation: Ronald Coase, "The Nature of the Firm" (1937) 4 *Economica* 386. For a discussion of influence of the work of Berle and Means and Coase on corporate law scholarship, see generally Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities* (University of Chicago Press, 2006) 47–49, 248; Michael Whincop, "Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate Law" (1997) 21 *Melbourne University Law Review* 187.

[14] See David K Millon, "New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law" (1993) 50 *Washington and Lee Law Review* 1373; Lawrence Mitchell (ed), *Progressive Corporate Law* (Westview Press, 1995); Greenfield, n 13.

The proposed restricted director regime is designed to provide some protection for creditors from losses that could arise from future corporate insolvencies. The imposition of the restriction is not dependant on the establishment of malfeasance on the part of director, nor on any determination or action by the regulator. Those who believe that the state should not interfere in the internal affairs of corporations, and those who believe that a directorship is a right, may challenge the legitimacy of such a mechanism for various reasons. One is that such interference is not necessary because creditors are able to self-protect. The counter argument is that the state does have a legitimate role to play in protecting creditors' interests, even in circumstances where directors have not engaged in wrongdoing, because the ability to self-protect is, in reality, limited. We first consider the rights versus privileges debate before examining the argument that there is no need for state interference where there is a lack of director malfeasance because creditors are able to self-protect.

A. Directorship – A Right or a Privilege?

Related to the tension between the contractarian and progressive views of corporate law is the tension between those who view the holding of a directorship as a right, and those that view it as a privilege. According to Finch, scholars adopting a rights-based approach view:

> directing a company incorporated with limited liability as a valuable asset or right worthy of protection in the exercise of commercial ventures. This model reflects the "business enterprise" perspective on company law, which sees the director as a taker of business risks, subject to a company law that respects and enables his/her freedom to manage rather than makes managerial decisions liable to judicial second-guessing.[15]

Those who believe that a directorship is a right would argue that restricting an individual's right to hold a directorship is only legitimate where it can be demonstrated that the person in question has engaged in some form of wrongdoing.[16] Fraud or some other misfeasance must be present in order to justify a full disqualification or some other restriction, rather than mere incompetence.

However, the alternate view is that the ability to be appointed as a director, along with the other advantages that flow from incorporation, is a privilege.[17] The "privilege view" draws on the concession theory of the firm which envisages the "corporation as a tremendous capital accumulation device that was only made possible by the state conveying certain privileges to incorporators for which they could not otherwise privately contract".[18] These scholars argue that in exchange for granting these privileges, principally limited liability for shareholders and separate legal personality for the company, the state legitimately retains the right to regulate the corporate entity and its governance arrangements.[19] Moreover, as Padfield contends, "the fact that government permission is required to incorporate supports the legitimacy of state regulation, regardless of how freely such permission is granted."[20] Writing in the context of the United States, Sale argues that:

> [c]orporations, of course, are creatures of state government. … They were and still are defined by the state. Today they are easily formed and dissolved, in both cases by filing papers with the state's secretary of state. They remain, however, entities that exist with the permission of the government. In that sense, corporations have always been public, and all corporations are subject to publicness regardless of their legal status as "publicly" or "privately" held. [21]

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[15] Vanessa Finch, "Disqualifying Directors: Issues of Rights, Privileges and Employment" (1993) 22 *Industrial Law Journal* 35, 36.

[16] Finch, n 15.

[17] Finch, n 15.

[18] Stefan J Padfield, "Rehabilitating Concession Theory" (2014) 66 *Oklahoma Law Review* 327, 332.

[19] Padfield, n 18, 333.

[20] Padfield, n 18, 347. See also Grant Hayden and Matthew Bodie, "The Uncorporation and the Unraveling of 'Nexus of Contracts' Theory" (2011) 109 *Michigan Law Review* 1127, 1130.

[21] Hillary A Sale, "Public Governance" (2013) 81 *George Washington Law Review* 1012, 1015.

Lee agrees, maintaining that: "[t]he fact that the state makes corporate law available to citizens for them to use more or less as they wish does not rule out the imposition of conditions for the use of the corporate form, for the protection of the public interest."[22] He draws an analogy between the state's role in providing the legal structures that allow corporations to exist as a "vehicle for the pursuit of private ends"[23] and the state's role in the:

> provision of other public facilities, such as parks and highways. The state contemplates, to be sure, that citizens will use these facilities for their own purposes. Nevertheless, both legal and informal norms reflect society's expectation that users show consideration for the interests of other users as well as non-users who may be affected by the activity; no one thinks it unusual if the use of a public facility is made subject to rules designed to promote or protect these interests. Just as a municipal park bylaw may include rules to protect non-users living in the vicinity from excessive noise, so too might corporate law impose requirements for reasons beyond the convenience of the parties to the "corporate contract".[24]

Where multiple corporate failures occur, either through fraud, misfeasance or incompetence, it should be possible to restrict future use of the corporate form, as a privilege provided by the state, in order to protect creditors. It should make no difference whether the privilege was abused deliberately or through incompetence. Finch argues that:

> The privilege approach thus justifies action against two very different kinds of errant director, " ... the person who is simply exploiting limited liability in a cynical way with a disregard for proper responsibility" or alternatively the director who is exploiting it "because he is so stupid and ignorant that he is quite incapable of appreciating what has happened and thereby causes large losses by in a sense incompetence". In both of these cases it has been indicated that there is a need to "protect the public" from further abuse of the privilege of limited liability.[25]

The proposed director restriction regime has the potential to provide protection for creditors against the actions of incompetent directors, which, as is explained below, is not currently occurring under the Australian disqualification regime.[26]

B. The Ability of Creditors to Self-protect

Not all scholars share the view that creditors require protection. Contractarians would not be in favour of allowing the state to interfere in the internal governance arrangements of companies by imposing restrictions on directors in order to protect future creditors without the need to establish misfeasance on the part of the directors. Creditors should either protect themselves through the terms of their contracts with the company or take their business elsewhere[27] if they cannot make satisfactory arrangements. Under this view, creditors become responsible for checking that they are satisfied with the competency of the company's management. This means it is incumbent on prospective creditors to inquire about the management of companies and the corporate history of its directors.

However, there are a number of impediments to this idealised view of corporate contracting. First, the information necessary to make this sort of assessment of management competence is not easily available. Second, creditors may lack the bargaining power[28] to insist on security or other protective measures such as a personal guarantee from its directors. Third, trade insurance may not be available[29] and it may not

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[22] Ian B Lee, "The Role of the Public Interest in Corporate Law" in Claire A Hill and Brett H McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar, 2012) 106, 117.

[23] Lee, n 22, 115.

[24] Lee, n 22, 115.

[25] Finch, n 15, 39–40, quoting *Re Douglas Construction Services Ltd* [1988] BCLC 397, 402 (Hannan J).

[26] See Parts III(B) and V.

[27] Andrew Keay, "Wrongful Trading and the Liability of Company Directors: A Theoretical Perspective" (2005) 25 *Legal Studies* 431, 442.

[28] Keay, n 27, 451.

[29] Keay, n 27, 442–443.

be possible to diversify away the risk of loss. Even where creditors can insist on protective measures, it may not be possible to foresee all contingencies that should be covered, or the cost of doing so may be prohibitive. In the eyes of progressive corporate law scholars, these realities justify a "greater willingness [on the part of the state] to use legal intervention to overcome the transaction costs and market failures that impede self-protection through contract".[30] The proposed director restriction regime is designed to assist in the achievement of this aim.

