

Abusing the Corporate Form:
Limited Liability, Phoenix Companies, and a
Misguided Response

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INTRODUCTION

The principles of limited liability and separate legal identity are fundamental to modern company law. Statements to such effect arise in the introductory lines of numerous company law discussions.¹ This discussion is no different. Together they comprise the backbone of the corporate form, with their advantages recognised and adopted by companies both large and small. While some question their applicability across the board, their position at the heart of company law is not seriously disputed. However, despite their importance, these principles have the potential to be abused.

Phoenix companies provide an example of such abuse. Typically arising during insolvency, in this area, phoenix company arrangements can provide a beneficial alternative. However, they also have the potential to become vehicles for abuse. As such, it is desirable to use our best efforts to prevent this, and any, abuse of the corporate form. Failure to do so weakens company law principles and questions their legitimacy. However, before we can attempt to solve this problem, it is imperative that the development and theory behind both principles is understood. It is only then that an appropriate solution can be reached.

Sections 386A-F introduced to the Companies Act 1993 (“the 1993 Act”) in November 2007 attempt to solve the phoenix company problem. However, what becomes apparent is that they are a misguided and ill-targeted response. The development and importance of company law principles has not been taken into account. The difficulty faced in regulating phoenix companies is the need to recognise their beneficial aspects and ensure that only those arrangements that abuse the corporate form are restricted. In this regard, the new provisions have failed.

As they currently stand, if given full effect, the new provisions will potentially impose the severity of their penalties on those involved in beneficial phoenix

¹ Three examples of many include: F Easterbrook and D Fischel “Limited Liability and the Corporation” (1985) *Uni Chi L Rev* 89, 89; J Freedman “Limited Liability: Large Company Theory and Small Firms” (2000) *Modern Law Review* 317, 317; S McArley “Phoenix Companies and the Corporate Veil” (2004) *CSLB* 47, 47.

arrangements. As such, there is a need for further legislative reform or a watchful judicial interpretation. Failure to do so will result in an unjustified inroad to the principles that company law holds so dear. With the provisions only recently enacted, the most likely outcome will be the need for the Courts to play an active interpretive role. Fortunately there is a way that the Courts can strike a balance between company law principles and regulating their abuse. Such an interpretation will be of the utmost importance.

PART ONE

THE CORPORATE FORM

1. A brief history

The corporate form has two principal facets. These are separate legal identity and limited liability. Although both are well known concepts, it is worth setting out briefly their origins and what they mean.

Significant developments to the corporate form as we know it today can be traced back to nineteenth century England. At this time, two main business vehicles existed for carrying out large scale ventures, namely the corporation and the joint stock company.²

Corporations had been used from the end of the sixteenth century and were created by the Crown granting charters of incorporation.³ They were legal entities distinct from their members, who were theoretically not liable for their debts.⁴ However, this limited liability was illusory in practice as the corporation would call on its members to meet its debts.⁵ This form of incorporation also came with the expense and delay of attaining a charter.⁶

On the other hand, the joint stock company had taken over the commercial scene by 1840.⁷ It was essentially a sophisticated partnership with emphasis remaining on the elements of association and joint stock.⁸ Original partners could transfer shares according to the partnership agreement.⁹ Their total number ran into four figures

² R Grantham and C Rickett "The Bootmaker's Legacy to Company Law Doctrine" in R Grantham and C Rickett (eds) *Corporate Personality in the 20th Century* (Oxford, Hart Publishing, 1998) 1, 2.

³ G Morse *Charlesworth & Morse Company Law* (14th ed, London, Sweet & Maxwell, 1991) 6.

⁴ *Ibid.*

⁵ P Davies *Gower's Principles of Modern Company Law* (6th ed, London Sweet & Maxwell, 1997) 22.

⁶ Grantham and Rickett n.2 above, 3.

⁷ L Sealy "Perception and Policy in Company Law Reform" in D Feldman and F Meisel (eds) *Corporate and Commercial Law: Modern Developments* (London, Lloyd's of London Press, 1996) 22.

⁸ *Ibid.*, 23.

⁹ Davies n.5 above, 21.

and the largest companies had over one thousand members.¹⁰ However, being a partnership, it was not recognised in law as a separate entity from its partners.

To simplify matters the United Kingdom Joint Stock Companies Act 1844 was passed. Compliance with the statutory machinery provided separate legal existence.¹¹ This had the effect of rendering the corporation practically extinct. The expense and effort of gaining a charter was no longer necessary. The role of the joint stock company was also made redundant. Partnership numbers were restricted, which forced joint stock companies to take on the corporate form provided by the Act.¹²

Therefore from 1844 it became far easier to form a company that was a separate legal entity from its owners. However, the Joint Stock Companies Act 1844 “*expressly preserved* the full personal liability of members for company debts”.¹³ A further eleven years went by before this changed. The enactment of the United Kingdom Limited Liability Act of 1855 granted companies limited liability. It is necessary to pause here and consider what limited liability is.

Limited liability means that investors in a company are not liable for more than the amount they contribute. When an investor buys \$100 worth of shares in a company, the maximum amount they put at risk is \$100. The company’s liability is not limited in that it somehow eschews the responsibility of paying its debts, as, like everyone else, a company must pay all its debts.¹⁴ To this extent companies have the same limitation on liability as any individual. An individual can only repay their debts until they become bankrupt. The difference with a company is that although its owners, the shareholders, may not individually be bankrupt, they do not have to finance their bankrupt company over and above the amount of capital they originally contributed.

¹⁰ Sealy n.7 above, 22.

¹¹ Grantham and Rickett n.2 above, 3.

¹² Ibid.

¹³ J Smillie “Tort, Contract and the Limited Liability Company: Reflections on *Trevor Ivory Ltd v Anderson*” (2008) 14 NZBLQ 96, 99 (original emphasis).

¹⁴ F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (Harvard University Press, 1991) 41.

The significance of the nineteenth century United Kingdom legislation is that it provided the framework for this system. The onset of the Industrial Revolution made such a system highly attractive. Projects such as the construction of railways and canals required large amounts of capital, which could not easily be provided by small numbers of investors.¹⁵ However, wealthy investors did not want to put their entire fortune at risk over the success of one project. A separate legal entity, with its owners restricted as to their maximum liability, made the prospect of large scale projects more feasible.

This brings us to the next major development. Although the framework existed, it was not certain how the Courts would interpret such a drastic change from the past. The House of Lords was able to shed light on this uncertainty towards the end of the nineteenth century in what has become a landmark company law case, *Salomon v A. Salomon & Co Ltd.*¹⁶

Mr Aron Salomon was a leather merchant and wholesale boot manufacturer. He carried on business on his own account very successfully for a number of years. In 1892 he formed a company, Aron Salomon & Company Limited. The United Kingdom Companies Act 1862 required a company to have seven shareholders. Aron Salomon & Company Limited fulfilled this requirement by Mr Salomon holding the vast majority of shares and his six other immediate family members holding one share each.

However, the company hit hard times and became insolvent. An action was brought by the liquidator of the company to recover personally from Mr Salomon in respect of losses incurred by the company. The basis of the claim was that the company was a fraud designed to shield Mr Salomon from his creditors because six of the seven subscribers were “dummies” under Aron Salomon’s control.¹⁷

The Court of Appeal upheld this argument. The Court said that the formation of the company was a mere scheme to enable Mr Salomon to carry on his business with

¹⁵ J McDermott *Understanding Company Law* (LexisNexis NZ Limited, 2005) 3.

¹⁶ [1897] AC 22.

¹⁷ Grantham and Rickett n.2 above, 3-4.

limited liability contrary to the true nature of the Companies Act 1862. Lindley LJ stated that it did “infinite mischief”, bringing the Act into disrepute “by perverting its legitimate use”.¹⁸

The House of Lords, however, unanimously made it clear that the liquidator’s claim could not succeed. The company consisted of seven shareholders as was required by the Companies Act 1862. The Act made no provision for the level of involvement or interest of the seven shareholders. Nor did it expressly prohibit forming a company so as to carry on business in the name of a company.

Lord Macnaghten confirmed the previous legislative developments when he said:¹⁹

The company is at law a different person altogether from the subscribers ... and though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers, as members, liable in any shape or form, except to the extent and manner provided in the Act.

Thus the House of Lords held that when the legislation was complied with, the company became a separate legal entity and was provided limited liability. This remained the case even when an individual’s control of a company was absolute. Accordingly, the corporate form could “be used legitimately to shield an ‘owner’ of the business from liability for the conduct of that business”.²⁰

It must be noted that the Court of Appeal’s decision had been consistent with the understanding of company law at the time. The existence of a partnership had been a prerequisite to incorporation both legally and historically, therefore the House of Lords’ decision was a radical change.²¹ However, their Lordships’ decision recognised the importance of limited liability and the use of companies, even in relation to small, closely-held companies where the directors are also the controlling shareholders.

¹⁸ *Broderip v Salomon* [1895] 2 Ch 323 at 339.

¹⁹ *Salomon v A. Salomon & Co Ltd* n.16 above, at 51.

²⁰ *Grantham and Rickett* n.2 above, 5.

²¹ *Ibid*, 8.

The development of company law in the United Kingdom “was essentially duplicated in New Zealand by the Joint Stock Companies Act 1860 and, later, the Companies Act 1955”.²² The Privy Council then confirmed the applicability of *Salomon* in the case of *Lee v Lee’s Air Farming Ltd.*²³ The most recent stage of development came with the enactment of the 1993 Act. Section 15 states that “a company is a legal entity in its own right separate from its shareholders and continues in existence until it is removed from the New Zealand register”. Furthermore, s 97 states that unless the constitution of the company otherwise provides, shareholders’ liability is limited to the amount paid or payable on shares held in the company.

Therefore the concept of the corporate form has been firmly established in New Zealand law. Its presence is undeniable. However, there is some room to doubt its applicability to all types of companies.

²² McDermott n.15 above, 3.

²³ [1961] NZLR 325.

2. Justifying the corporate form

Through the development of the corporate form, the law has shifted in a relatively short period of time from a system where individuals stood behind their work and their debts, to a system where individuals can use a separate legal form to conduct their business and limit their liability. Although this is now long-accepted it is important to consider its justification and, in particular, whether it is susceptible to abuse.

