ANGAS LAW SERVICES PTY LTD (IN LIQUIDATION) AND ANOTHER..... APPELLANTS; PLAINTIFFS,

AND

CARABELAS AND ANOTHER..... RESPONDENTS. DEFENDANTS,

[2005] HCA 23

ON APPEAL FROM THE SUPREME COURT OF SOUTH AUSTRALIA

Companies — Books of account — Wrong entries intentionally made — Effect.

Companies — Directors — Improper use of position — Limits on ratification by unanimous body of shareholders — Companies (South Australia) Code, s 229(2), (4).

HC of A
2004-2005

Dec 8
2004

April 27
2005

Gleeson CJ,
Gummow,
Kirby,
Hayne and
Heydon JJ

Section 229(2) of the *Companies (South Australia) Code* required an officer of a corporation at all times to exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties. Sub-section (4) prohibited an officer or employee of a corporation from making improper use of his position as such an officer or employee, to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

A company had two shareholders and directors one of whom was the only active participant in its affairs. That person (the borrower) borrowed money from a bank, some of which he lent to the company. That part of the borrowed funds was used to discharge a mortgage over the company's property, which was then mortgaged to the bank to secure the borrower's debt to the bank. When the property was sold, the whole of the proceeds went to the bank in reduction of the borrower's debt. The company's books then showed that the borrower owed $446,710.31 to the company. A subsequent journal entry in the company's accounts purported to correct this position by showing that various amounts were owed to the company by other companies controlled by the borrower. Those amounts, together with $15,501.59 owed by the borrower amounted to $446,710.31. The other companies were insolvent and their debts were later written off in the company's books. The company subsequently went into liquidation and its liquidator claimed compensation from directors on the basis that the journal entry indicated that they had contravened s 229(2) and (4) by procuring the company's entry into a contract of novation by which the borrower's debt to it was discharged and replaced by debts owed to it by insolvent companies. In addition, book entries had been made in the accounts of the company which purported to show that the company had reduced its debt to the directors by paying off the directors' debts to some of the other companies. The liquidator sought orders under s 588FF(1) of

the *Corporations Law* (Cth) on the ground that those book entries were evidence that transactions involving preferences under ss 588FA and 588FC of the *Corporations Law* had occurred.

Held, that there was no evidence of any contract of novation. The journal entry in issue was erroneous and the borrower's debt to the company had not been discharged. The book entries were also erroneous as there was no evidence of any transaction justifying their being made. Hence there were no transactions involving preferences that bound the company.

Per curiam. (1) If a novation had occurred as alleged, it would have involved the expropriation of the company's property by the borrower, a form of abuse of power that could not have been ratified by the self-interested consent of the borrower and the acquiescence of the other shareholder.

(2) While in some circumstances the informed assent of all the shareholders to a transaction might be a fact relevant to impropriety, the provisions of s 229 creating offences operate according to their terms. The shareholders of a company cannot release directors from duties imposed by s 229(2) and (4).

Per Gummow and Hayne JJ. Whether conduct is "improper" for the purposes of s 229(4) depends in each case on the content to be given to the standards of conduct that would be expected of the officer, having regard to the position occupied by the officer in the company and the circumstances surrounding the impugned conduct (ie the commercial context).

Decision of the Supreme Court of South Australia (Full Court): *Carabelas v Scott* (2003) 177 FLR 334, affirmed.

APPEAL from the Supreme Court of South Australia.

Angas Law Services Pty Ltd (In liq), with its liquidator, commenced proceedings in the Supreme Court of South Australia against George Carabelas and his wife, its sole shareholders and former officers, in respect of transactions reflected in its books which were alleged to be breaches of statutory duties imposed by s 229(2) and (4) of the *Companies (South Australia) Code* and to be transactions involving preferences. The defendants contended that in borrowing money, Mr Carabelas acted as agent for the companies he controlled, which were all engaged in a joint venture, and that the alleged transactions involving preferences had not in fact occurred. Williams J held that there was no joint venture, that Mr Carabelas had borrowed money as a principal, and lent it as a principal to his companies and found that breaches of s 229(2) and (4) had been established (1). The Full Court (Doyle CJ, Prior and Vanstone JJ), reversing that judgment, held that even though there was no joint venture, there had been no breach of s 229(2) or (4), and that no transactions involving preferences of the

(1) *Scott v Carabelas* [2003] SASC 156.

kind that were purportedly recorded had occurred (2). McHugh, Gummow and Kirby JJ granted the company and its liquidator special leave to appeal to the High Court from the judgment of the Full Court.