C. Encouraging Entrepreneurship or Protecting Creditors

An interesting backdrop to this discussion is the Australian Government's National Innovation and Science Agenda (NISA announced by then-Minister Christopher Pyne on 7 December 2015.[31] Underpinning NISA is the promotion of risk taking by entrepreneurs.[32] The Department of Industry, Innovation and Science's "NISA Report" argues that Australia needs:

> a greater emphasis on celebrating success rather than penalising failure. This takes a cultural shift to encourage more Australians and businesses to take a risk on a smart idea. We need to leave behind the fear of failure, and challenge each other to be more ambitious.[33]

The NISA Report considers a number of initiatives including reform of insolvency laws which are seen to "put too much focus on penalising and stigmatising business failure. The Government understands that sometimes entrepreneurs will fail several times before they succeed – and will usually learn more from failure than from success".[34] Yet while the Government promotes entrepreneurialism and risk taking in this way, it has also indicated its concern about the cost to the economy of phoenix activity.[35] This activity occurs when persons in control of a company that becomes insolvent or is abandoned transfers the assets of that company to a second company that they control, and the second company is used to run the same or a related business. The second company may be a new company, or it may be an existing company, including but not limited to a related company within a corporate group. Phoenix activity can involve a legitimate and desirable business rescue, which may in fact achieve the best possible outcome for the creditors of the first company.[36] The risk-taking entrepreneurs lauded in the NISA report who fail multiple times may in fact engage in this type of acceptable phoenix activity.

The Government is right to be concerned about phoenix activity. The Senate Economics References Committee concluded in 2015 that "illegal phoenix activity remains a significant issue not only in the construction industry, but throughout the economy".[37] Similar conclusions were reached by the Productivity Commission which found that "even conservative estimates suggest that [phoenix activity] … is a significant issue".[38] Various estimates of the cost of such activity have been provided. In 2009

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[30] Millon, n 14, 1379.

[31] Christopher Pyne, "Agenda to Transform the Australian Economy" (Media Release, 7 December 2015) <https://www.minister.industry.gov.au/ministers/pyne/media-releases/agenda-transform-australian-economy>.

[32] Australian Government, *Improving Bankruptcy and Insolvency Laws: Proposals Paper* (April 2016).

[33] Department of Industry, Innovation and Science (Cth), *National Innovation and Science Agenda Report* (December 2015) <https://www.industry.gov.au/national-innovation-and-science-agenda-report>.

[34] Department of Industry, Innovation and Science (Cth), n 33.

[35] For example, the Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP, announced a package of reforms to address illegal phoenix activity on 12 September 2017: Kelly O'Dwyer, "A Comprehensive Package of Reforms to Address Illegal Phoenixing" (Media Release, 12 September 2017). On 28 September 2017 the then-Minister released a consultation paper entitled "Combatting Illegal Phoenixing" and said that "[t]he Government is committed to helping the honest and diligent entrepreneurs who drive Australia's productivity, but we won't tolerate those who misuse the corporate framework for their own advantage": Kelly O'Dwyer, "Consultation on Reforms to Address Illegal Phoenixing" (Media Release, 28 September 2017).

[36] Helen Anderson et al, "Defining and Profiling Phoenix Activity" (Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, December 2014) 8–10, 15–16, 24, 27–28.

[37] Senate Economics References Committee, Parliament of Australia, *'I Just Want to Be Paid': Insolvency in the Australian Construction Industry* (2015) xix.

[38] Productivity Commission, *Business Set-up, Transfer and Closure*, Inquiry Report No 75 (2015) 423.

the Australian Tax Office said that "[t]he cost to the Australian economy of phoenix and related practices has been estimated at between $1 billion and $2.4 billion a year".[39] PricewaterhouseCoopers (PwC) estimated in 2018 that the "net effect (of losses, gains and the flow-on effects of both) to the Australian economy of potential illegal phoenix activity is $1.8 billion to $3.5 billion lost gross domestic product (GDP)".[40] According to PwC the annual direct costs to business, employees and government are between $2.85 billion to $5.13 billion.[41] In May 2017, the Australian Government published a consultation paper on corporate misuse of the FEG scheme which concluded that "the incidence of illegal phoenix company activity, and subsequent costs to the FEG scheme, is increasing".[42]

Phoenix activity is arguably where the opposing theoretical views – contractarianism and the right to be a director, versus progressives who would limit the privilege of holding directorships to protect the public – collide. Serial phoenix activity is the context in which directors who are either fraudulent or inept inflict losses *repeatedly* on unsuspecting creditors. The cost of phoenix activity to the economy supports the argument that the pendulum of regulation should swing towards the protection of creditors. The state should be able to intervene to protect them from directors responsible for multiple failures, regardless of whether the failures are caused by incompetence or some form of culpable behaviour. The proposed director restriction is one such way that the state could intervene.

Of course the ultimate restriction that can be imposed on a director is a disqualification order. Such orders are available in many jurisdictions. The next Part of the article considers these orders, beginning with an examination of their background internationally. The discussion focuses on the United Kingdom because in that jurisdiction consideration has been given to the efficacy of allowing disqualification orders to be imposed in circumstances of multiple corporate failures in the absence of malfeasance. The following Part examines the current position with respect to disqualification in Australia and highlights two ongoing problems with the regime: first, the fact that disqualification for insolvency in Australia relies on action by ASIC, which does not occur often enough; and second, the current usage of disqualification only against blatant wrongdoers rather than repeatedly incompetent directors. Part V then makes the case for a new automatic restricted director regime designed to overcome these two deficiencies.

III. Background to Disqualification Orders

Many jurisdictions allow for the disqualification of directors. Examples in common law jurisdictions include the United Kingdom,[43] Ireland,[44] New Zealand,[45] South Africa,[46] Hong Kong,[47] India,[48] Singapore[49] and the United States.[50] Writing about Nordic and European company law, Sørensen states that "[m]any Member States have rules in place to ensure that those who have acted as a director of a

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[39] Australian Tax Office (ATO), *Targeting Tax Crime: A Whole-of-Government Approach* (July 2009) 16.

[40] PricewaterhouseCoopers (PwC) et al, "The Economic Impacts of Potential Illegal Phoenix Activity" (Report, June 2018) iii.

[41] PwC et al, n 40. Direct costs, unlike economy-wide impacts, do not take into account the gains and flow-on effects involved in potential illegal phoenix activity, which explains why the direct costs are higher than the economy-wide impacts.

[42] Australian Government, "Reforms to Address Corporate Misuse of the Fair Entitlements Guarantee Scheme" (Consultation Paper, May 2017) 5 [3.3].

[43] *Company Directors Disqualification Act 1986* (UK) Ch 46.

[44] *Companies Act 2014* (Ireland) Pt 14 Chs 4–6.

[45] *Companies Act 1993* (NZ) s 383.

[46] *Companies Act 2008* (South Africa) s 69.

[47] *Companies (Winding Up and Miscellaneous Provisions) Ordinance* (Hong Kong) cap 32 Pt IVA.

[48] *Companies Act 2013* (India) s 164.

[49] *Companies Act 1967* (Singapore, 2006 rev ed) Pt V Div 2.