The starting point is to justify the principle of separate legal identity, as this is the more straightforward concept. As Goddard summarises, separate legal identity:²⁴

allow[s] a company to enter into obligations, own property, and sue and be sued. The company does so in its own name, rather than in the names of, or on behalf of, its shareholders. They are not parties to its contracts and cannot be sued by its creditors. They do not have any right to its property – only a bundle of rights in relation to distributions of income and capital, and control of the company either directly (through votes of shareholders) or indirectly, via a board of directors.

The benefits of this relate primarily to reducing transaction costs. Ownership of the company can change hands simply by the transfer of shares as opposed to the transfer of all the company's different assets.²⁵ It is vital to a large company in that its survival is not dependent on the existence of any particular shareholder.

Turning to the justification of limited liability, there are both advantages and disadvantages to consider. As noted above, limited liability means that shareholders' liability is limited to the amount of capital they contribute to a company in the form of purchasing shares. This limit to liability has a number of important benefits.

²⁴ D Goddard "Corporate Personality – Limited Recourse and its Limits" in R Grantham and C Rickett (eds) *Corporate Personality in the 20th Century* (Oxford, Hart Publishing, 1998) 11, 11.

²⁵ *Ibid*, 18.

Firstly, limited liability decreases the need to monitor agents as shareholders have less at stake if the company becomes insolvent.²⁶ If shareholders were exposed to unlimited liability, the costs of monitoring the actions of the company's agents (namely the directors and managers) would be extremely high. This stems from the fact that a shareholder's entire personal wealth could potentially be at stake because of the actions of the company's agents.

Secondly, limited liability reduces the costs of monitoring other shareholders. Again, company insolvency in an unlimited liability regime puts shareholders' personal wealth at risk. Each individual shareholder therefore has a vested interest in the wealth of all the other shareholders and their ability to meet the company's liabilities. Accordingly, existing shareholders have an incentive to monitor other shareholders and ensure they do not transfer their shares to others with less wealth.

Thirdly, limited liability promotes the free transfer of shares. Shares are able to be traded at one price. The value of shares is set by the present value of the income stream generated by a company's assets. In an unlimited liability regime, the value of shares depends on the present value of future cash flows and the wealth of all the shareholders. The purchase price of a share includes the amount of wealth being put at risk and therefore varies depending on the purchaser. The ability to trade shares at one price also has the effect of providing directors and managers with an incentive to act efficiently. Inefficient management will lead to a drop in share price and an increased likelihood of takeover and managerial replacement.

Fourthly, limited liability allows efficient diversification. As Manne argues, "it allows individuals to use small fractions of their savings for various purposes, without risking a disastrous loss if any corporation in which they have invested becomes insolvent".²⁷ Diversification increases risk under a rule of unlimited liability. If any of the companies an investor contributes to become insolvent, that investor stands to lose their entire wealth. Therefore, investors would invest larger

²⁶ This summary of the benefits of limited liability is taken from Easterbrook and Fischel n.14 above, 41-44.

²⁷ H Manne "Our Two Corporation Systems: Law and Economics" (1967) 53 Va L Rev 259, 262.

amounts in a smaller number of companies. They would carry significant extra risk that could otherwise be diversified through a rule of limited liability.

Lastly, limited liability facilitates optimal investment decisions. Directors can accept higher risk ventures when investors are able to diversify. As long as a project has a positive net present value then the project should be accepted.²⁸ In an unlimited liability regime, some projects with positive net present values would be rejected as they would be too risky for investors who are unable to reduce their risk in the project through diversification.

The above summary illustrates how such a regime appeals to large companies wanting to engage in high cost and high risk projects. Raising capital for such projects is feasible as a large number of investors feel comfortable investing small amounts of money without having to put their entire wealth at risk. As McArley comments, “without this limitation on risk, the private capital needed to develop the capitalist economy would not have been made available”.²⁹

Limited liability is therefore a beneficial rule for large companies that have publicly traded shares. However, in 1989 the Law Commission estimated that “much less than one per cent of companies raise capital from the public”.³⁰ Furthermore, based on 2006 statistics, Matthew Farrington notes that around 95 per cent of companies in New Zealand have 5 or fewer shareholders.³¹ It is therefore arguable that the benefits of limited liability are not necessary for the vast majority of companies in New Zealand.

As Freedman argues, the advantages of limited liability tend to fall away when considering closely-held companies.³² The need to monitor directors (or managers) of the company is significantly reduced as, in small companies, shareholders and

²⁸ The net present value of a project is the present value of an investment’s future net cash flows minus the initial investment. If positive, the investment should be made (unless an even better investment exists), otherwise it should not. This is the standard method for calculating the value of long-term projects.

²⁹ McArley n.1 above, 47.

³⁰ New Zealand Law Commission *Company Law: Reform and Restatement* (Wellington, Law Commission, 1989) at para 17.

³¹ M Farrington “A Closely-Held Companies Act for New Zealand” (2007) 38 VUWLR 543, 545.

³² Freedman n.1 above, 331-2.

directors are commonly the same people. Secondly, shareholders are in a position to monitor each other and can do so at little cost. Thirdly, the shares in such companies are not freely transferable as they are not publicly traded. Fourthly, diversification of risk may not be possible for shareholders in small companies as they may be called on in their capacity as directors to provide personal guarantees, thus staking their entire wealth at risk anyway.

It is necessary to pause briefly at this point to consider those that are potentially at risk through limited liability. The most obvious are trade creditors and lenders, who are both voluntary creditors. They face the risk of non-payment because of a company having insufficient assets to meet its liabilities. Limited liability will protect the shareholders (and directors in closely-held companies) from contributing additional capital to meet this liability.

However, there may also be involuntary creditors, including tort victims, who may have a claim against a company which it is unable to meet. There is considerable academic debate as to the role of limited liability in this situation.³³ Discussion surrounding phoenix companies however, does not take us down this path. The claimants aggrieved by a phoenix company will invariably be voluntary creditors. The justification for limited liability can, therefore, be kept within these bounds. With this in mind, limited liability is justifiable not only for large, publicly-held companies but also for small, closely-held companies where shareholders and directors are one and the same. There are several reasons for this.

The first is that if limited liability was not an efficient default rule, we would expect to see it being eroded in a majority of transactions. However, the fact that the default position is reversed in very few transactions and that companies do not normally attract different pricing or contractual terms compared to businesses with unlimited liability, suggests that it is the efficient rule in most commercial contexts.³⁴ The rule is therefore low cost. As a default rule, parties are not required to spend time and money contracting around it.

³³ An insight into this debate can be found in: Easterbrook and Fischel n.1 above; Goddard n.24 above; Smillie n.13 above.

³⁴ Goddard n.24 above, 23.

The position is reinforced when voluntary creditors are considered. The lender to a company has the ability to adjust the interest rate it charges depending on the level of risk it perceives to be present. If the risk of insolvency is high, and consequently, the likelihood that the loan will not be repaid is high, the interest rate payable by the company is similarly going to be high. Another possibility is that the lender can require a personal guarantee from the shareholders of the company that they will make good the loan in the case of default.

The trade creditor has similar options available. Along with the option of a personal guarantee, it will possess a large client base through which it can diversify its risk of loss. The tradesman, for example, knows that if credit is given, a proportion of the bills will not be paid each year.³⁵ The price set by the trade creditor will thus reflect a relatively predictable level of bad debts.³⁶

Moreover, those voluntarily interacting with a company know exactly what they are dealing with. The concept of limited liability is well known or if not, such knowledge is easily attainable. Section 25 of the 1993 Act requires companies to ensure that every written communication contains the company name. As Cooke P stated, by incorporating a one-man company it is made “plain to all the world that limited liability [is] intended”.³⁷

Therefore, while a number of benefits of limited liability are reduced when closely-held companies are concerned, the default rule is justified. Although limited liability was intended for publicly-held companies engaged in large scale projects, the concept has undoubtedly been extended to all businesses that incorporate. In this way, *Salomon* must be seen as a case with enormous foresight. A closely-held company was confirmed as being able to reap the benefits of limited liability because those that deal with companies are aware of this and are able to protect themselves accordingly. The 1993 Act is entirely conformant to this view by placing very few restrictions on the ability to incorporate.³⁸

³⁵ Ibid, 22.

³⁶ Ibid, 21.

³⁷ *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517 at 524.

³⁸ A company need have only one shareholder and one director and can be registered online for a total cost of merely \$160.

With such clear legislative intent the words of Richmond P become pertinent when his Honour said “any suggested departure from the doctrine laid down in *Salomon v Salomon & Co Ltd* should be watched very carefully”.³⁹ However, as will be seen, there is the occasional need for departure. How the departure is made then becomes incredibly important.

³⁹ *Re Securitibank Limited (No 2)* [1978] 2 NZLR 136 at 159.

3. Potential for abuse

The corporate form is not without its drawbacks. There is the potential, in particular, to abuse the concept of limited liability. This becomes most apparent in closely-held companies. A well documented form of this abuse is reckless trading.

Although a voluntary creditor is able to adjust the terms on which it makes credit available, after it has done so it loses this ability. The concern is that after credit is extended a company may engage in irrationally risky activity that the creditor will not be able to fully compensate for. However, the likelihood of this is reduced so long as the company continues to return to the market for credit.⁴⁰ The problem arises when a company no longer envisages further funding.

At this point the company is staring down the barrel of insolvency. The shareholders have already lost their contribution, therefore it is logical for the company to undertake an investment that is “riskier but alone offers the possibility, albeit remote, of a bonanza payoff that will prevent insolvency”.⁴¹ Governments have therefore sought to eliminate this moral hazard.

Section 135 of the 1993 Act provides that directors “must not agree to the business of the company being carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors”. More generally, s 136 provides that “a director of a company must not agree to the company incurring an obligation unless the director believes at that time on reasonable grounds that the company will be able to perform the obligation when it is required to do so”.

The effectiveness of these reckless trading provisions is not relevant for present purposes. However, they are important as they illustrate the potential to abuse limited liability and show a need and willingness to address the issue. This then leads us to another type of corporate form abuse, that of phoenix company arrangements.

⁴⁰ Goddard n.24 above, 27.

⁴¹ J Coffee “Shareholders Versus Managers: The Strain in the Corporate Web” (1986) 85 Michigan L Rev 1, 61.