G Griffith QC (with him *L G De Ferrari*), for the appellants. The property of the directors is not the property of the shareholders (3). The principle of permissible ratification by the unanimous body of shareholders ought to be limited to the waiver of formalities as a form of estoppel on members of a company (4). At the least, permissible ratification cannot extend to instances where the shareholders share the improper purpose of the directors, otherwise it would make a mockery of the notion of the company as a distinct legal entity (5). The book entries showing transactions involving preferences were evidenced by advice given to the respondents as to how the accounts of the corporation should be altered to permit the deregistration of the first respondent's other companies, which explained the instructions from the first respondent to the corporation's accountant to make those book entries. [He also referred to Baxt, "Judges in their own cause: the ratification of directors' breaches of duty" (6); Yeung, "Disentangling the Tangled Skein: the Ratification of Directors' Actions" (7); and Hannigan, "Limitations on a Shareholder's Right to Vote – Effective Ratification Revisited". (8)]

R J Whitington QC (with him *M B Manetta*), for the respondents. There was no finding of novation and thus no possible case for loss or damage arising from the mortgage transaction or its sequel. The rule of unanimous shareholder assent is not limited to the extent suggested by the appellants. The mere fact that the shareholders themselves might be interested in the director's actions is not a recognised limitation (9). It is unclear what an improper corporate purpose might be, particularly in

(2) *Carabelas v Scott* (2003) 177 FLR 334.
(3) *In re George Newman & Co* [1895] 1 Ch 674; *ANZ Executors & Trustee Co Ltd v Qintex Australia Ltd* [1991] 2 Qd R 360.
(4) *Herrman v Simon* (1990) 4 ACSR 81; 8 ACLC 1,094.
(5) *Cook v Deeks* [1916] 1 AC 554; *Ngurli Ltd v McCann* (1953) 90 CLR 425; *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666; *Hurley v BGH Nominees Pty Ltd [No 2]* (1982) 31 SASR 250; *Marson Pty Ltd v Pressbank Pty Ltd* (1987) 12 ACLR 465; 6 ACLC 338; *Residues Treatment & Trading Co Ltd v Southern Resources Ltd* (1988) 51 SASR 177 at 204; *Colarc Pty Ltd v Donarc Pty Ltd* (1991) 4 ACSR 155; *ANZ Executors & Trustee Co Ltd v Qintex Australia Ltd* [1991] 2 Qd R 360; *Miller v Miller* (1995) 16 ACSR 73; *Gray Eisdel Timms Pty Ltd v Combined Auctions Pty Ltd* (1995) 122 FLR 253; *Jalmoon Pty Ltd (In liq) v Bow* (1996) 15 ACLC 233; *Macleod v The Queen* (2003) 214 CLR 230; cf *Pascoe Ltd (In liq) v Lucas* (1998) 27 ACSR 737; 16 ACLC 1,247.
(6) *Monash Law Review*, vol 5 (1978) 16.
(7) *Australian Law Journal*, vol 66 (1992) 343.
(8) [2000] *Journal of Business Law* 493.
(9) *Attorney-General (Can) v Standard Trust Co of New York* [1911] AC 498; *In re Duomatic Ltd* [1969] 2 Ch 365; *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242.

the case of a solvent company (10). In any event such a limitation would be hard to apply in practice as the law has traditionally been reluctant to enquire into the motives underlying the exercise by shareholders of their voting rights or to constrain the exercise of those rights in a self-interested way. There is no clear authority for the proposition that the codification of directors' duties by statute has limited the unanimous shareholder asset rule to cases where the directors have not acted in breach of their statutory duties (11). A director would not in any event be acting improperly or unreasonably if his actions were authorised by the shareholders and there were no actual dishonesty, fraud on a minority or, in the case of actual or near insolvency, failure to have regard to the interests of creditors. The potential existence of criminal liability is no bar to the operation of the unanimous shareholder assent rule in a private or civil law context, as criminal liability does not affect the possibility of waiver or release of private rights and obligations as between the corporation and the director. Moreover, it is a matter of statutory construction in each case whether the prospective authorisation of a course of conduct by a victim for whose protection the provision primarily exists means that no offence is ever committed. There is no authority for the proposition that appropriation of a company's assets by directors cannot be ratified by unanimous shareholder assent where there is no fraud on the minority. The substantial limitations on a company's power to release a director from civil liability that result from the limitations on the unanimous shareholder assent rule suggested by the appellants would result in uncertainty for directors. In any event the appellants had not demonstrated that the mortgage transaction contravened even the limitations they suggested should operate. The book entries that appeared to show the transactions involving preferences were not made at the specific instructions of the respondents but largely at the discretion of the corporation's accountant and were not shown to the respondents. Further, there was no evidence that anything was done before liquidation.