[50] 15 USC § 78u(d)(2).

company and who have proved to be unfit to carry on the business of a company are disqualified from acting as directors for a given period”.[51]

Kraakman et al compare corporate law in a number of jurisdictions concentrating on Brazil, France, Germany, Italy, Japan, the UK, and the US. The authors note that “every corporate law includes some provisions protecting corporate creditors”[52] and that most of jurisdictions they examine “have directors” disqualification schemes that permit the state to sanction failure by directors to meet relevant standards of pro-creditor conduct (including breaches of accounting rules or fiduciary duties) by banning them from being involved in the management of a company.[53] In some jurisdictions such as the United States, disqualification is more limited as it “is only available for directors of publicly traded companies, and is not employed as a creditor protection measure”.[54]

An examination of some of the secondary sources in the UK sheds light on the development of the disqualification provisions in that jurisdiction. Of particular interest is the debate in the UK around the need for disqualification both for directors engaged in illegal behaviour and for those whose businesses fail as a result of incompetence. This debate provides some support for the argument that it is legitimate for the state to put in place measures to protect creditors from incompetent directors.

The early UK disqualification provisions required some proof of culpability on behalf of the directors before the order could be imposed. The first disqualification provisions introduced in the UK were contained in the *Companies Act 1928* (UK). Undischarged bankrupts were disqualified from being directors and those engaging in fraudulent trading could be subject to court-ordered disqualification as well as criminal and civil sanctions.[55] In 1948 the UK provisions were extended to allow for disqualification following a conviction “in connection with the promotion, formation or management of a company”.[56] The Act also provided for “disqualification if in the course of winding up it appeared that a person was guilty of an offence of fraudulent trading, even though not convicted, or had been guilty while an officer of fraud in relation to the company, or of any breach of duty”.[57] The offences that could lead to disqualification were expanded in 1981 to include “offences in connection with liquidation or receivership or management of the property of a company”.[58]

The Jenkins Committee was set up in 1959 to examine the provisions and workings of the *Companies Act 1948* (UK) and other related legislation.[59] The Jenkins’ Committee Report, which was delivered in 1962, noted that the committee had received submissions critical of the fact that the Act did not provide for disqualification where directors had “been shown to have acted recklessly or incompetently in relation to the affairs of any companies of which he is, or has been, a director (or otherwise concerned in the management)”.[60] The report noted that:

> [T]here is nothing in the present Act to prevent such persons from continuing to act as company directors, and we agree that the Court should have power to prevent them from so acting when satisfied that this is in the public interest. We recognise that it may be difficult to decide in any particular case whether a company director has acted so recklessly or incompetently that he should no longer be allowed to remain

[51] Sørensen, n 2, 327.

[52] John Armour, Gerard Hertig and Hideki Kanda “Transactions with Creditors” in Reinier Kraakman et al (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP, 3rd ed, 2017) 109, 109.

[53] Armour, Hertig and Kanda, n 52, 130

[54] Armour, Hertig and Kanda, n 52, 130.

[55] These provisions were enacted following recommendations of the Company Law Amendment Committee, under the Chairmanship of Wilfred Greene KC: see Andrew Hicks, “Disqualification of Directors — Forty Years On” [1988] *Journal of Business Law* 27, 29.

[56] *Companies Act 1928* (UK) 18 & 19 Geo 5, c 45 s 188.

[57] Hicks, n 55, 32.

[58] Hicks, n 55, 32.

[59] Board of Trade, Parliament of the United Kingdom, *Report of the Company Law Committee* (1962) [1] (Jenkins Report).

[60] Board of Trade, n 59, [80].

> a director. But in serious cases where, for example, a man has succeeded in steering a series of companies into insolvency, we think that the Court should be able to put a stop to his activities.[61]

In 1976, the UK introduced court-ordered disqualification for involvement in failed companies. Section 9 of the *Insolvency Act 1976* (UK) allowed the authorities to apply to the court for a disqualification order "where a person was or had been a director of two companies which at any time went into insolvent liquidation within five years of each other". However, an element of culpability was still required because prior to imposing the disqualification order the court had to be satisfied that the director's conduct made him "unfit to be concerned in the management of a company". [62]

According to Hicks, the *Insolvency Bill 1985* (UK) removed the requirement for misfeasance and proposed a mandatory provisional disqualification order that would apply to all the directors of a company that was ordered to be wound up by the court on the grounds that the company in question was not able to pay its debts, subject to the right of the director to apply within a period of three months for an annulment where they could prove that they had "acted in a manner which in the circumstances was in the best interests of the company's creditors."[63] These amendments were not enacted. Hicks states that the proposed mandatory disqualification "raised a storm of protest from all City interests",[64] and it failed to gain support in the House of Lords.[65]

Currently, the UK disqualification provisions are contained in the *Company Directors Disqualification Act 1986* (UK) (*CDDA*). That Act retains the need for some form of culpability to be established before a director of an insolvent company can be disqualified. In the context of insolvency, s 6 of the *CDDA* provides that the court must make a disqualification order where it is satisfied that a person has been a director of an insolvent company and their conduct as a director of that company "makes him unfit to be concerned in the management of a company".[66] Schedule 1 of the *CDDA* sets out the matters that must be considered when determining "unfitness". Those matters include: "the extent to which the person was responsible for the causes of a company … becoming insolvent"; and "[a]ny misfeasance or breach of any fiduciary duty by the director in relation to a company".[67]

While the UK disqualification provisions have been viewed positively from a comparative perspective,[68] the effectiveness of the regime has been questioned. The fact that the regime is reliant on insolvency practitioners and official receivers finding evidence of unfit conduct to cause them to make a report has been described as a weakness in the system.[69] A 1993 report by the National Audit Office highlighted the relatively low number of disqualification orders imposed when compared with reported conduct. The report found that since the inception of the Act there had been at most 1,712 disqualification orders imposed despite there having been 18,165 instances of reported conduct over the same period.[70] The apparent low level of awareness among directors of the provisions has also been a cause for concern. A 2012 survey revealed that only 43% of directors were aware of the disqualification provisions, calling into question the sanction's effectiveness as a deterrent. Amendments in 2000 provided for

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[61] Board of Trade, n 59, [80].

[62] Hicks, n 55, 34.

[63] Hicks, n 55, 35..

[64] Hicks, n 55, 35.

[65] Hicks, n 55, 35.

[66] *Company Director Disqualification Act 1986* (UK) Ch 46 ss 6, 7.

[67] *Company Director Disqualification Act 1986* (UK) Sch 1.

[68] Andreas Rühmkorf and Jean Jacques du Plessis, "The United Kingdom" in Jean Jacques du Plessis and Jeanne Nel de Koker (eds), *Disqualification of Company Directors: A Comparative Analysis of the Law in the UK, Australia, South Africa, the US and Germany* (Routledge, 2017) 32, 37.

[69] Richard Williams, "Disqualifying Directors: A Remedy Worse Than the Disease" (2007) 7 *Journal of Corporate Law Studies* 213, 234–235.