PART TWO

PHOENIX COMPANIES

4. Phoenix companies generally

In a 2001 Discussion Document the Ministry of Economic Development described a phoenix company as “a company that has been ‘reborn’ soon after (and in some cases before) its failure. The new company takes on the failed company’s business, often using a similar name, the same managers and directors, and the same assets”.⁴²

To put the above statement in slightly more detail, a phoenix company is one that spawns from a pre-existing company (the “original company”). The original company may have several promising aspects to its business, for example a number of fruitful contracts. There may also be a number of uneconomic aspects to its business, for example a potentially crippling liability. In the usual circumstance the original company is heading towards liquidation. As an alternative to liquidation, the directors of the original company turn to a phoenix arrangement.

Under such an arrangement a new company is formed (the “phoenix company”). Typically, before the original company is placed into liquidation, the directors transfer the profitable parts of the original company to the phoenix company. In turn they also become directors of the phoenix company and transfer their staff and assets across to the new company.

The phoenix company has a similar name to the original company and in almost every respect appears exactly the same. It has risen from the ashes of the original company. It leaves behind an original company that is a shell of its former self. All that remains are its creditors, the uneconomic parts of the business that were driving it towards liquidation.

⁴² Ministry of Economic Development “Insolvency Law Review: Tier One Discussion Documents” (2001) (Internet) <<http://www.med.govt.nz/upload/12734/tierone.pdf>> (accessed 21 April 2008) at p.102.

Phoenix company arrangements will practically only ever occur in closely-held companies. The sale of a company's assets will fall under the definition of a major transaction in s 129 of the 1993 Act. A major transaction includes the sale or purchase of assets, the value of which is more than half the value of existing assets. All major transactions require the special resolution of a company's shareholders. This fact alone limits the option of phoenix companies to those companies that are owned and controlled by the same people.

5. Legitimate phoenix arrangements

The phoenix arrangement described above can be beneficial. Provided that the transfer of assets to the phoenix company is for full market value there is no injustice done. The original company will be able to pay off its creditors and the phoenix company can carry on its profitable business. This type of transaction will be referred to as a legitimate phoenix arrangement.

A legitimate phoenix arrangement can be favourable to all concerned. It avoids the costs of liquidation and has the advantage of preserving value which could be lost in liquidation, most notably any goodwill the company may have. Such action also potentially preserves the jobs of existing employees. Creditors, realising that recovering the full extent of their debt is not practicable, may agree to the transfer of an original company's business to a phoenix company in exchange for a discounted return of their debt. The directors of the original company can then continue their previously successful business whilst avoiding the same mistakes that led the original company to liquidation.

It is useful at this point to provide two examples of legitimate phoenix arrangements. In *Customs and Excise Commissioners v Anchor Foods Ltd*⁴³ the New Zealand Dairy Board was selling its products in the United Kingdom through its subsidiary company Anchor Foods Limited ("AFL"). Customs contended that it was owed a sum in the region of £264 million in respect of customs duty accrued between 1994 and 1998. AFL disputed this amount and had lodged an appeal to the Value Added Tax and Duties Tribunal, but it remained in the background as a potential liability. It was unknown if this debt would ever eventuate, but if it did it would plunge AFL into insolvency. This situation created uncertainty and posed a serious threat to AFL's continued ability to operate.

AFL had a profitable business selling New Zealand dairy products in the UK. The customs duty was historic and no longer accruing. Therefore what AFL proposed to the UK Customs office was to set up a new company, New Zealand Milk (UK)

⁴³ [1999] 3 All ER 268

Limited. The new company would have the same directors, managers and staff as AFL. AFL would then sell its business to the new company. In order to legitimise the transaction, it hired a reputable firm of chartered accountants, Ernst & Young, to independently value the business. The value it reached was £9 million.

This proposed transaction would leave AFL as a shell company with assets of £9 million. If the historic duties were found to be payable then this would be the maximum amount Customs could be paid. Customs applied for an injunction to stop the transaction, primarily on the grounds that it disputed the valuation of the business. The Judge decided the best course of action would be for the valuers to collaborate and try to reach an agreement.

The outcome of the case is not relevant for present purposes. What is important is that the case shows how an arrangement similar to a phoenix arrangement may be used legitimately. It was not a true phoenix arrangement because the new company did not have a similar name. However, if the new company did have a similar name the transaction would still have been legal and one of good faith.

The business was independently valued and therefore the transaction was as if it were at arms length. The transaction allowed AFL to continue its profitable business under a new company without a potentially crippling liability hanging over its head. AFL never had £264 million to pay its potential liability. If the debt was payable then £9 million was the maximum Customs could ever have hoped to recover from liquidation. This transaction therefore gave certainty to both AFL and Customs.

Another example can be found in *Lion Nathan Ltd v Lee*.⁴⁴ That case involved one company (May Campbell Ltd) selling its assets to another member of its group of companies (Academy Lighting Ltd). The transaction was to avoid an expensive lease that May Campbell Ltd had entered into. The business was independently valued and the transfer of the business, except for the lease rental, was made for \$2.2 million.

⁴⁴ (1997) 8 NZCLC 261,360.

The original company was left with an expensive lease and insufficient assets to meet the cost. However, a claim under s 320 of the Companies Act 1955, which concerned directors knowingly defrauding creditors, failed. The business had been independently valued and the transaction took place at what the Judge found to be a generous price.⁴⁵ Furthermore, the directors of the company believed their actions towards the lessor were neutral in that what they recovered was the most they would ever recover. Even though the directors preferred one body of creditors to another, by using the purchase price to pay off all liabilities except the lease rental, this was insufficient to amount to intent to defraud.

Although again not a true phoenix arrangement, the case illustrates that even if a similarly named company had been used in the arrangement, no injustice would have occurred. Full value was paid for the business of the original company and the transaction was again as if it were at arms length. The creditors were repaid the full amount they could ever have obtained in liquidation. In fact, the general body of creditors most probably benefited as opposed to the business being placed into liquidation.⁴⁶ Therefore, in certain situations, legitimate phoenix arrangements can provide a beneficial alternative to liquidation.

⁴⁵ Ibid, at 261,380.

⁴⁶ An independent valuation reached a figure of around \$1 million. The business was advertised for sale at this price but attracted no interested buyers.

6. Abusing the corporate form

The problem is that phoenix arrangements are not only used in this positive sense. Indeed if the transfer is made for full value or the creditors are willing to agree to a discounted rate of repayment then there may be little point in creating a phoenix company. The original company could simply pay its creditors and continue business.

The problem surrounding phoenix companies is where the transfer is made at an undervalue. The phoenix company pays less than market value for the business and strips the original company of any ability it ever had to repay its creditors. In other words, an illegitimate phoenix arrangement.

As well as disadvantaging creditors, illegitimate phoenix arrangements allow directors who mismanaged the original company to retain control and potentially repeat the same mistakes. This does nothing other than to start the cycle over again. Furthermore, any creditors that are unaffected by the phoenix arrangement may be unaware of what has happened. The phoenix company may pay a particular creditor's debt in order to keep them as a trading partner. A subtle name change between the phoenix company and the original company may go unnoticed by a creditor that could well be interested in the actions of its trading partner. In other words, the phoenix company may confuse those dealing with it into thinking that it is the same company as the original company it spawned from.

The most common form of transfer at an undervalue is where the goodwill in the original company's name is not taken into account. As Fogarty J noted in *Sojourner v Robb*, goodwill is a company's ability to generate future income.⁴⁷ In *The Commissioners of Inland Revenue v Muller & Co's Margarine Limited* Lord Macnaghten had the following to say of goodwill:⁴⁸

⁴⁷ [2006] 3 NZLR 808 at para 43.

⁴⁸ [1901] AC 217, at 223-224.

It is the benefit and advantage of the good name, reputation, and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start.

Phoenix companies are particularly adept at retaining goodwill. Any goodwill that has been established by the original company will be passed to the phoenix company as it shares a similar name and carries on an identical business. As a further twist, the original company's name is usually changed before it is placed into liquidation. The phoenix company's goodwill is then unaffected by the original company's liquidation.

Illegitimate phoenix company arrangements are more likely to arise before a company is placed into liquidation.⁴⁹ The company is still in the hands of the directors at this point and a transfer for less than market value is more possible than during liquidation. Once in liquidation the sale of the company's assets is the responsibility of the liquidator. They are required to act in the interests of creditors and secure the highest price reasonably obtainable for the company's assets.

However, the problem could be more widespread. There is a belief in the business community that a "friendly liquidator" can be found. The liquidator's fees are set in advance and the transfer of assets at an undervalue agreed upon.⁵⁰ This gives the transfer a perceived legitimacy. This point is again raised by Lynne Taylor as she states "inappropriate phoenix activity may also arise in voluntary liquidations if a 'director friendly' liquidator is appointed who sells the company's business to its directors at an undervalue".⁵¹

It may be helpful at this point to provide an example of an illegitimate phoenix arrangement. In *Robb v Sojourner*⁵² Mr and Mrs Robb owned and operated

⁴⁹ Hon L Dalziel, Minister of Commerce "Paper for Cabinet Economic Development Committee" (6 January 2004) (Internet) <http://www.med.govt.nz/templates/MultipageDocumentTOC____6211.aspx> (accessed 4 September 2008) at para 14.

⁵⁰ Madison Hardy Newsletter "New Laws to Control Phoenix Companies" (Internet) <http://www.madisonhardy.com/Newsletters/Articles/new_laws_to_control_phoenix_comp.htm> (accessed 21 April 2008).

⁵¹ L Taylor "The Regulation of Director Involvement in Phoenix Companies Under Sections 386A to 386F of the Companies Act 1993"(2008) 23 NZULR 111 at 112.

⁵² [2008] 1 NZLR 751 (CA)

Aeromarine Ltd (“Aeromarine”), which specialised in the manufacture of fibreglass products, particularly small boats. This core part of its business was profitable and the company had traded successfully for more than 20 years. In 2000 and 2001 Aeromarine took on two contracts to make two large catamarans. Both jobs became a complete failure. The debts they were incurring threatened to take down Aeromarine’s profitable core business.