G Griffith QC, in reply.

Cur adv vult

27 April 2005

(10) *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666; *Residues Treatment & Trading Co Ltd v Southern Resources Ltd* (1988) 51 SASR 177 at 204; *ANZ Executors & Trustee Co Ltd v Qintex Australia Ltd* [1991] 2 Qd R 360; *Colarc Pty Ltd v Donarc Pty Ltd* (1991) 4 ACSR 155; *Jalmoon Pty Ltd (In liq) v Bow* [1997] 2 Qd R 62.

(11) *Marson Pty Ltd v Pressbank Pty Ltd* (1987) 12 ACLR 465; 6 ACLC 338; *Miller v Miller* (1995) 16 ACSR 73; *Gray Eisdel Timms Pty Ltd v Combined Auctions Pty Ltd* (1995) 122 FLR 253.

The following written judgments were delivered: —

1 GLEESON CJ AND HEYDON J. The first respondent, George Carabelas, and the second respondent, his wife, were at all material times the holders of the two issued shares in the capital of Angas Law Services Pty Ltd (ALS). They were also the only directors of ALS. Mr Carabelas is a legal practitioner. Apart from signing some financial statements, Mrs Carabelas does not appear to have taken an active part in the affairs of ALS, but the case was conducted on the assumption that she acquiesced in decisions made by her husband. ALS was incorporated in 1986. It was wound up, on the ground of insolvency, by order of the Supreme Court of South Australia dated 26 April 1994. The petitioning creditor was the Deputy Commissioner of Taxation, who was owed $25,408 for capital gains tax incurred upon the sale, in October 1989, of a property in Angas Street, Adelaide, which was the company's principal asset. The petition was presented on 16 March 1994, which was agreed to be the date relevant for considering preference issues. The second appellant is the liquidator of ALS.

2 ALS and the liquidator brought two claims against the respondents in the Supreme Court of South Australia. The first was a claim by ALS for compensation under s 229(7) of the *Companies (South Australia) Code* (the Code), based upon alleged contraventions of s 229(2) and s 229(4). The second was an application by the liquidator for orders under s 588FF(1) of the *Corporations Law*, based upon a contention that, during the period specified in the statute and before the commencement of the winding up of ALS, and at a time when ALS was insolvent, ALS entered into transactions involving preferences under ss 588FA and 588FC. The preference issue occupied only a small part of the time taken in this Court, and it is convenient to put it aside until the conclusion of these reasons.

The statute

3 Section 229 of the Code, so far as presently relevant, provided:

> "(2) An officer of a corporation shall at all times exercise a reasonable degree of care and diligence in the exercise of his powers and the discharge of his duties.
>
> Penalty: $5,000.
>
> …
>
> (4) An officer or employee of a corporation shall not make improper use of his position as such an officer or employee, to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.
>
> Penalty: $20,000 or imprisonment for 5 years, or both.
>
> …
>
> (7) Where a person contravenes or fails to comply with a provision of this section in relation to a corporation, the corporation may, whether or not the person has been convicted of

an offence under this section in relation to that contravention or failure to comply, recover from the person as a debt due to the corporation by action in any court of competent jurisdiction —

(a) if that person or any other person made a profit as a result of the contravention or failure – an amount equal to that profit; and

(b) if the corporation has suffered loss or damage as a result of the contravention or failure – an amount equal to that loss or damage.

…

(10) This section has effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person by reason of his office or employment in relation to a corporation and does not prevent the institution of any civil proceedings in respect of a breach of such a duty or in respect of such a liability."

4 The loss claimed to have been suffered by ALS in consequence of the alleged contraventions of s 229 was $474,950. (In the pleadings, written submissions, and reasons for judgment, the amount varied between $474,950 and $474,960. The difference is immaterial.)