[70] National Audit Office, n 2. See also Sally Wheeler, "Directors' Disqualification: Insolvency Practitioners and the Decision-Making Process" [1995] 15 *Legal Studies* 283, 283–285.

disqualification undertakings[71] and according to Rühmkorf and Du Plessis "[i]n practice, the majority of disqualifications are now done by undertakings and not by court orders".[72] However, disqualification undertakings still require an element of culpability to be established because they can only be accepted from persons the Secretary of State considers to be unfit.[73]

The recommendations of the Jenkins Committee and the changes to the disqualification provisions contained in the *Insolvency Bill 1985* (UK), that if enacted would have allowed for automatic disqualification to be imposed on grounds that did not require proof of misfeasance, did not eventuate. However, the fact that these proposals were given serious consideration points to the difficulties associated with the disqualification regime that existed at the relevant times in the UK and provides some support for the restriction regime proposed in this article. The next part examines the Australian regime.

IV. DISQUALIFICATION ORDERS IN AUSTRALIA

In Australia the *Corporations Act* allows for directors to be disqualified for a variety of reasons. Section 206B provides for automatic disqualification on the basis of criminal convictions, bankruptcy and foreign court orders, while ss 206EA and 206EB result in automatic disqualification where there is prior court-ordered disqualification under the *Competition and Consumer Act 2010* (Cth) and the *Australian Securities and Investments Commission Act 2001* (Cth) respectively. Sections 206C, 206E and 206EAA allow ASIC to seek court-ordered disqualification for contraventions of civil penalty provisions, repeated contraventions of the Act, and prior disqualification under a law of a foreign jurisdiction respectively. With the exception of s 206B, these sections require additional elements to be present and the exercise of discretion by ASIC and/or the court before a director can be disqualified.[74]

Of most relevance to this article are the disqualification provisions in *Corporations Act* that allow for disqualification in the context of multiple corporate failures. Section 206F of the *Corporations Act* empowers ASIC to disqualify administratively and s 206D of the *Corporations Act* provides for court-ordered disqualification on ASIC's application.

Under s 206F ASIC may disqualify a director for up to five years where it is satisfied that during the last seven years the person has been a director of two or more companies that have been wound up. The liquidators of both companies must have lodged reports with ASICs under s 533(1) that state that both companies were unable to pay their unsecured creditors more than 50 cents in the dollar. Before ASIC can disqualify the director, it must issue a "show cause" notice that gives the director an opportunity to be heard on the question of their disqualification and a chance to demonstrate why such an order should not be made,[75] and it must be "satisfied that the disqualification is justified".[76] In determining whether the disqualification is justified ASIC may give consideration to a number of matters including the director's "conduct in relation to the management, business or property of any corporation; and whether the disqualification would be in the public interest".[77] While the section does not require malfeasance on the part of the director, an examination of some of the ASIC media releases discussed below indicates

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[71] *Insolvency Act 2000* (UK) c 39.

[72] Rühmkorf and du Plessis, n 68, 47, citing Derek French, Stephen W Mayson and Christopher L Ryan, *Mayson, French & Ryan on Company Law* (OUP, 30th ed, 2013–2014) [20.13.2.9].

[73] *Company Director Disqualification Act 1986* (UK) Ch 46 s 7(2A) requires the Secretary of State to be satisfied that the conditions of s 6(1) are satisfied before a disqualification undertaking can be accepted.

[74] See *Corporations Act 2001* (Cth) Pt 2D.6.

[75] *Corporations Act 2001* (Cth) s 206F(1)(b).

[76] *Corporations Act 2001* (Cth) s 206F(1)(c).

[77] *Corporations Act 2001* (Cth) s 206F(2)(b)(i)–(ii). Section 206F is the most recent of the disqualification powers. Its original predecessor was *Companies Act 1981* (Cth) s 562A, which was enacted in 1985. The Explanatory Memorandum to the 1985 legislation does not explain the rationale for the introduction of the administrative disqualification: Explanatory Memorandum, *Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985* (Cth).

that often ASIC relies on this form of disqualification in cases where the directors have allegedly engaged in serious breached in the law.

Alternatively, ASIC may apply to the court for a disqualification order of up to 20 years under s 206D(1) if:

> (a) within the last 7 years, the person has been an officer of 2 or more corporations when they have failed; and
>
> (b) the Court is satisfied that:
> (i) the manner in which the corporation was managed was wholly or partly responsible for the corporation failing; and
> (ii) the disqualification is justified.[78]

The fundamental deficiency with the present insolvency disqualification regime in Australia is that ASIC appears to rely almost solely on s 206F. There is little evidence of ASIC applying for disqualification orders under s 206D. A search of the ASIC media releases issued between 2004 and 2017 and a search of the Austlii databases for the same period disclosed only two court applications issued by ASIC pursuant to this section.[79]

This is problematic. Section 206F relies upon an adverse liquidator report being lodged with ASIC under s 533(1), and such a report is not produced for every failed company. It has been acknowledged for over two decades that abandoned and subsequently deregistered companies are a haven for illegal phoenix activity. It stated in the 1995 report of the Australian Securities Commission (as it then was) into phoenix activities and insolvent trading:

> Importantly it would appear that approximately 92% of Phoenix companies are deregistered under the ASC's section 574 program [the predecessor to s 601AB of the Corporations Act].
>
> Effectively the ASC is unintentionally assisting Phoenix offenders to escape prosecution and detection by deregistering the company and closing off the trail. This is particularly the case in circumstances where debts may be many, but small and no creditor action is taken to place the company under administration.[80]

While there is no need for an adverse liquidator report under s 206D(2)(d) – a court may disqualify a director where the company "ceases to carry on business and creditors are not fully paid or are unlikely to be fully paid" – there are issues of detection. There is no mechanism set-up within ASIC to alert the organisation to deregistrations of abandoned companies with common directors, meaning that ASIC is highly unlikely to bring a disqualification action under s 206D on this basis. The significance of the abandoned company issue is highlighted by the fact that more than five times as many companies are deregistered for failure to respond to ASIC as are liquidated.[81]

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[78] The first time a provision similar to s 206D was enacted appears to have been in 1971 in *Companies Act 1971* (Vic) s 374H. The Explanatory Memorandum stated that the new s 374H "relates to defaulting officers and provides that directors who have been responsible for the failure of a company are disqualified from acting as directors": Explanatory Memorandum, *Companies Bill 1971* (Vic) Cl 51. There was no explanation of the reasons for the introduction of the disqualification regime.

[79] *Australian Securities and Investments Commission v Elm Financial Services Pty Ltd* (2005) 55 ACSR 544; [2005] NSWSC 1065; *Australian Securities and Investments Commission v Elm Financial Services Pty Ltd* [2005] NSWSC 1033; *Australian Securities and Investments Commission v Elm Financial Services Pty Ltd* (2005) 55 ACSR 411; [2005] NSWSC 1020; *Australian Securities and Investments Commission v McIntyre* [2016] FCA 1276. See also Anderson et al, "Quantifying Phoenix Activity: Incidence, Cost, Enforcement", n 6, xvi.

[80] Australian Securities Commission, "Project One: Phoenix Activities and Insolvent Trading – Public Version" (Research Paper No 95/01, 13 May 1996) 75.