Therefore Mr and Mrs Robb set up a new company called Aeromarine Industries Ltd (“Industries”). The staff of Aeromarine all moved across to Industries, which then purchased Aeromarine’s business, except for the two catamaran contracts. However, the sale was at an undervalue because Industries did not pay for the goodwill of Aeromarine. Aeromarine was therefore left with two unprofitable contracts. It was a shell of its former self. It had insufficient assets to meet its liabilities. Its name was then changed to Kut Price Yachts Ltd and it was placed into liquidation.

Meanwhile, Industries continued to trade profitably in the years following. It had retained the profitable parts of Aeromarine and had received its goodwill without paying for it. Aeromarine’s goodwill was largely unaffected by the liquidation of Kut Price Yachts Ltd because at the time of liquidation it was no longer known as Aeromarine.

This case illustrates a classic illegitimate phoenix company arrangement. A profitable business is in danger of liquidation due to several unprofitable aspects of its business. To avoid liquidation a new company is set up to carry on the profitable parts of the original company’s business. The sale between the companies is not at arms length. Although such a transaction can never truly be at arms length, it can be treated as if it were by obtaining independent valuation. In the case of an illegitimate phoenix arrangement, such valuation is not obtained. Most commonly the goodwill of the original company is not paid for. This leaves the original company with liabilities it cannot meet. The new company then continues to trade unaffected.

The new company shelters behind the fact that it is a separate legal entity from the original company. The phoenix company is not obliged to cover the original company's debts as it is at law a completely separate entity. The shareholders of the original company then use the principle of limited liability to walk away from its debts. They are not required to inject additional capital into the company to meet the obligations to its creditors.

In this way the phoenix company abuses both concepts of the corporate form outlined in Part One. Essentially what happens is the directors of the original company increase the risk to the company's creditors by reducing the amount of capital available to meet its obligations after credit has been extended. As was noted in the case of reckless trading, creditors are not able to protect themselves in this situation.

It should be mentioned however, that the corporate form as such is not the concern. The problem is the transfer of assets from the original company to the phoenix company at an undervalue. The mere fact that companies are at times unable to repay their creditors due to insolvency is not the fault of limited liability. Those dealing with companies understand that insolvency may prevent their debt being repaid. As was noted above, creditors can take various steps to protect themselves.

Take the case of *Robb v Sojourner*. The two clients wanting Aeromarine to build them large catamarans did so at a price that was acceptable to them. They would have been aware, or could have been without a great deal of investigation, that Aeromarine did not specialise in the construction of large boats. They took a risk that the company could build their boats to the standard of any other boat builder. It is highly likely that they were compensated for this risk and the lack of experience on Aeromarine's part. The most obvious compensation is the fact that Aeromarine may have agreed to build the boats at a cheaper price than other boat builders could offer.

In the ordinary course of events, the catamaran owners can have no complaint if Aeromarine becomes insolvent. They could have taken steps to protect their position by paying for the boats in instalments instead of an upfront payment. They

could also have insisted on a personal guarantee from the Robbs. However, there is cause for complaint when the company originally dealt with no longer has the same level of assets available because they have been transferred to a phoenix company at an undervalue after credit has been extended. It is this problem that requires attention.

PART THREE

THE NEW PROVISIONS

7. Remediating the abuse

New provisions were introduced to the 1993 Act on 1 November 2007 by the Companies Amendment Act 2006. They appear in the form of ss 386A-F. They are based on ss 216 and 217 of the United Kingdom Insolvency Act 1986 (“the UK Act”).

The new provisions are aimed at reducing the risk of corporate form abuse posed by illegitimate phoenix companies. The new provisions target two of their most common aspects. The Minister of Commerce stated that:⁵³

it [will] prevent directors of companies in liquidations setting up phoenix companies using a name that might lead creditors of the insolvent company to believe that they continue to deal with the former business. It would also reduce the risk of the value of the business being lost to the directors (through the non-payment of goodwill associated with the company name).

It is worth mentioning that the background to the reforms emerged from the heightened public interest in phoenix companies following the insolvency of New Zealand Stevedoring Limited in February 1998.⁵⁴ As outlined by the Minister,⁵⁵ during the insolvency the assets of three companies were sold to a related company as going concerns. As a result there was insufficient money to meet employee redundancies. The Registrar of Companies investigated but found no evidence of a transfer of assets at an undervalue. Therefore this was not a phoenix company problem but rather an issue caused by a lack of priority for employee redundancy pay in insolvency. Nevertheless the public’s interest was alerted to the potential problem posed by illegitimate phoenix companies.

⁵³ Dalziel n.49 above, at para 45.

⁵⁴ Ibid, at para 8.

⁵⁵ Ibid, at paras 9 and 10

Reform was forthcoming. The new provisions are intended as a “low cost statutory disincentive that can be easily enforced”.⁵⁶ It was acknowledged that the adopted approach would neither create a widespread restriction on the re-use of the name of an insolvent company,⁵⁷ nor would it eliminate the abuse of phoenix companies, but would supplement existing provisions within the 1993 Act.⁵⁸ Where there are gaps, existing sections in the 1993 Act must be reverted to. It is important then to have a brief understanding of these before analysing the new provisions in detail.

⁵⁶ Ibid, at para 48.

⁵⁷ Ibid, at para 52

⁵⁸ T Keeper “Phoenix Companies” in New Zealand Law Society *Business Insolvency* (NZLS, Wellington, 2007) 117 at 118.

8. Supplementing the existing law

Creditors defeated by illegitimate phoenix arrangements have never been without recourse. The 1993 Act contains a number of provisions that are capable of dealing effectively with such a situation.

The first provision to note is s 131(1). This is a restatement of the general fiduciary duty that directors must act in good faith and in the best interests of a company.⁵⁹ Any transfer at an undervalue is in breach of this duty. It is not in the original company's best interests to have its assets sold for less than full market value.

A director in breach of a duty owed to a company faces potential enforcement action under s 301. If a creditor makes an application under that section the Court is able to order the director to pay the creditor a sum it considers just. This has a potentially wide application. Section 301 was the recourse used by the Court of Appeal in *Robb v Sojourner*. Both the High Court⁶⁰ and the Court of Appeal held that the Robbs, in their capacity as directors, had breached their s 131 duty of good faith to the original company Aeromarine. By using s 301 the plaintiffs were awarded the full amount of their debt.

Furthermore, transactions at undervalue and for excessive or inadequate consideration are specifically catered for in ss 297 and 298. If the phoenix company buys assets for less than market value, the liquidator of the original company is able to recover the difference once the company is placed into liquidation.

Directors carrying on illegitimate phoenix arrangements also run the risk of breaching s 380. This section provides that if a director knowingly carries on business with intent to defraud creditors they are liable to the penalties set out in s 373(4). That section sets out the harshest penalties under the 1993 Act. Directors are liable to imprisonment for a term not exceeding 5 years or a fine not exceeding \$200,000.

⁵⁹ Taylor n.51 above, 114.

⁶⁰ *Sojourner v Robb* n.47 above

Although *Robb v Sojourner* shows how these existing provisions can be used to great effect, many illegitimate phoenix arrangements go undetected. This is primarily because those affected do not have the resources to pursue a remedy. Access to the legal system is expensive. Many creditors caught by phoenix situations cannot justify the expense of taking a claim through the Courts when there is no certainty of success.

These were essentially the concerns raised in 2004 by the Minister of Commerce.⁶¹ Also of note is the public policy objective that the reforms are a way to show governmental action in response to the general perception of the business community that the laws controlling phoenix companies are inadequate.⁶²

Whatever the truth behind the perceived need for legislative action, it is without doubt that these new provisions form part of New Zealand company law. It is only through their detailed analysis that an assessment can be made of their effectiveness in dealing with illegitimate phoenix companies. It must also be assessed whether or not the response can be justified in terms of the importance that has been placed on the principles behind the corporate form.

⁶¹ Dalziel n.49 above, at para 16.

⁶² Ministry of Economic Development “Phoenix Companies – Regulatory Impact Statement” (Internet) <<http://www.med.govt.nz/upload/13180/phoenix.pdf>> (accessed 21 April 2008). It is perhaps this reason alone that led to the introduction of the new provisions.

9. The new provisions

The principal section is s 386A.⁶³ Sections 386A-F only begin to operate once the original company, as outlined above, is placed into liquidation. Once this occurs, it is thereafter known as a failed company.⁶⁴ Section 386A(1) states:

(1) Except with the permission of the Court, or unless 1 of the exceptions in sections 386D to F applies, a director of a failed company must not, for a period of 5 years after the date of commencement of the liquidation of the failed company, –

- (a) be a director of a phoenix company; or
- (b) directly or indirectly be concerned in or take part in the promotion, formation, or management of a phoenix company; or
- (c) directly or indirectly be concerned in or take part in the carrying on of a business that has the same name as the failed company's pre-liquidation name or a similar name.

Section 386B(1) provides a number of definitions. A director of a failed company is “a person who was a director of the failed company at any time in the period of 12 months before the commencement of its liquidation”. A phoenix company means, “in relation to a failed company, a company that at any time before, or within 5 years after the commencement of the liquidation of the failed company, is known by a name that is also (a) a pre-liquidation name of the failed company, or (b) a similar name”.⁶⁵

These elements of a phoenix company are then further defined by s 386B(1). A pre-liquidation name is “any name (including any trading name) of the failed company in the 12 months before the commencement of that company's liquidation”. A similar name is “a name that is so similar to a pre-liquidation name of a failed company as to suggest an association with that company”. Essentially then a phoenix company is one that either uses a previous name of a failed company or one that is so similar as to suggest an association with it.

⁶³ This is based on s 216(3) of the UK Act.

⁶⁴ Section 386B(1).

⁶⁵ Refer to s 216(2) of the UK Act.

Section 386A(2) states that a person who contravenes s 386A(1) is liable to the penalty set out in s 373(4). As noted for a breach of s 380, this is the most severe penalty possible under the 1993 Act; imprisonment for a term not exceeding 5 years or a fine not exceeding \$200,000. It is further provided in s 386C(1) that those who contravene s 386A(1)(a) or (b) will be personally liable for all the relevant debts of the phoenix company. These are the debts incurred when the person liable is involved in the management of the phoenix company.⁶⁶

Section 386C(2) states that those involved in the management of a phoenix company may also be personally liable for its relevant debts, regardless of their involvement with a failed company. For this to be the case they must have acted, or have been willing to act, on instructions given by a person who the manager knows is contravening s 386A(1). The relevant debts are those that are incurred while the manager was so acting.⁶⁷

Management is not defined in the new provisions, however its interpretation will be of key concern. Not only does the definition of relevant debts include the term, but a director of a failed company must also not be involved in the management of a phoenix company. This wider ban on involvement with phoenix companies is an attempt to stop people from acting in the background of a company and using others to put up a legitimate front.⁶⁸

A helpful definition of management could be found in the case law on s 382(1) of the 1993 Act. This relates to persons convicted of certain offences being prohibited from being directly or indirectly concerned in, or taking part in, the promotion or management of a company. Therefore it uses similar terminology.