The allegations of contravention and loss

5 The loss of $474,950 was said to have resulted from what the primary judge described as a course of conduct, involving two transactions. Although the appellants argued that the first transaction itself contravened s 229, the loss alleged resulted directly from the second transaction, if it took place. In the events that occurred, the first transaction, if it stood alone, would not have resulted in the loss of which the appellants complained.

6 In June 1988, Mr Carabelas approached the Adelaide branch of the Commonwealth Bank seeking an advance of up to $2.5 million. An internal bank memorandum shows that his approach was warmly received. The bank manager recorded that Mr Carabelas was "very active in the property market", that ALS owned the Angas Street premises from which he conducted his legal practice, and that various other properties were owned either by Mr Carabelas or by other companies of which he and his wife were the directors and shareholders. Other evidence identified the companies as Barry Simpson Pty Ltd, Citizac Pty Ltd, Wamville Pty Ltd, Tusport Pty Ltd and Blackcroft Pty Ltd. The bank manager estimated the total value of properties owned by Mr Carabelas or by his companies at about $3.6 million. The memorandum also recorded that the property owning companies were incorporated solely for investment purposes, each company owning separate properties. Rental income from the various properties was $348,000 per annum. The manager recommended the advance. At the time, the Angas Street property was subject to a mortgage to the Hindmarsh Building Society (HBS) to secure a debt of $435,040 owing by ALS to HBS.

7 On or about 15 July 1988, the Commonwealth Bank advanced $1,750,000 to Mr Carabelas. The bank required, and obtained, as security, a first mortgage over all the real estate owned by Mr Carabelas or by his companies, including ALS. Mr Carabelas applied $435,040, part of the amount of $1,750,000, by lending it to ALS to enable ALS to repay its debt to HBS and obtain a discharge of mortgage. ALS then gave a mortgage over the Angas Street property to the bank. The mortgage was expressed to be in consideration for accommodation and advances to Mr Carabelas, and secured all moneys then owing, or which might become owing, by Mr Carabelas to the bank. That is the first transaction. It is common ground that, at the time, ALS and Mr Carabelas were solvent. There was no clear evidence as to how Mr Carabelas applied the balance of the sum of $1,750,000, apart from $435,040 lent to ALS, although certain accounting entries suggested he may have made similar loans to other companies, and procured the grant by them of similar mortgages. It was not claimed that the mortgage transaction resulted in any direct or immediate loss or damage to ALS.

8 It is convenient, at this stage, to mention a factual issue that was raised by Mr Carabelas and resolved against him, both by the primary judge and by the Full Court of the Supreme Court of South Australia. Mr Carabelas attempted to establish that his various companies were engaged in a joint venture, and that, in borrowing money from the bank, he was merely acting as an agent for each company, and not as a principal. This was a major issue at trial, and in the Full Court. The primary judge found that Mr Carabelas was "borrowing from the bank and then supplementing these funds from other sources as necessary to support a particular project". There was, he found, no joint venture, and Mr Carabelas was not merely an agent. He was borrowing as a principal and then lending to his companies. Those findings were upheld in the Full Court. There is no reason for this Court to depart from those concurrent findings of fact. However, the contention by Mr Carabelas, unsuccessful as it was, explains certain accounting entries relevant to what was claimed to be a second breach of s 229.

9 The accounts of ALS were kept, and its annual financial statements were prepared, by Mr Vlassis. The accounts of ALS, following the mortgage transaction, showed a loan by Mr Carabelas to ALS of $435,040, giving rise to a debt owing by ALS to Mr Carabelas in the same amount. Although there was no detailed examination of the topic in the evidence, it appears that, during the second half of 1989, the fortunes of Mr Carabelas and his companies declined. On 11 October 1989, the Angas Street property was sold for $910,000. The whole of the proceeds of sale went to the mortgagee, the Commonwealth Bank, and were applied in reduction of Mr Carabelas' indebtedness to the bank. Mr Vlassis recorded the financial consequences of this by making a journal entry (GJ2), dated 30 June 1990. The journal entry began with an amount of $474,960, which was the difference between $910,000 (the gross proceeds of sale of the Angas Street property) and