[81] In 2014–2015 (the year for which we have comparable data), 7,044 companies entered liquidation. This represented only 6.2% of the 112,714 companies that were deregistered in that year. Data obtained from ASIC indicates that, of the remaining companies, 42,059 were deregistered at ASIC's instigation under *Corporations Act 2001* (Cth) s 601AB. Of these, about 89.4%, or 37,600 companies, are believed to have been wound up pursuant to s 601AB(1) for failure to respond to a return of particulars, lodge documents and carry on a business, or pursuant to s 601AB(1A) for failure to pay fees: Email from Adrian Brown (ASIC, Senior Executive Leader, Insolvency Practitioners) to Helen Anderson, 18 March 2016. Many of these deregistered companies were likely abandoned, and a significant proportion of these companies could be companies abandoned by illegal phoenix operators.

The present grounds for disqualification under s 206F which require ASIC to be satisfied that the order is justified may capture incompetence, but almost all of the directors disqualified by ASIC pursuant to this provision are accused of engaging in significant contraventions of the law. For example on 22 October 2017 ASIC announced it had disqualified Peter Nicholas Cook for five years as a result of his involvement in 12 failed companies.[82] ASIC's media release states that it found that Cook had committed several contraventions including improperly using his position, insolvent trading and failing to exercise his duties with due care and diligence.[83] Similarly, on 20 December 2017 ASIC announced that it had disqualified for three and a half and four years respectively John Thomas Shannon and Jason Thomas Shannon who were directors of five failed companies.[84] ASIC's media release stated that it "was concerned that both men had failed to discharge their director duties by … [among other things] accruing large debts to the Australian Taxation Office, Workcover Queensland and unsecured creditors … and engaging in conduct amounting to phoenix activity".[85] Creditors were owed more than $4.15 million.

A recent example occurred on 25 May 2018 when ASIC announced that it had disqualified Frank Anthony Criniti, a director of seven failed companies, from managing companies for five years.[86] ASIC's media release states that it found that Criniti had:

- improperly used his corporate position to gain an advantage for himself and others;
- provided false information to authorities;
- failed to prevent some of the companies from trading while potentially insolvent;
- failed to pay tax and ensure that proper financial records were kept;
- failed to exercise his duties as a director with due care and diligence;
- failed to comprehensively monitor company operations and financial position; and
- acted as a de facto director, assuming responsibility for the management of companies while not appointed as a director.[87]

The loss to creditors exceeded $3.5 million.[88]

It is possible that ASIC only uses s 206F for the most egregious cases because it fears its decisions being appealed. An example of this occurred in 2018 when Mr Lubo Zivanovic unsuccessfully appealed ASIC's decision to disqualify him from managing corporations for three years.[89] Zivanovic was found to have been a director of 18 insolvent companies that had failed to keep books and records with an estimated total deficiency of nearly $27 million.[90] While ASIC was ultimately successful, significant time and resources would have been expended defending the appeal.

The proposed restricted directorship regime, which is explained in the following section, has a number of advantages in addition to providing creditors with greater protection against incompetent directors. The proposed regime does not require ASIC to take any action nor to form any view about the culpability of the director in question. It has the potential to reduce ASIC's workload in assessing cases for s 206F

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[82] ASIC, n 8.

[83] ASIC, n 8.

[84] ASIC, "ASIC Disqualifies Queensland Father and Son from Managing Companies" (Media Release, No 17-452MR, 20 December 2017) <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2017-releases/17-452mr-asic-disqualifies-queensland-father-and-son-from-managing-companies/>.

[85] ASIC, n 84.

[86] ASIC, "ASIC Disqualifies Sydney Restaurateur from Managing Companies for Five Years" (Media Release, No 18-154MR, 25 May 2018) <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-154mr-asic-disqualifies-sydney-restaurateur-from-managing-companies-for-five-years/>.

[87] ASIC, n 86.

[88] ASIC, n 86.

[89] ASIC, "AAT Affirms ASIC's Decision to Disqualify Director of 18 Failed Companies" (Media Release, No 18-147MR, 23 May 2018) <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-147mr-federal-court-dismisses-appeal-from-aat-decision-to-disqualify-director-of-18-failed-companies/>.

[90] ASIC, n 89.

disqualification and should reduce the number of appeals to the Administrative Appeals Tribunal against ASIC imposed disqualifications, because many of the less egregious cases will be dealt with under the new regime.

V. THE PROPOSED RESTRICTED DIRECTORSHIPS REGIME

As discussed above the aim of the proposed restricted directorship regime is to protect creditors. The risk to creditors should be reduced where those with a history of multiple failures are not allowed to manage so many companies simultaneously and are subject to increased surveillance and other restrictions. For example, rather than spreading their loss-making activities over many companies and "flying under the radar" of creditors such as the Australian Tax Office (ATO) and the department administering the FEG, these directors would be restricted to managing a small number of companies which are conspicuously "on the radar" of regulators and major creditors.

If introduced, the restriction would be imposed automatically on directors on the occurrence of certain events. There would be no need to establish malfeasance by the directors. Once restricted, those directors and the corporations they control would be subject to additional conditions and requirements. For reasons outlined below, restricted directors would be limited to holding five concurrent directorships. The corporations they control would be subject to additional surveillance and reporting requirements to the regulators and those companies would be required to comply with ATO obligations more frequently. Restricted directors would have the capacity to reduce the period of the restriction if they voluntarily undertook educational programs. Penalties would be imposed if the conditions were breached.

The following discussion will outline how the system would operate, its advantages over the present regime, and the international precedents for restricting the number of directorships.

A. The Operation of a Restricted Directorship Regime

The proposed regime has a number of distinguishing features. First, it is based on "incompetence", as evidenced purely by a string of prior corporate failures or abandoned companies. Second, the regime is automatic such that neither ASIC nor a court needs to determine whether the director's restriction is justified. Third, it allows the potential director to manage a small number of companies, provided various supervisory conditions are complied with. The intention of these three features is to achieve a balance between creditor protection and the "right" to be a director in the absence of clear wrongdoing, in a regime that is easy to administer.

1. The Restriction Mechanism

Under the proposed regime, any person who has been an officer of five corporations that have either "failed" or been abandoned and deregistered at ASIC's instigation[91] within the previous 10 years would be subject to an automatic restriction for a period of five years. As to the former, legislation would define "failure" in a similar manner to the present s 206D(2), which in essence picks up entry into insolvent external administration. The latter occurs under s 601AB(1) where a company has failed to lodge required documents with ASIC, and ASIC is of the opinion that the company has ceased to carry on business. ASIC then deregisters the company.

The five-year period of restriction is consistent with the maximum duration of ASIC's administrative disqualification under s 206F of the *Corporations Act*. Should a restricted director be a director or secretary of another company that fails or is abandoned within the five-year restriction period – that is, one of the five companies that the restricted director is permitted to manage – that restriction period would be extended automatically until a date that is five years from the date of the last corporate failure or abandonment. In other words, the restriction period would not lapse until five years has passed since the restricted director's last corporate failure or abandonment, thereby seeking to ensure that the pattern does not continue. When the restricted period lapses, the restriction would be automatically lifted.

[91] See n 81.

The proposed automatic extension of the restriction period would not be the only safeguard against repeated harmful corporate failures. Despite the operation of the automatic restriction regime, there would be nothing to stop ASIC from bringing a disqualification action under ss 206F or 206D of the *Corporations Act* or other forms of legal action against restricted directors if the circumstances warranted it.

Every corporation of which a "restricted director" is a director or secretary at the time the restriction commences, and every additional corporation that the person becomes a director or secretary of within the restricted period, would be deemed to be a "restricted corporation". This allows for conditions, discussed below, to be imposed on both the restricted director *and* any company in the management of which the restricted director is involved.