However, as is well summarised by Chisholm J in *Thompson v District Court at Christchurch*, in the end, what is management of a company and what is not is a

⁶⁶ Section 386C(3)(a). This personal liability is provided for by s 217(1)(a) and (3)(a) of the UK Act.

⁶⁷ Section 386C(3)(b). Refer to s 217(1)(b) and (3)(b) of the UK Act.

⁶⁸ This is consistent with the definition of director in s 126(1)(b) of the 1993 Act, which includes as directors those people who give directions or instructions to a company's actual directors. Sections 386A-F have been added to the list of sections in s 126(1)(b) to which this extended definition of director applies.

question of degree.⁶⁹ Although his Honour stated that at best judicial attempts to define the concept can only provide general guidance, he did comment that the concept of management is essentially captured by the Supreme Court of Victoria in *Commissioner for Corporate Affairs v Bracht*.⁷⁰ In that case Ormiston J made the following observation in relation to the Victorian equivalent of s 382(1):⁷¹

It may be difficult to draw the line in particular cases, but in my opinion the concept of “management” for present purposes comprehends activities which involve policy and decision-making, related to the business affairs of a corporation, affecting the corporation as a whole or a substantial part of that corporation, to the extent that the consequences of the formation of those policies or the making of those decisions may have some significant bearing on the financial standing of the corporation or the conduct of its affairs.

It is difficult to predict exactly when a person is involved in management. However, it is likely that the provisions will extend to those that are involved in matters that relate to the business affairs of the company. The relevant debts of a phoenix company will therefore similarly include a period of such involvement.

Finally, a director of a failed company cannot avoid liability by adopting a non-corporate form for the new business. Section 386A(1)(c) extends the reach of the provisions to prohibit any involvement in a business with the same name as a failed company or a similar name.

In summary, what the new provisions do is create a blanket ban on phoenix companies. For five years, directors of failed companies cannot be directors of phoenix companies or be involved in their management. There is no requirement that there be any asset transfer from the failed company to the phoenix company. This definition of a phoenix company is therefore far wider than originally set out by the Ministry of Economic Development in 2001.⁷² It encapsulates more than just illegitimate phoenix companies. Those directors caught by the provisions

⁶⁹ (2002) 9 NZCLC 262,824 at para 24.

⁷⁰ [1989] VR 821; (1988) 14 ACLR 728.

⁷¹ *Ibid*, at 830. Cited with approval by Chisholm J in *Thompson* at para 24 and also by Fisher J in *Tregurtha v Police* unreported, HC Auckland, AP 123/93, 15 October 1993, Fisher J.

⁷² Refer to p.19 above.

potentially face both criminal liability and civil liability for the relevant debts of the phoenix company.

There appears to be the underlying assumption that the directors of failed companies will similarly run phoenix companies into insolvency. In other words, the assumption is not that a phoenix company will be legitimately used to avoid known mistakes made in managing a failed company, but rather that the same mistakes will be knowingly repeated to the detriment of the phoenix company's creditors.

The provisions rely on the directors and shareholders of both the failed company and the phoenix company being the same people. Although phoenix arrangements will only be used in companies with few shareholders, those shareholders may not necessarily be the directors or have any managerial involvement. In such a case, the directors will be at risk of incurring criminal and civil liability yet the shareholders will not. Considering that shareholders ultimately receive the profits of a company, the role of non-managerial shareholders in small companies seems to have been overlooked.

10. Likely operation

The blanket ban on phoenix activity has led the English Court of Appeal to comment on the “surprisingly long reach of this legislation”.⁷³ However, in recognition of the beneficial aspect of phoenix arrangements, there have been a number of exceptions carved into the provisions. Those potentially liable will have to look to these exceptions if they wish to continue their involvement. As will be seen, it is the interpretation of these exceptions that will be of crucial importance in ensuring that only illegitimate phoenix companies are entangled in the provisions.

Exactly how these provisions will be interpreted by New Zealand Courts is unknown. However, the English experience will most probably provide valuable guidance. Therefore, before being able to conclude on the overall effectiveness and justification for these new provisions, it is important to analyse in detail how they will most likely operate.

A. Section 386D – successor companies:

The first specific exception is found in s 386D. This allows a person who is named in a successor company notice to be exempt from s 386A. A successor company notice can only be issued by a successor company. A successor company is defined in s 386D(2) as being a company that acquires the business of a failed company under arrangements made by a liquidator, a receiver, or made under a deed of company arrangement under Part 15A of the 1993 Act. A successor company must then send a successor company notice to all the creditors of the failed company within twenty days of the acquisition. The successor company notice must contain various details. These include the circumstances in which the successor company acquired the business of the failed company and the names of both the failed company and the successor company.⁷⁴

⁷³ *Ricketts v Ad Valorem Factors Ltd* [2004] 1 All ER 894; [2004] 1 BCLC 1; [2004] BPIR 825; [2003] EWCA Civ 1706 at para 24 per Simon Brown LJ.

⁷⁴ The UK provisions contain a similar exception. This is rule 4.228 of the United Kingdom Insolvency Rules 1986. It is essentially the same as s 386D. An independent person, as provided in the Act, may supervise the transfer of a failed company’s business to a successor company. Notice

This exception allows legitimate phoenix arrangements to occur. It attempts to ensure arms length transactions for full market value by involving an independent liquidator or receiver. The directors are prepared to be open about the company's dealings and alert those involved with their companies about the position. This exception avoids any creditor confusion as the creation of a phoenix company is made known to the failed company's creditors.

Interestingly, s 386D makes no provision for creditors of the failed company to object to the transaction between the successor company and the failed company. It has been noted that this will become a potential avenue for abuse.⁷⁵ However, provided the liquidator or receiver oversees the transaction properly, there should theoretically be no room to abuse this exception.⁷⁶

B. Section 386F – non-dormant phoenix companies:

The second specific exception relates to failed companies that operate as part of a group of companies. Section 386F states that s 386A will not apply to a phoenix company if it has been known by its name for more than 12 months prior to the failed company's liquidation, and it has not been dormant during those 12 months. This allows directors of a group of companies to avoid liability if one of their companies goes into liquidation.⁷⁷

For example, A and B are directors of both XYZ (North Otago) Ltd and XYZ (Otago) Ltd. If the latter company is placed into liquidation then A and B will not be in breach of s 386A provided that XYZ (North Otago) Ltd has been known by that name for more than 12 months.

must then be given to the failed company's creditors within 28 days and contain various details including the circumstances in which the business is acquired and the names of both the failed company and the successor company. The notice can name people to whom section 216 may apply, and give details as to the nature and duration of their directorships of the failed company, with a view to them being a director or manager of the successor company.

⁷⁵ T Keeper "The New Order of the Phoenix" (2008) 14 NZBLQ 21, 32.

⁷⁶ The concern over potential abuse of this exception most likely relates back to the problem regarding "director friendly" liquidators. As mentioned at p.25 above, these liquidators oversee a transfer of assets to the phoenix company at an undervalue. If this problem is widespread then the successor company notice exception may well be a way to legitimise illegitimate phoenix arrangements.

⁷⁷ The UK equivalent of this is found in rule 4.230 of the United Kingdom Insolvency Rules 1986.

Without this exception the provisions would be unworkable. Companies within a group cannot be expected to change their name or remove a common director whenever one company within the group is placed into liquidation.⁷⁸

It is also relevant to note that the company must not have been dormant during the 12 month period. As stated in s 386F(2) a company will not be dormant if transactions that are required to be kept by s 194(2) of the 1993 Act have been recorded.⁷⁹ This requirement prevents directors from “having an incorporated company kept ‘on the shelf’ waiting to be used once it is clear that a failing company is about to be placed into liquidation”.⁸⁰ This activity, coupled with the need for the company to be at least 12 months old, effectively means that there will be no illegitimate phoenix company and therefore no mischief present.

C. Sections 386A and 386E – “permission of the Court”:

If a director does not fall within either of the specific exceptions they must look to the general exception. Section 386A(1) is prefaced with the words, “except with the permission of the Court”. This allows directors of failed companies to obtain leave of the Court to continue their involvement. There are no guiding factors set out for the Court to consider therefore the English case law on the equivalent s 216(3) of the UK Act is likely to be of assistance.⁸¹

In *Re Bonus Breaks*,⁸² Morritt J considered that the legislation allowed him to look at the conduct of the applicant, the proposed capital and management structure of the new company and also the skills and experience of the other directors. There was no evidence of dishonesty by the applicant but the evidence was clear that the failed company should have ceased to trade approximately 18 months before it actually did. Undertakings were offered to ensure the financial security of the new

⁷⁸ Keeper n.75 above, 33.

⁷⁹ This includes entries of money received and spent each day and a record of assets and liabilities.

⁸⁰ Keeper n.75 above, 33.

⁸¹ Section 216(3) is prefaced with the words “except with leave of the Court”.

⁸² [1991] BCC 546

entity. Although not specifically stated in the judgment, it appears that the application may have been refused were it not for the undertakings.⁸³

This approach was criticised by Chadwick J in *Penrose v Official Receiver*.⁸⁴ The case involved an application for two directors to be granted leave to become directors of Hudsons Coffee Houses (Holdings) Ltd. They had previously been the directors of Hudsons Coffee Houses Ltd, which had been placed into liquidation due to ill-advised expansion and undercapitalisation. There was found to be no dishonesty on the part of the directors. The original company's assets were independently valued and then purchased by the new company. No successor company notice was obtained and there was no evidence as to why this was the case.