$435,040 (the debt owed by ALS to Mr Carabelas). The amount of $474,960 was adjusted for agent's costs and commission and some other minor items, producing a net figure of $446,710.31. The correctness of these adjustments, and of the net figure, is not in dispute. The amount of $446,710.31 was debited to Mr Carabelas' loan account with ALS. Thus, one consequence of the sale of the Angas Street property, and the payment of the proceeds of sale to the bank in reduction of the indebtedness of Mr Carabelas to the bank, was that, whereas before the sale ALS owed Mr Carabelas $435,040, after the sale Mr Carabelas owed ALS either $474,960 or, if the adjustments were to be taken into account, $446,710.31. According to the appellants, the journal entry GJ2 accurately reflected the true state of accounts as between ALS and Mr Carabelas immediately following the sale of the Angas Street property. At that stage, assuming the solvency of Mr Carabelas (which was not in issue), and disregarding any further contingent liability of ALS to the bank (a contingent liability which, as will appear, never became an actual liability), the net assets of ALS had not diminished. The value of the company's equity in the Angas Street property was replaced by a debt of the same amount owed to it by Mr Carabelas.

10 The financial statements of ALS for the year ended 30 June 1990 were prepared, belatedly, by Mr Vlassis. They were signed by both Mr and Mrs Carabelas. Before they were prepared, Mr Vlassis made another journal entry, GJ10, also dated 30 June 1990. In order to understand GJ10, it is necessary to bear in mind the contention of Mr Carabelas that his borrowing from the bank in July 1988 was as agent for various companies, including ALS, and not as principal. That contention, although rejected by the primary judge, was reflected in GJ10, and the financial statements of ALS. The journal entry GJ10 purported to correct GJ2. Journal entry GJ2 showed Mr Carabelas as owing $446,710.31 to ALS. Journal entry GJ10 showed various amounts which, together with an amount of $15,501.59 owed by Mr Carabelas, made up a total of $446,710.31, as being owed to ALS by Barry Simpson Pty Ltd, Blackcroft Pty Ltd, Wamville Pty Ltd, Tusport Pty Ltd and Citizac Pty Ltd respectively. If the money originally borrowed by Mr Carabelas from the Commonwealth Bank, and apparently later applied by him by way of loans to various companies, had been borrowed by him merely as agent for the companies, this may have justified the entries in GJ10. At least, those entries would have been consistent with Mr Carabelas' case. That case was rejected both at trial and on appeal. The appellants, however, sought to make a positive case of misfeasance, based, not upon treating the accounting entries as erroneous, but upon treating them as recording or reflecting a real and effective, but unlawful, transaction, described in the pleadings as a "novation". By the time of the making of the journal entry of GJ10 (which time was never clearly established) each of Barry Simpson Pty Ltd, Blackcroft Pty Ltd, Wamville Pty Ltd, Tusport Pty Ltd and Citizac Pty Ltd was insolvent. The debts said to

have been owed by those companies to ALS were later written off. The appellants argued that the second contravention of s 229 (or, as the primary judge saw it, the second aspect of a single course of conduct in contravention of s 229) was the procuring of ALS to enter into a contract of novation by which the debt owed to ALS by Mr Carabelas was discharged, and in its place there was a series of debts owing to ALS by a number of insolvent Carabelas companies. That allegation depended upon the shaky premise that in truth there had been such a transaction, rather than a series of incorrect accounting entries by Mr Vlassis. Apart from the journal entries, and the financial statements in which they were reflected, there was no evidence of any contract of novation. The signatures of Mr and Mrs Carabelas to the financial statements were not admissions that there had been a novation. Rather, they reflected the contention (ultimately found to be without foundation) that Mr Carabelas had not been a principal borrower but had acted merely as agent for various companies.

11 If there had been a transaction of novation, by which a debt owed by Mr Carabelas to ALS was discharged and there was substituted for it a series of debts owed by insolvent companies, it would be clear that the transaction contravened s 229 and resulted in loss to ALS. The problem for the appellants was to establish that there had been such a transaction.

12 Before turning to the way in which the primary judge, and the Full Court, dealt with the s 229 claim, it is worth mentioning another feature of the litigation. The evidence showed that, in June 1993, years before proceedings were commenced, Mr Carabelas entered into a deed with the Commonwealth Bank under which his outstanding liabilities to the bank were discharged. The commercial circumstances of that arrangement were not the subject of any findings by the primary judge. It was accepted by the parties that one consequence of that deed was that ALS was under no further obligation to the bank. That probably explains why no attempt was made to treat the amount of the contingent liability incurred by ALS in June 1988 (or that amount less $435,040) as a loss. ALS was insolvent as at 30 June 1992, but, apart from the bank, its only significant creditor appears to have been the Federal Commissioner of Taxation, who was owed $25,408. If it were not for legal and accounting expenses incurred in relation to the liquidation, and this litigation, the only people who would stand to gain from the present action would be Mr and Mrs Carabelas, in their capacity as shareholders of ALS. The opening qualification to that sentence, of course, is important. The proceedings at first instance lasted thirteen days. The only substantial debt originally owing to a third party has been dwarfed long since by costs of the liquidation and the litigation. Apart from the relatively modest amount owing to the revenue, and legal and accounting costs, the ultimate fruits of the litigation, if there are any, will go to the respondents. That in itself is curious. It is also curious that the attempt to recover $474,950 from Mr Carabelas was based upon an allegation of contraventions of s 229