2. Automatic Imposition

The advantage of an automatic mechanism is that it reduces the enforcement burden on ASIC and the courts because it is not reliant on ASIC taking action. It would operate in the same way that s 206B of the *Corporations Act* provides for automatic disqualification on the basis of bankruptcy or criminality.

Requiring five past corporate failures or ASIC-instigated deregistrations, rather than the two failures required under ss 206F and 206D, safeguards against overreach where there is no ex ante scrutiny of the disqualification. Five corporate failures or abandonments indicates a clear pattern of either recklessness or ineptitude. It is proposed that the time limit within which the failures or deregistrations must have occurred be set at 10 years, rather than the seven years under ss 206F and 206D, to accommodate the higher number of insolvent companies required.

3. Operational Considerations

While the status of being a restricted director is automatically imposed, it depends upon information held by ASIC. Administrative arrangements need to be put in place so that ASIC, the director themselves, other regulators, and the public become aware of the restriction.

The Australian Government is committed[92] to introducing a Director Identification Number (DIN).[93] The DIN, linked to Australian Company Numbers (ACNs), would be used to aggregate the corporate failure and abandonment data on which the restriction depends. A properly constructed information system would ensure that ASIC generates an automatic notification once a particular DIN has been associated with the ACNs of five failed or abandoned companies within a 10-year period. ASIC would then send the notification to the relevant director to inform him or her of it and to explain his or her obligations and rights in relation to the restriction. The information would also be available to other regulators. At present, the Government is overhauling its linked databases via the Modernising Business Registers project.[94] Restriction information, along with disqualification and other relevant data, would be shared freely with other agencies under the new system. Draft legislation introducing the DIN and to modernise Commonwealth registers was released for consultation on 1 October 2018.[95]

Alerting the public to the greater risks associated from dealing with restricted directors is more challenging. Consistent with the protective purpose of the proposed regime, it is recommended that ASIC create a public, searchable, free-of-charge register of restricted directors and corporations.[96] Knowledge of a director's restricted status allows potential creditors to take steps to protect against loss,

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[92] O'Dwyer, "A Comprehensive Package of Reforms", n 35; O'Dwyer, "Consultation on Reforms", n 35.

[93] For a discussion of factors that need to be taken into account in implementing the DIN, see Phoenix Activity Report Recommendations, n 6, [1.1.1].

[94] Australian Government, Treasury, "Modernising Business Registry Services" (Discussion Paper, 2017) <https://consult.treasury.gov.au/market-and-competition-policy-division/modernising-business-registers/supporting_documents/Discussionpaper.pdf>.

[95] See Treasury (Cth), *Modernising Business Registers and Director Identification Numbers Legislation* (2018) <https://treasury.gov.au/consultation/c2018-t330649/>.

[96] See Treasury (Cth), n 95, [1.4.2] for further discussion of the importance of maintaining an accessible register of restricted and disqualified directors.

for example by shortening payment terms or requiring personal guarantees. Moreover, a publicly available register would improve the detection of directors acting in breach of their restricted status. Previous research has identified a number of concerns regarding the accessibility of the existing registers of banned and disqualified individuals, including the charging of fees, poor search facilities, and a lack of information regarding the circumstances of the ban or disqualification, among other issues.[97] These concerns ought to be addressed both for the purpose of improving the existing disqualification registers and for the purpose of creating the new restriction register.

4. Appealing against Restricted Director Status

Restricted directors would be given the right to apply to the court for an order to set aside or vary the restriction, just as s 206G of the *Corporations Act* provides that a person who is disqualified from managing corporations (including those who are automatically disqualified under s 206B) has the right to apply to the court for leave to manage all or specified corporations, provided that the person was not disqualified by ASIC.[98] The right to appeal should ensure that the regime does not treat a director with multiple past failures unfairly.

5. Additional Consequences of Being a Restricted Director or a Restricted Company

To further enhance creditor protection, restricted directors and restricted corporations would be subject to the following additional conditions.

Interaction with the regulator can encourage greater compliance with regulatory requirements and discourage non-compliant behaviour. Kingsford Smith argues that regular contact with the regulator is especially important in circumstances where the regulated community is large and non-compliance is difficult to detect.[99] This is the case with serial phoenix activity, as it predominantly occurs within the small business sector, which encompasses millions of companies.[100]

One important form of interaction with the regulator is reporting. Restricted directors and restricted corporations would be made subject to increased reporting requirements. This has two advantages: it provides increased opportunity for regulators to detect risks and non-compliance, and it sends the message to restricted directors that they are being monitored. At present, s 292 of the *Corporations Act* requires an annual financial report and a directors' report containing prescribed information for, inter alia, public companies and large proprietary companies. Public and large proprietary corporations that are restricted should be required to submit these reports to ASIC twice as frequently. Small proprietary companies[101] are not required to report unless shareholders or ASIC direct them to do so.[102] These are the sorts of companies that are the most likely to be phoenixed and to be managed by directors with

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[97] See n 96.

[98] Section 206G does not apply to disqualification by ASIC pursuant to s 206F; however, it does apply to persons who are automatically disqualified pursuant to s 206B: see *Phillips v Inspector-General in Bankruptcy* (2012) 58 AAR 452, [200]; 10 ABC(NS) 512; [2012] AATA 788. Persons disqualified by ASIC are able to appeal to the Administrative Appeals Tribunal instead.

[99] Dimity Kingsford Smith, "A Harder Nut to Crack? Responsive Regulation in the Financial Services Sector" (2011) 44 *University of British Columbia Law Review* 695, 695. See also Christine Parker and Vibeke Lehmann Nielsen, "Do Businesses Take Compliance Systems Seriously? An Empirical Study of the Implementation of Trade Practices Compliance Systems in Australia" (2006) 30 *Melbourne University Law Review* 441, 464. Parker and Nielsen found that businesses were more likely to fully implement compliance programs when they had been subject to investigation or enforcement by the regulator, in this case the ACCC: 482.

[100] As of October 2017 there were 2,409,919 small proprietary companies in Australia: Australian Securities and Investments Commission, *Cost Recovery Implementation Statement: Levies for ASIC Industry Funding (2017–18)* (October 2017) 37.

[101] A "small proprietary company" is defined as a company that satisfies at least two of the following three criteria: consolidated revenue of less than $25 million; consolidated assets of less than $12.5 million; and fewer than 50 employees: see *Corporations Act 2001* (Cth) s 45A(2).

[102] *Corporations Act 2001* (Cth) ss 292–294.

histories of multiple corporate failures.[103] Small proprietary companies run by restricted directors should be automatically required to produce and lodge these reports on an annual basis.

Restricted corporations should also be required to lodge their business activity statement (BAS) and remit their PAYG(W) and GST amounts more frequently. Businesses holding ABNs which are registered for the GST are required to lodge their BAS by a due date.[104] The current requirements are that businesses with an annual turnover of $20 million or more must report and pay GST monthly and those with an annual turnover of less than $20 million must report and pay GST quarterly, unless the ATO has advised them otherwise.[105] Restricted corporation status should generate an automatic requirement to report monthly. Again, the benefit achieved is that the ATO receives more timely information about amounts owing and it makes the restricted directors more conscious of the fact that their activities are subject to heightened scrutiny.