However, Chadwick J allowed the application. He held that the purposes for which s 216 was enacted are relevant. He found there to be two elements of mischief that the legislation seeks to meet: firstly, a danger that the business of the old insolvent company has been acquired at an undervalue; and secondly the danger that creditors of the old company may be misled into the belief that there has been no change in the corporate vehicle.⁸⁵ When these dangers are not present, it is inappropriate to look to the structure of the new company and make an assessment of the likely risks of the venture. In this case there was no risk to creditors of the new company beyond that which is permitted under the law relating to the incorporation of limited liability companies.⁸⁶ In other words there had been no abuse of the corporate form.

Chadwick J also found the provisions of the Company Directors Disqualification Act 1986 to be relevant. That Act empowers the Court to disqualify directors in various situations. These include a person who is convicted of an indictable offence in connection with the formation or management of a company; a person persistently in default in relation to the keeping or filing of accounts and returns;

⁸³ Chadwick J alludes to this in *Penrose v Official Receiver* [1996] 2 All ER 96 at 105.

⁸⁴ [1996] 2 All ER 96; [1996] 1 WLR 482; [1996] 1 BCLC 389; [1996] BCC 311

⁸⁵ *Ibid.*, at 104.

⁸⁶ *Ibid.*

and where a person is guilty of an offence of fraud. Although there is no replica Act in New Zealand there are various provisions in the 1993 Act that bear similarities.⁸⁷

Chadwick J held that it is inappropriate to be able to assess the risks of a company when factors from the Company Directors Disqualification Act 1986 are not present. Such an inquiry would be too harsh considering a new company could avoid this scrutiny by adopting an unrelated name to the failed company or by following one of the two exceptions.

The case of *Re Lightning Electrical Contractors Ltd*⁸⁸ confirms this approach. In that case Lightning Electrical Contractors Ltd had been placed into liquidation due to one of the two directors making large and unjustified drawings from the company. The other director, who was the driving force behind the company, applied for leave to be the director of a new company called Lightning Electrical Construction Ltd. The latter company had purchased the assets of the former company with approval of the receivers. There was again no allegation of any dishonesty by the applicant and the Judge commented that the case came close to fulfilling the successor company exception.⁸⁹ The Judge adopted the approach of Chadwick J in *Penrose* and allowed the application.

Therefore the approach to the s 386A exception adopted by the English Courts has been to focus on the mischief that the phoenix company provisions seek to address. Risk that may be present in a new company through, for example, undercapitalisation or mismanagement is not a risk the Court should assess. It is a legitimate risk that the Legislature allows by way of the established corporate form.

In both *Penrose* and *Re Lightning* the new companies had bought the assets of the old company at full value. There was, in other words, no abuse of the corporate

⁸⁷ Those in breach s 377 – 380 of the 1993 Act are liable to the penalties set out in s 373(4). Section 377 is concerned with the making of false or misleading documents. Section 378 prohibits fraudulent use or destruction of company property. Section 379 relates to falsification of company records and s 380 (as mentioned at p.31 above) concerns directors knowingly carrying on business with intent to defraud creditors. The Court may, under s 382, prohibit a person convicted of one of ss 377-380 from managing a company for up to 5 years. Similarly under s 383 the Court may prevent a person convicted of the same offences from being a director for up to 10 years.

⁸⁸ [1996] 2 BCLC 302; [1996] BCC 950

⁸⁹ *Ibid*, at 307. As in *Penrose* there was no indication as to why this exception was not adhered to.

form. Leave of the Court was granted despite the fact that the successor company exception was available but not followed.

A stricter interpretation was possible. Their Honours could have held that the exception has been created for directors to use. Failure to do so runs the risk of breaching the provisions. Such an interpretation would leave the general exception in s 386A with extremely limited scope.⁹⁰ However, as will be expanded on in Part Four, this exception will be of vital importance. Both Judges in *Penrose* and *Re Lightning* adopted the appropriate interpretation. Neither case involved an illegitimate phoenix company. Given the fundamental importance of company law principles, and the severe penal nature of the penalties, leave should always be granted in cases that do not involve illegitimate phoenix companies. Both *Penrose* and *Re Lightning* are thus important precedents in this regard.

Finally, s 386E must be read in conjunction with the s 386A exception. This provides a grace period to obtain the Court's permission. A director seeking an exemption under s 386A can apply to the Court within 5 working days of the failed company's liquidation. They will then be exempt for a period which ends on the earlier of six weeks after the commencement of the failed company's liquidation or the date the Court allows an exemption.⁹¹

However, as was pointed out by Trish Keeper, the dates provided are likely to be an oversight. The problem is that a director who is denied an exemption by the Court could continue to be a director of the phoenix company until the end of the six week period. This cannot have been Parliament's intention as it would undermine the Court's refusal to grant permission. It will most likely fall on the Court to construe s 386E in such a way as to avoid this absurdity.⁹²

⁹⁰ It could possibly be used, for example, in situations where the creditors of the failed company assent to the transfer of the failed company's assets in exchange for a discounted return of their debt.

⁹¹ Section 386E(2).

⁹² Keeper n.75 above, 33. The UK equivalent is rule 4.229 of the United Kingdom Insolvency Rules 1986. However, it does not contain this anomaly as temporary leave ends on the sooner of six weeks after the company's liquidation or the day the Court disposes of the application.

D. How similar is “similar”?

Section 386B(1) defines similar name as one that is so similar to that used by a failed company in the 12 months before the commencement of its liquidation, *as to suggest an association* with that company. It includes both registered and trading names. The purpose of this definition is to prevent phoenix companies exploiting any goodwill that a failed company may retain.

Section 22 of the 1993 Act provides that a company may not register a name that is identical or almost identical to another company. Section 386B(1) will require less than this standard, but where the line will be drawn is unclear. It is useful to consider the developments in the United Kingdom as s 216(2)(b) of the UK Act is worded in almost identical fashion.

The leading case on the issue is the Court of Appeal’s decision in *Ricketts v Ad Valorem Factors Ltd.*⁹³ The contention was that a phoenix company by the name of Air Equipment Co Ltd (“Air Equipment”) had a similar name to a failed company called The Air Component Co Ltd (“Air Component”). Mr Ricketts was appointed as a director of Air Component on 10 February 1998. One month later it was placed into liquidation. On 2 March 1998 he became a director of Air Equipment. Air Equipment then also went into liquidation owing Ad Valorem more than £6,000.

The only question for determination was whether the names of the two companies were so similar as to suggest an association with each other. If they were, with all other aspects of s 216 satisfied, Mr Ricketts would be personally liable for the debt to Ad Valorem.

Importantly, this was not a case involving an illegitimate phoenix arrangement. Mummery LJ stated:⁹⁴

there was no transfer of assets by Air Component to Air Equipment at an undervalue;
there was no evidence that the companies were used to run up debts and to avoid their payment either on the part of Air Component or Air Equipment; there was no

⁹³ *Ricketts v Ad Valorem Factors Ltd* n.73 above.

⁹⁴ *Ibid*, at para 16.

evidence that creditors of Air Equipment or anyone else had been misled by the similarity of the names of the two companies or the fact that Mr Ricketts was a director of both.

In other words this was not a case where the mischief was present that the Legislature intended to prevent.

Mummery LJ held that the two names were so similar to each other as to suggest an association. In reaching that conclusion his Honour stated that:⁹⁵

It is necessary ... to make a comparison of the names of the two companies in the context of all the circumstances in which they were actually used or likely to be used; the types of product dealt in, the locations of the business, the types of customers dealing with the companies and those involved in the operation of the two companies.

When viewed in that light, his Honour was in no doubt that the name Air Equipment suggested an association with Air Component. The fact that the two companies dealt in the same product and a similar market was enough to meet the test.

Simon Brown LJ agreed that the two names were so similar as to suggest an association. However, he noted his unease with the view of the Judge at first instance that the threshold of suggesting an association is a very low one.⁹⁶ He pointed out the “Draconian consequences, both criminal and civil, which can all too easily flow from finding a company’s name to be a [similar name]”.⁹⁷ His Honour made reference to the well-established principle of statutory interpretation that a Court should strive to avoid adopting a construction which penalises someone where the legislator’s intention to do so is doubtful, or penalises him or her in a way which is not made clear.⁹⁸

With this in mind, his Honour stated that “the similarity between the two names must be such as to give rise to a probability that members of the public, comparing

⁹⁵ Ibid, at para 22.

⁹⁶ Ibid, at para 30.

⁹⁷ Ibid.

⁹⁸ F Bennion *Statutory Interpretation: a code* (4th ed, London, Butterworths, 2002) s 271, at p.705. Referred to at para 30 of the judgment.

the names in the relevant context, will associate the two companies with each other, whether as successor companies or ... as part of the same group”.⁹⁹

In *Commissioners for HM Revenue and Customs v Walsh*¹⁰⁰ Laddie J was faced with the question of whether Walsh Construction Limited had a similar name to SG & T Walsh Company Limited. Again this was the only question for the Court. His Honour applied the *Ricketts* test of context and association.

Five points were submitted that tended to suggest a similar name. As to the relevant context, both companies claimed to be building and civil engineer contractors. Secondly, for a period of time the trading address for both companies was the same. The clients of both companies were similar or, in some cases, the same. The persons involved in both companies were the same and finally, the letterheads of the companies were very similar.

Of the submission that Walsh is a common name, Laddie J referred to the judgments in *Ricketts*. His Honour held that it was inherent, particularly in the comments of Mummery LJ, that he must have dismissed the suggestion that the mere fact the words are in common use or are ordinary is not enough in itself to be a bar to a finding of a relevant association.¹⁰¹ His Honour held that the five factors relied upon were enough to make it probable that the reasonable customer or member of the public who knows of both companies would associate them with each other.

In *Revenue and Customs Commissioners v Benton-Diggins*¹⁰² the High Court held that Williams Hair Studio Ltd and Williams and Xpress Ltd shared a similar name. Both companies were involved in the field of hairdressing. The defendant was a director of both companies and was “the leading light in relation to [their] affairs”.¹⁰³ The two companies operated out of premises in close proximity and for some time Williams and Xpress Ltd took over the business of Williams Hair Studio

⁹⁹ *Ricketts v Ad Valorem Factors Ltd* n.73 above, at para 30.

¹⁰⁰ [2005] BPIR 1105; [2005] EWHC 1304 (Ch)

¹⁰¹ *Ibid.*, at para 31.