rather than upon a straightforward claim (at least in the alternative) that he owed ALS that amount, and that his debt was never discharged.

The decision of the primary judge

13 The proceedings in the Supreme Court of South Australia were commenced in 1997. The case for the appellants was ultimately expressed in a second further amended statement of claim dated 13 September 2000. The matter came on for hearing before Williams J in February 2003. Williams J found in favour of ALS and assessed the amount of compensation for which the respondents were liable at $474,950. He also ordered the respondents to pay interest of $731,423. He ordered the respondents to pay to ALS a total amount of $1,206,373, together with costs (12).

14 The primary issue of fact which Williams J had to resolve arose out of the agency theory advanced by the respondents. If that theory had been accepted, it may have provided an answer to the allegations of contravention of s 229. In particular, it would have explained, and may have justified, the journal entry GJ10. Williams J rejected the theory, and his reasoning in that respect was upheld by the Full Court.

15 As to the financial position of ALS, which was relevant both to the claims under s 229 and to the preference issues, Williams J noted that at the date of the winding up order (26 April 1994) ALS owed the revenue authorities $25,408.41. That amount became due and payable on 4 March 1991. In a letter to the Australian Taxation Office of 23 September 1993, ALS acknowledged its inability to pay that debt. Williams J accepted the evidence of an accountant that ALS was insolvent on 30 June 1992, and on 30 June 1993.

16 There was no finding that ALS was insolvent on 15 July 1988. On the contrary, assuming that the ultimate sale price of the Angas St property in 1989 was a reasonable reflection of its true value in July 1988, then in July 1988 the assets of ALS substantially exceeded its liabilities, and it had no pressing commitments it could not meet. The effect of the mortgage transaction of 15 July 1988 was to replace the debt of $435,040 owed by ALS to HBS with a liability in the same amount to Mr Carabelas. At the same time, ALS incurred a contingent liability to the Commonwealth Bank by reason of the security it gave for Mr Carabelas' borrowings from the bank. Against that liability, presumably it had rights of contribution from its co-sureties (the other Carabelas companies) and rights against Mr Carabelas, but any rights against the other companies were never investigated or pursued. No doubt this was because the arrangement between Mr Carabelas and the bank in 1993, by which his liability to the bank was discharged, was thought to render such questions of academic interest only. When, in 1997, the appellants made their claim for compensation, they identified as the loss suffered by ALS the amount of the debt owed by

(12) *Scott v Carabelas* [2003] SASC 156.

Mr Carabelas to ALS after the sale of the property, which was lost by the supposed transaction of novation.

17 Williams J recorded the contention of the appellants as being that "ALS either has lost the sum of $446,710 by virtue of [the respondents causing it to grant] a mortgage for the whole of its value (so that CBA could take the whole sale price), or by virtue of the defendants 'novating the liability' from [Mr Carabelas] to Barry Simpson, Blackcroft, Wamville, Tusport and Citizac so that ALS could not recover the sum from [Mr Carabelas]." In his reasoning, Williams J appears to have treated the agency theory as the only substantial response to that contention. Having rejected that theory, he moved directly to the conclusion that breaches of s 229(2) and s 229(4) had been demonstrated.

18 Williams J made no finding as to when or how a transaction of novation occurred. He seems to have assumed that a finding that there had been such a transaction followed from a rejection of the agency theory.