In addition to the reporting requirements suggested above, regulators could use restricted directors and restricted company status to augment their surveillance and inspection programs. The ATO already targets high-risk people, conducts surprise visits to businesses and residential properties connected with suspected phoenix operators,[106] and has a history of conducting random audits of businesses and individual taxpayers in order to detect tax evasion.[107] The restriction categorisation is similar to the Higher Risk Entities designation on which the Government consulted in late 2017.[108] However, this designation did not find its way into the draft anti-phoenixing legislation released in August 2018.[109]

6. Ameliorating Restricted Director Status

As an incentive to improve business skills, restricted directors should have the option of undertaking approved educational programs in order to reduce the duration of the restriction. Rather than mandating that restricted directors undertake remedial training, directors could choose to reduce the duration of their restriction by voluntarily undertaking education that helps them become more responsible and capable directors. The aim is to reduce those failures that are a result of ignorance and lack of financial competence, where those directors genuinely want their businesses to succeed. This should result both in better outcomes for creditors as a reduced need for enforcement action by the regulators, especially ASIC, the ATO and the FWO.

This sort of proposal is supported by the Inspector General of Taxation’s 2015 review of the ATO’s management of debt collection, which found that educational resources for small business owners would improve the regulation of phoenix activity:

> The IGT recommends that the ATO:
>
> a. jointly develop with other relevant agencies, a suite of educative materials for small business owners on their legal responsibilities; and

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[103] In 2011 the ATO believed that a significant number of phoenix companies operate in the SME market – that is, enterprises with a turnover of $2 million to $250 million. See Evidence to House of Representatives Standing Committee on Economics, Parliament of Australia, Canberra, 27 October 2011, 29 (Grant Darmanin, Senior Director/Phoenix Risk Manager, Australian Taxation Office). Anderson et al, “Quantifying Phoenix Activity: Incidence, Cost, Enforcement”, n 6, 31–32.

[104] ATO, *Business Activity Statements* <https://www.ato.gov.au/Business/Business-activity-statements-%28BAS%29/>.

[105] ATO, *Options for Reporting and Paying GST* <https://www.ato.gov.au/Business/GST/Lodging-your-BAS-or-annual-GST-return/Options-for-reporting-and-paying-GST/>.

[106] See, eg, ATO, “ATO Swoops on Phoenix Businesses” (Media Release, 11 June 2015); ATO, “Phoenix Taskforce Swoops on Pre-insolvency Industry” (Media Release, 12 August 2016).

[107] See, eg, Nassim Khadem, “Tax Man to Hit SMEs and Individuals with Random Audits”, *The Sydney Morning Herald,* 5 November 2015.

[108] Treasury (Cth), “Combatting Illegal Phoenixing” (Consultation Paper, September 2017) 23.

[109] Draft versions of the *Treasury Laws Amendment (Combating Illegal Phoenixing) Bill 2018* (Cth) and *Insolvency Practice Rules (Corporations) Amendment (Restricting Related Creditor Voting Rights) Rules 2018* (Cth) are available at: Treasury (Cth), *Reforms to Combat Illegal Phoenix Activity — Draft Legislation* (2018) <https://treasury.gov.au/consultation/c2018-t313204/>.

b. continue to implement and refine the integrated risk treatment plan, for phoenix activity across the organisation, which incorporates the new inter–agency powers, engagement with intermediaries and assessment tools for measuring the success of the plan.[110]

7. Enforcement

The final requirement of a successful restriction regime is enforcement action where necessary. The increased transparency and accountability provided by the proposed register may be sufficient to deter many restricted directors from breaching the conditions of their restriction. However, it is important that regulators have strong enforcement tools available to punish those who are not deterred by this fear of exposure. Just as s 206A of the *Corporations Act* imposes penalties for failure to comply with an order disqualifying a person from managing corporations, there must be penalties for failure to comply with restricted directorships status.

The ASIC Enforcement Review Taskforce has recommended that the maximum penalties for breaches of disqualification orders be increased to imprisonment for up to five years and/or a fine of up to 600 penalty units (currently $126,000).[111] Consistent with the underlying rationale of the restricted directorship regime as a compromise between full directorship and disqualification, it seems appropriate to set the maximum penalties for breaches of restricted directorships at 2.5 years of imprisonment and/or 300 penalty units. However, in some circumstances, criminal prosecution may be too severe an enforcement response. As such, it is recommended that s 206F of the *Corporations Act* be amended to give ASIC the power to administratively disqualify directors from managing all corporations for breaching the conditions of restricted directorships.

B. Restriction or Quasi-restriction Regimes Internationally

While the director restriction regime proposed in this article is unusual, it is not unique. Some jurisdictions impose a form of restriction in certain circumstances. For example, the *Companies Act 2008* (South Africa) allows for the imposition of a probation order upon directors when, within a 10-year period, more than one company that the individual is a director of fails to pay all of its creditors in certain defined circumstances.[112] According to Du Plessis and Delport the probation provision "is aimed at protecting the public against people who are involved in the management of several companies and close corporations that were unsuccessful".[113] According to the authors the implication is "that these individuals are not competent and pose a risk to the public and creditors."[114] Probations can be imposed for a maximum of five years.[115] The court imposing the probation may subject the director to any conditions it considers appropriate.[116] Such conditions may include a requirement to undertake remedial education and/or community service, pay compensation, be supervised by a mentor while acting as a director or be limited to acting as a director of particular companies, or particular categories of companies.[117]

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[110] Inspector General of Taxation, *Debt Collection: A Report to the Assistant Treasurer* (2015) Recommendation 2.4, xiv.

[111] Treasury (Cth), *ASIC Enforcement Review: Positions Paper 7 – Strengthening Penalties for Corporate and Financial Sector Misconduct* (2017) 19–20 [28]–[29].

[112] *Companies Act 2008* (South Africa) s 162(7). For a discussion of the provisions see Rehana Cassim, "Delinquent Directors under the Companies Act 71 of 2008" [2013] *De Rebus* 14; Neels Kilian, Jean Jacques du Plessis and Jeanne Nel de Koker, "South Africa" in Jean Jacques du Plessis and Jeanne Nel de Koker (eds), *Disqualification of Company Directors: A Comparative Analysis of the Law in the UK, Australia, South Africa, the US and Germany* (Routledge, 2017) 112, 145–146. Other grounds for the imposition of probation orders that are not related to multiple corporate insolvencies are also provided for in the section.

[113] Jean du Plessis and Piet Delport, "'Delinquent Directors' and 'Directors under Probation': A Unique South African Approach Regarding Disqualification of Company Directors" (Research Paper No 17–28, Deakin Law School Legal Studies, 2017) 7.

[114] du Plessis and Delport, n 113, 7–8.

[115] *Companies Act 2008* (South Africa) s 162(9)(b).

[116] *Companies Act 2008* (South Africa) s 162(9).

[117] *Companies Act 2008* (South Africa) s 162(9)–(10). See also Kilian, du Plessis and de Koker, n 112, 146.