¹⁰² [2006] 2 BCLC 255; [2006] BPIR 1116; [2006] EWHC 793 (Ch)

¹⁰³ *Ibid.*, at para 11.

Ltd. Although William is a common Christian name his Honour found this to be beside the point when considering the *Ricketts* test.¹⁰⁴

The English authorities make it clear that context will be all important when determining the similarity of phoenix company names. The cases show that a wide range of factors will be considered. Although Simon Brown LJ in *Ricketts* did not agree that the threshold was a very low one, the results in the above three cases tend to suggest otherwise. In all three cases the fact that the two companies shared an identical aspect to their name was enough to find the names to be similar regardless of other differences.

Adopting a low threshold is important because it ensnares more illegitimate phoenix companies within the provisions. However, it also catches more directors of legitimate phoenix companies that have not fallen within an exception or perhaps thought their adopted name was not similar enough to be caught by the provisions. Despite this possibility a low threshold is important and should be adopted in the New Zealand context. However, due to the expanded definition of phoenix company, there must be a watchful eye kept over the type of company being given this title.

E. Strict liability:

Section 386A(2) states that a person who contravenes s 386A(1) commits an offence and is liable on conviction to the penalty set out in s 373(4). On the face of it there is nothing to suggest that a wrongdoer must have any intention to commit an offence.

The English Court of Appeal has considered the role of mens rea in the equivalent s 216(4) of the UK Act.¹⁰⁵ The Court held in *R v Cole*¹⁰⁶ that the offence was one of strict liability. The prosecution need not prove knowledge or intention to defraud or

¹⁰⁴ Ibid, at para 19.

¹⁰⁵ That sub-section states that “if a person acts in contravention of this section, he is liable to imprisonment or a fine, or both”.

¹⁰⁶ [1998] 2 BCLC 234, [1998] BCC 87

deceive.¹⁰⁷ The same approach was taken in *R v Doring*.¹⁰⁸ The Court refused any argument on behalf of the accused that they did not realise their conduct amounted to management of a phoenix company.¹⁰⁹

In *Thorne v Silverleaf*¹¹⁰ the accused, Mr Thorne, had been the director of three companies that had been placed into liquidation. Each of the companies had Mike Spence as part of their name. Mr Thorne was a director of the first two companies in the 12 months prior to their liquidation. He then became a director of the third company within five years after the liquidation of the first two companies. There was no evidence of any asset transfer between the companies. The third company was funded by a Mr Silverleaf, who had knowledge of the previous two companies' failures. When the third company was wound up Mr Silverleaf claimed a debt of close to £135,000.

The Court held Mr Thorne liable under ss 216 and 217 of the UK Act. Peter Gibson LJ stated that “in the absence of an application under s 216(3) for leave, the court is left with no discretion on the application of the sections”.¹¹¹ Ralph Gibson LJ noted the potential severity of the provisions but commented that:¹¹²

It must have been supposed [by Parliament] that such a person would, in the ordinary course of things, learn of this provision of the law or that directors which go into insolvent liquidation should be left to inform themselves of the consequences in law of acting in contravention of s 216.

Therefore the provisions applied despite the company not being set up as an illegitimate phoenix company.

In *Archer Structures Ltd v Griffiths*¹¹³ her Honour Judge Frances Kirkham followed *Thorne v Silverleaf* and held that she could not exercise discretion in relation to a director of both a failed company by the name of MPJ Construction Ltd and a

¹⁰⁷ Ibid, at 237.

¹⁰⁸ [2002] BPIR 1204; [2002] EWCA Crim 1695.

¹⁰⁹ This would be a claim under s 386A(1)(b) of the 1993 Act.

¹¹⁰ [1994] 1 BCLC 637; [1994] BCC 109

¹¹¹ Ibid, at 642-643. Mummery LJ made similar comments in *Ricketts v Ad Valorem Factors Ltd* n.73 above, at para 22.

¹¹² Ibid, at 646.

¹¹³ [2004] 1 BCLC 201; [2003] EWHC 957 (Ch)

phoenix company, MPJ Contractors Ltd. There was no evidence of a transfer of assets between the two companies at an undervalue. However, her Honour said that “the name MPJ Contractors Ltd is as nearly as similar to MPJ Construction Ltd as it is possible to be”.¹¹⁴ In refusing to use her discretion she noted that “Contractors could have asked permission to use the name”.¹¹⁵

As well as the English case law, guidance in this area can be gained from the approach to s 382(1)(b) of the 1993 Act. As already mentioned, this section makes it an offence, unless leave of the Court is obtained, to be a director or to be directly or indirectly concerned in, or take part in, the management of a company after being convicted of certain offences.¹¹⁶ Section 382(4) is worded in a similar fashion to s 386A(2).¹¹⁷

In *Attorney-General v Auckland District Court*¹¹⁸ the argument in relation to s 382(1)(b) was that the accused was unaware of their ability to apply for leave of the Court. It was held that to be guilty, a person must knowingly and intentionally become a director without leave of the Court.¹¹⁹ However, it need not be proved that the accused had knowledge that they could apply for leave.¹²⁰ Such a requirement would run contrary to s 25 of the Crimes Act 1961, which states that the fact an offender is ignorant of the law is not an excuse for any offence committed by him.¹²¹

The English position to s 386A(1) is that arguments regarding unawareness as to the existence of the provisions, or that conduct amounted to a breach of the provisions, will be rejected. This is rightly so where illegitimate phoenix arrangements are concerned. However, in *Thorne v Silverleaf* the Court of Appeal held that the same result will follow even when there is no illegitimate phoenix arrangement. This was the case in *Archer Structures*. *Attorney-General v Auckland District Court* seems to

¹¹⁴ Ibid, at para 18.

¹¹⁵ Ibid, at para 39.

¹¹⁶ These are sections 377-380, which are described at n.87 above.

¹¹⁷ It states “a person who acts in contravention of this section ... commits an offence and is liable on conviction to the penalty set out in section 373(4)”.

¹¹⁸ (2000) 8 NZCLC 262,314

¹¹⁹ Ibid, at para 10

¹²⁰ Ibid.

¹²¹ Ibid.

suggest a similar approach to general unawareness of the provisions may be adopted in New Zealand.

The availability in New Zealand of a middle ground of offences, to which a defence of absence of fault is possible, may be of assistance.¹²² This could be used if a defendant “is able to show that reasonable steps were taken to comply with one of the three statutory exceptions, or they had taken some action that they mistakenly believed complied with the exceptions”.¹²³ This is unlikely to be a favourable approach when illegitimate phoenix companies are concerned, but it could remedy the situation of *R v Doring* if those involved in legitimate phoenix companies do not realise their conduct breaches the provisions.

However, despite *Attorney General v Auckland District Court*, New Zealand Courts should go a step further. Directors of phoenix companies should be excused when they have not formed an illegitimate phoenix company. This should be the case even if no permission from the Court is sought due to their unawareness of the provisions. Section 382 can be distinguished in this regard by the requirement for a director to obtain leave of the Court. Section 386A(1) simply states that the Court may grant *permission* and not necessarily as a result of an application. The Court could simply step in and allow directors in such a position to continue their involvement despite an exception not being followed and no application for permission being made. In so far as the English cases of *Thorne v Silverleaf* and *Archer Structures* run contrary to this, they should not be followed.

With the provisions’ potential to entangle more than simply illegitimate phoenix companies, it is imperative that the Courts strive for an interpretation that avoids this. It is therefore necessary to illustrate why such a position is justifiable and how it could be adopted.

¹²² Keeper n.75 above, 25.

¹²³ Ibid.

PART FOUR

JUSTIFIED REFORM?

11. A misguided response

The development of company law shows that both Parliament and the Courts hold the underlying principles of the corporate form in high regard. Therefore, one would expect any inroad to either principle to be both targeted and as restricted as possible in order to address the mischief presented. It is apparent from the analysis in Part Three that this is not the case.

As Mummery LJ stated in *Ricketts*, “the provisions are another example of a limited, though significant, departure from the general principles of corporate law”.¹²⁴ The provisions primarily make inroads to the principle of limited liability by making directors personally liable for the relevant debts of phoenix companies. However, instead of a targeted response to illegitimate phoenix arrangements there is now a blanket ban on all phoenix companies. The onus has been shifted to the directors to prove the legitimacy of a phoenix arrangement.

Although the Legislature should be encouraged to reform the law when there are gaps that allow corporate form abuse, the response in this instance is unjustifiable. The provisions lack direction as they do not address the key mischief posed by illegitimate phoenix arrangements. To make matters worse, they lack substance as they do not provide a remedy for the party most at risk of being wronged.

Phoenix companies only abuse the corporate form when assets from an original company are transferred to them at an undervalue. Yet there is no mention of this in the new provisions. A new company with a similar name to an insolvent company does not abuse the corporate form. By failing to require the need for a transfer of assets at an undervalue, these new provisions extend the definition of phoenix

¹²⁴ *Ricketts v Ad Valorem Factors Ltd* n.73 above, at para 2.

company. This has the potential to catch legitimate phoenix arrangements and those companies not formed as part of a phoenix arrangement at all. Examples of this can be seen in cases such as *Ricketts* and *Thorne v Silverleaf*.

Ralph Gibson LJ in *Thorne v Silverleaf* was surely correct when he commented that it must have been Parliament's intent that directors of failed companies would become aware of the provisions and fulfil one of the created exceptions in order to continue their involvement in a phoenix company.¹²⁵ But, as the English experience shows, this has not always been the case. Nor should it be. As was highlighted in Part One, the 1993 Act has continued to recognise the importance and efficiency of limited liability as a low cost default rule. In this particular area of company law these provisions reverse this. There will be costs involved with directors having to become aware of their potential liability. By failing to do so, directors may find themselves personally liable for a company's debts when they have committed no wrongdoing.

The second major problem with these reforms is that they do not provide a remedy for those most at risk from illegitimate phoenix arrangements. The purpose of an illegitimate phoenix arrangement in most circumstances will be to defeat the claims of creditors to the original company's assets. By transferring assets away from the original company at an undervalue there is less money available to meet such claims.

However, the new provisions only provide personal liability of those in breach for the debts of the phoenix company's creditors *not* the creditors of the original company. The phoenix company may not even have any debts. The creditors of the original company are forced to pursue a claim under the existing law. While it has been shown that such claims are possible, introducing new provisions cutting into the principle of limited liability without assisting those most in need seems an extremely strange response.

¹²⁵ *Thorne v Silverleaf* n.110 above, at 646.

What then is the reason for such a misguided response? A potential answer may be found in the origins of the reforms. There was a perceived need to respond to the business community's belief that legislation in this area was inadequate.¹²⁶ However, the business community's suspicion as to the potential harm caused by illegitimate phoenix companies was aroused by the liquidation of New Zealand Stevedoring Limited, which was not in itself a phoenix company arrangement. A quick fix may have been thought necessary without thinking through the implications.

Support for this can also be found in the model for the provisions. Sections 216 and 217 were a late amendment to the United Kingdom Insolvency Bill and were introduced as an afterthought.¹²⁷ It has also been commented in regard to the United Kingdom provisions that "if the objective of s 216 was designed to curb the potentially prejudicial effect of the phoenix syndrome, the provision must be viewed as an unmitigated failure".¹²⁸ The reforms were made in spite of this, which strengthens the argument that this was more about a quick fix than a well thought through response.

What is also somewhat disturbing is a comment from the Minister of Commerce that the new provisions would "reduce the risk of the value of the business being lost *to the directors* (through the non-payment of goodwill associated with the company name)".¹²⁹ The company does not have any value to the directors. It is the shareholders that own the company and thus have a stake in its value.

It is true that phoenix arrangements are used predominately by closely-held companies where directors and shareholders are commonly the same people. However, the problem with phoenix companies is that the value of the original company is reduced to defeat creditors' claims. As phoenix arrangements invariably occur when a company is facing insolvency, the shareholders/directors have no value left in the company. Therefore this statement by the Minister

¹²⁶ Ministry of Economic Development n.62 above.

¹²⁷ D Milman "Curbing the Phoenix Syndrome" (1997) JBL 224, 224.

¹²⁸ S Griffin "Extinguishing the Flames of the Phoenix Company" (2002) 55 Current Legal Problems 377, 388.

¹²⁹ Dalziel n.49 above, at para 45. Also noted at p.29 above.

regarding what the provisions will remedy shows a lack of understanding as to the actual problem.

Similar indications of this misunderstanding can be gleaned from the fact that the provisions make no account for liability of shareholders. A non-managerial shareholder of both a failed company and a phoenix company, who assents to a transfer of the business, will not be caught by these provisions. Considering that shareholders stand to benefit the most from a phoenix arrangement, it is surprising that they are not mentioned.

Therefore, while a small inroad into the principle of *Salomon*, it is nevertheless a significant one. Without actually addressing either the real mischief or those most at risk, the effectiveness of these reforms is likely to be severely diminished.

It is also important to keep in mind the severe penalties for breaching the provisions. Besides personal liability for the relevant debts of a phoenix company, potential liability also includes imprisonment for a term not exceeding 5 years or a fine not exceeding \$200,000. This implies that a breach of the provisions is one of the most serious offences that can be committed under the 1993 Act.¹³⁰ Given that this can happen inadvertently and when no illegitimate phoenix company is concerned, this is a most surprising response.

Bearing in mind Richmond P's warning in *Re Securitibank* to watch departures from *Salomon* very closely, it is appropriate to consider what could or should be done to restrict the depth of this inroad.

¹³⁰ As noted in p.34 above, this is the most severe penalty possible under the 1993 Act.

12. Potential solutions

There are two potential solutions. Firstly, the Legislature could amend the current provisions to create a more targeted attack on illegitimate phoenix companies. The second potential solution would involve the Courts' interpretation of the provisions as they are currently framed. Considering the reforms were introduced less than twelve months ago, the latter solution seems more achievable.

A. Legislative response:

Even though it may be highly unlikely that the Legislature will amend the new provisions in the near future, it is helpful to consider what amendments could be made if such a course was adopted. A targeted amendment could be easily implemented. Two things would need to change.

Firstly, a straightforward amendment to the relevant part of s 386B(1). The revised definition of phoenix company could read:

phoenix company means, in relation to a failed company, a company that –

(a) at any time before, or within 5 years after, the commencement of the liquidation of the failed company, is known by a name that is also –

(i) a pre-liquidation name of the failed company; or

(ii) a similar name; and

(b) has all or any of its assets transferred from the failed company at an undervalue.

This simple modification would have the effect of targeting the provisions to the mischief they are supposedly enacted to prevent. By making a transfer at an undervalue between the phoenix company and the failed company a requirement, the provisions become an acceptable intrusion to the *Salomon* principle. Unlimited liability would only extend to directors of illegitimate phoenix companies.

The second modification would be just as simple. Section 386C(1) could be amended to read “a person who contravenes section 386(1)(a) or (b) is personally

liable for all the relevant debts of the phoenix company and the failed company”. The relevant debts of the failed company would have a corresponding definition to the relevant debts of the phoenix company as defined in s 386C(3). This would provide the real victims of phoenix activity a more direct response than under the existing law. It would also provide a further disincentive for directors to engage in illegitimate phoenix arrangements.¹³¹

Legislative response would be the preferred method of rectifying this unjustified inroad to company law principles. However, as already noted, this is probably unlikely. As such, the second type of response will be necessary.

B. Judicial response:

The Courts will likely have considerable regard to the English jurisprudence in this area. This should be adopted in every respect except in one significant way. As mentioned above, the English cases have adopted a low threshold for determining whether a phoenix company’s name is “so similar to a preliquidation name of a failed company as to suggest an association”.¹³²

This interpretation is preferable. Setting the threshold low catches more illegitimate phoenix arrangements. The provisions in this regard are aimed at preventing a phoenix company from gaining any benefit from a failed company’s goodwill. Lowering the threshold prevents this behaviour. It forces phoenix companies to adopt a completely different name from a failed company. This, in turn, no longer brings them within the definition of a phoenix company and makes the whole scheme less attractive.

The mischief surrounding phoenix companies is not that directors of failed companies form new companies. The mischief is present when directors of failed companies form similarly named companies that purchase the failed company’s

¹³¹ As will be recalled from Dalziel n.49 above, at para 48, and noted at p.30 above, one of the main intentions of the reforms is to act as a low cost statutory disincentive. Extending liability to include debts of the failed company strengthens this.

¹³² Refer to p.46 above.

assets at an undervalue. Insofar as this transfer of assets is between companies with dissimilar names, the remedy must be found in the existing law, regardless of common directorship.¹³³

However, a low threshold catches more legitimate phoenix arrangements that have for some reason not fallen within an exception. It also catches a greater number of phoenix companies that have not been party to any asset transfer and have therefore inadvertently breached the provisions. In neither case will there be any wrongdoing. The solution is not to raise the threshold but instead use the discretion of s 386A(1) to exempt those involved in these phoenix companies from liability. This can be done regardless of whether one of the three statutory exceptions is complied with.

The English cases seem to make it half-way there. When considering leave applications, the High Court in both *Penrose* and *Re Lightning* allowed permission when there was no illegitimate phoenix arrangement. However, the Court of Appeal in *Ricketts* and *Thorne v Silverleaf*, took a stricter interpretation. There was similarly no illegitimate phoenix arrangement, but with no application for leave the provisions applied.

If such a situation arises in New Zealand, the Court should intervene. Although Peter Gibson LJ in *Thorne v Silverleaf* thought the Court had no discretion in such a case, this is not necessarily so.¹³⁴ The Court could interpret the preface in s 386A of “except with the permission of the Court” as a signal from the Legislature to use its discretion.

In fact, this is the only available interpretation when company law principles are considered. The Court must be prepared to uphold these principles when they are unjustifiably attacked. The Court need simply cite *Salomon, Lee* and Richmond P’s comments in *Re Securitibank* for support. Parliament cannot have intended such an unjustified inroad to well founded principles. The preface has been inserted so that

¹³³ Refer in particular to p.31 above.

¹³⁴ *Thorne v Silverleaf* n.110 above, at 642-643.

the Courts can limit the extent to which an otherwise literal interpretation would erode *Salomon* and indeed the foundations of modern company law.

New Zealand Courts may be more willing to adopt such an interpretation. The existence of an absence of fault defence, unavailable in the United Kingdom, may provide the answer. When there is no illegitimate phoenix company, there will be no fault on the part of the accused. The Court should therefore grant permission under s 386A(1), regardless of whether it is sought, so as to prevent any possible by-catch of those involved in legitimate phoenix companies.

This interpretation will not undermine the created exceptions. Directors of failed companies that want to be involved in legitimate phoenix companies will still be better off complying with one of the exceptions. It will also not run contrary to s 25 of the Crimes Act 1961. An accused will be ignorant of the law, but the Court's permission is not allowing them to escape punishment for committing an offence. This is because directors of phoenix companies commit no wrongdoing unless they are directors of illegitimate phoenix companies.

By adopting such an interpretation, the Court is simply acting as a backstop. It will ensure that the provisions only catch illegitimate phoenix companies and, by doing so, prevent the mischief they have been enacted to remedy.

CONCLUSION

The two main tenets of company law are the principles of separate legal identity and limited liability. Together they make up the corporate form, which brings with it numerous benefits and has proven a cornerstone of modern day development.

While their importance is undoubted to publicly-held companies, the need for limited liability in relation to closely-held companies has been questioned. However, the justification remains, in large part, because those who deal with companies understand what it is they are dealing with. As such they are able to protect their own interests.

The corporate form does have its downside in that it can potentially be abused. Illegitimate phoenix arrangements are one such example. However, it is not a simple problem to rectify. Phoenix arrangements can be legitimate and beneficial. It is in this regard that Parliament's response has failed to adequately take into account the fundamental principles and development of company law.

The provisions lack direction by not targeting the primary mischief posed by illegitimate phoenix companies and by not assisting those most at risk from their activity. Whatever the reason for such a misguided response, it cannot be allowed to remain. Either Parliament should amend the provisions in the simple and effective way outlined above, or the Courts must step in to prevent the provisions from having their full erosive effect.

Salomon has stood for more than 110 years. Its origins go back a further half century and beyond. If what this fundamental case stands for is to be preserved, this latest attack on its authority must be addressed. The Legislature and the Courts should work hard at preventing any abuse of the corporate form and the significant benefits it provides. However, they should not remedy a specific abuse in a misguided manner that overlooks the development of company law in the past 160 years.

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