A restriction regime has existed in the Republic of Ireland since 1990.[118] In that jurisdiction liquidators are required to make an application to the High Court for an order restricting the directors of all insolvent companies unless the Director of Corporate Enforcement relieves them of this duty.[119] If imposed a restriction lasts for five years, during which time the person subject to the order can only be appointed a director of a company that meets certain minimum capitalisation requirements.[120] According to Ahern:

> the primary purpose of the restriction jurisdiction is to protect the public against the future conduct of companies by persons whose past records as directors of insolvent companies have shown them to be a danger to others, particularly creditors because they have not acted honestly or responsibly or because there is another reason why it would be just and equitable to restrict them.[121]

In determining whether to impose the restriction the court considers three key factors in relation to the conduct of the director: did he or she act honestly and responsibly, did he or she cooperate with the liquidator and were there any other reasons why it would be just and equitable to restrict the director.[122] Ahern argues that irresponsible conduct on the part of some directors has been sufficient to justify the imposition by the courts of a restriction order.[123]

While not available in the UK, comments made in the Cork Report were supportive of some form of restriction for directors of failed corporations. The report states that:

> [w]e do not think it an undue burden to impose on any director of a failed company that, simple by virtue of his association with that failure, he must either ensure that the company with which he next becomes involved is adequately capitalised or must go through a summary Court procedure to put his personal wealth at risk in the second venture – if only in part and if only for a time.[124]

Outside the context of insolvency there is international precedent for restricting the right of individuals to hold an unlimited number of directorships. For example, in Ireland:

> A person shall not … be a director of more than: 25 private companies limited by shares; or 25 companies, one, or more than one, of which is a private company limited by shares and one, or more than one, of which is any other type of company capable of being wound up under this Act.[125]

The Irish approach combines a large number of concurrent directorships – 25 – with no particular grounds such as previous failures to justify such a limit.

However, limiting *all* directors in this way could adversely affect some genuine entrepreneurs. Instead, the restriction proposal outlined in this article has a more stringent limit of five concurrent directorships but it is only to be applied to restricted directors, as those with a history of failed corporations seem more likely to abuse concurrent directorships. Where the number of directorships held at the time of restriction exceeds the limit, the restricted director should be required to bring themselves within the prescribed limit within a prescribed period of time.

VI. Analysis and Conclusion

At present, Australian courts may allow a person to manage a company in a restricted manner. Section 206G allows disqualified directors to "apply to the Court for leave to manage: corporations; or

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[118] The regime was introduced by the *Companies Act 1990* (Ireland).

[119] *Companies Act 2014* (Ireland) s 683.

[120] *Companies Act 2014* (Ireland) s 819.

[121] Deirdre Ahern, "The Responsible Director in an Economic Downturn: Lessons from the Restriction Regime" (2009) 31 *Dublin University Law Journal* 183, 183.

[122] *Companies Act 2014* (Ireland) s 819(2).

[123] Ahern, n 121, 184, citing *Re Cavan Crystal Group Ltd* (26 April 1996) (HC); *Re Squash (Ireland) Ltd* [2001] 3 IR 35; *Re Club Tivoli Ltd (in vol liq)*; *Foster v Davis* [2005] IEHC 468.

[124] Insolvency Law Review Committee, *Report of the Review Committee on Insolvency Law and Practice*, Cmnd 8558 (1982) 1835 (Cork Report).

[125] *Companies Act 2014* (Ireland) s 142(1).

a particular class of corporations; or a particular corporation".[126] Australian courts have granted leave in some cases. In one case the disqualified director was granted leave to take part in management in a limited capacity on condition that majority control was with non-employee directors, not including the applicant or any relative of the applicant.[127] In another case the Court granted leave to a disqualified director to manage two specific corporations on condition that he not be the sole director in either case.[128] However, s 206G falls far short of the comprehensive restricted directorship regime we recommend.

It is fair to say that if ASIC took regular action against illegal phoenix activity, either via the civil penalty regime or even through appropriate use of s 206F and court applications pursuant to s 206D, there would be less need for the proposed regime. There would be sufficient messages of deterrence sent that those who fail to manage companies competently, and those who deliberately abuse the corporate form for their own gain, would think twice about serial incorporations and insolvencies. The present s 206F, allowing for disqualification where ASIC determines it is justified, is broad enough to capture incompetence.

The main advantages of the proposed regime are its flexibility and its automatic nature, with consequent cost savings to government. A restriction is more flexible than a disqualification order. It allows persons who have been involved in a number of failed companies to continue as a director, albeit in a more limited, controlled and monitored way, and it provides incentives for inexperienced entrepreneurs to engage in education that may improve their business skills.

The automatic nature of the restriction is of great benefit, especially in light of the limited number of director disqualification orders that are instigated by ASIC under the current regime. External administrator (EXAD) reports[129] which are lodged with ASIC within six months of the commencement of an insolvency engagement, show vast numbers of suspected criminal and civil penalty breaches. These are criminal and civil penalty duty breaches, insolvent trading and failure to keep records. These EXAD reports are collated and their statistics are published annually. For example, in 2016–2017,[130] there were 18,734 suspected instances of misconduct contained in 7,765 EXADs' reports.

The EXAD data needs further unpicking. On the face of it, there are many thousands of offences being committed which would "justify" an ASIC imposed disqualification for directors involved in multiple corporate failures. Why then is there a need for a new automatic restriction regime based on incompetence when there are so many candidates for "normal" disqualification under the existing law? The answer lies in both the amount of ASIC enforcement and the reasons for the insolvencies given in the EXAD reports.

In the period 1 July 2018 to 30 September 2018 ASIC reported that it had administratively disqualified 12 directors.[131] Fifty directors were administratively disqualified in the 2017–2018 financial year.[132] The disparity between the numbers of misconduct reports and the number of disqualifications is striking.

The external administrator reports provide nominated causes of failure presented in tabular form.[133] The top five are inadequate cash flow or high cash use, poor strategic management of business, trading losses, poor financial control, including lack of records, and under-capitalisation. External factors such as poor economic conditions and industry restructuring are much less significant.

[126] *Corporations Act 2001* (Cth) s 206G(1).

[127] *Re Magna Alloys & Research Pty Ltd* (1975) 1 ACLR 203.

[128] *Re Gay* (2014) 26 Tas R 1; 99 ACSR 199; [2014] TASSC 22.

[129] ASIC, *Regulatory Guide 16: External Administrators – Reporting and Lodging* (July 2008) ('*ASIC Regulatory Guide 16*').

[130] ASIC, *Insolvency Statistics: External Administrators' Reports (July 2016 to June 2017)*, Report No 558 (2016) table 13, 22.

[131] ASIC, *ASIC Enforcement Outcomes* (9 August 2018) 1 <http://asic.gov.au/about-asic/asic-investigations-and-enforcement/asic-enforcement-outcomes/>.

[132] ASIC, n 131.

[133] ASIC, n 130, table 12, 21.

These three sets of data – the suspected breaches, the actual disqualifications and the nominated causes of failure – prompt a series of questions. Does the misconduct and causes of failure data, when considered together, suggest that directors' own lack of skill leads many of them to commit breaches of the *Corporations Act* when their companies are facing insolvency? Or rather, does the small number of disqualifications, taken with the causes of failure data, indicate that ASIC does not see the disqualification of those who are simply poor business people as a priority, even where their conduct might amount to a breach of the law?

Surely a regime that limits these people from managing many companies at a time, and which encourages them towards education in business skills, is preferable to the present "all or nothing" approach. If complete disqualification is too severe a consequence for incompetent directors – and ASIC reserves it for those blatantly engaged in wrongdoing – then a compromise category as suggested above is worth considering.