19 The rejection of the agency theory did not necessarily involve, or require, a conclusion that, in fact and in law, there had been a novation which resulted in a discharge of the liability of Mr Carabelas to ALS. On the findings of Williams J, as a result of the sale of the Angas Street property, and the application of the whole of the proceeds of sale in part payment of Mr Carabelas' debt to the bank, Mr Carabelas became indebted to ALS. Although the judgment did not examine the precise state of Mr Carabelas' loan account with ALS, there was evidence that ALS also owed him money. Apart from what might have been inferred from GJ10, there was no evidence of any resolution of directors or shareholders, or of any agreement, or of any other transaction, between ALS, Mr Carabelas, and the other Carabelas companies, that brought about any discharge, by novation or otherwise, of Mr Carabelas' liability to ALS. The journal entry, GJ10, and the financial statements prepared on the basis of that journal entry, reflected the agency theory, found by Williams J to be spurious. So far as appeared from the evidence, the novation theory was equally spurious. It seems to have been an attempt to rationalise GJ10, and the financial statements, in some alternative fashion. There was no evidence that a novation had occurred. The evidence, and the findings of primary fact, showed that the financial statements were wrong, and that the liability of Mr Carabelas to ALS had never been discharged. The reasons of Williams J explain his rejection of the agency theory, but not his acceptance of the novation theory. It was not necessary to rationalise GJ10. On the evidence, it was simply wrong.

20 Similarly, perhaps because the agency theory was advanced as the justification for the July 1988 mortgage, Williams J did not give any detailed reasons for concluding that the mortgage transaction itself was part of a contravening course of conduct. All he said on that topic was:

> "The defendants contend that there is nothing unusual in an arrangement under which a number of trading entities provide

> mutual financial support to each other by guarantees of their collective borrowings from a common account. As relevant to this case, that proposition is an incomplete reflection of the pertinent facts. The various entities were not trading in partnership, and upon the sale of property by one company, the bank was entitled immediately to apply the proceeds of sale in reduction of the account. Although the bank in the exercise of its discretion might then be prepared to release funds for some other approved investment, the arrangement seems to me to be difficult to justify."

The decision of the Full Court

21 In the Full Court, counsel for the present respondents sought, for the first time, to raise the matter of certain amounts owed by ALS to Mr Carabelas, and complained of the failure of the trial judge to give credit for those amounts which, it was said, would have reduced Mr Carabelas' liability to $257,512. Counsel was refused leave to do so. The argument, however, serves to emphasise the fact that, in the proceedings at first instance, neither side approached the problem as one of attempting to work out the correct state of Mr Carabelas' loan account with ALS, and to apply the conclusion directly by way of a claim for debt.

22 One of the grounds of appeal to the Full Court was expressed as follows:

> "The learned trial judge erred in law in failing to apply the principles enunciated in *Pascoe Ltd* to defeat the [compensation] claim."

23 *Pascoe Ltd (In liq) v Lucas* (13) was a decision of the Full Court of the Supreme Court of South Australia. The somewhat circumspect reference to that case was evidently intended to raise an argument based on the fact that Mr and Mrs Carabelas were the owners of all the issued shares in the capital of ALS. The precise legal significance attributed to that fact, which does not appear to have featured in the arguments to the primary judge, was not stated in the notice of appeal.

24 *Pascoe* was a case in which a company was incorporated for a special purpose of participating in a series of transactions entered into for the benefit of a group of which it was a member. All the shares in the company were owned by another member of the group. The company was solvent. It entered into the transactions at the behest of its sole shareholder. After the group encountered financial difficulties, a liquidator sued one of the Pascoe directors claiming breaches of s 229 of the *Companies (Western Australian) Code*, and of fiduciary duty. The trial judge found that the director acted honestly, and rejected the liquidator's allegation of impropriety. In the Full Court of the Supreme Court of South Australia, reference was made to two related but distinct lines of authority, both of which turn upon the significance of knowledge and unanimous approval by shareholders of conduct of

(13) *Pascoe Ltd (In liq) v Lucas* (1999) 75 SASR 246.

directors. The first line of authority, exemplified by *In re Duomatic Ltd* (14), concerns cases in which, by reason of some feature of a company's internal structure, or some failure to comply with its articles of association, there is a potential defect in a purported exercise of corporate power. In such a case, the unanimous consent of the shareholders, even if there has been no formal resolution of a general meeting, may be as binding as a resolution in general meeting would have been (15). This line of authority is often invoked to meet a contention that a company is not bound by some decision or conduct by reason of administrative irregularity, failure to comply with articles of association, or want of authority on the part of some internal organ (16). The second group of cases concerns ratification by shareholders of breaches of duty by directors (17). They are exemplified by *Bamford v Bamford* (18). The principles were considered and applied in *Winthrop Investments Ltd v Winns Ltd* (19), and were discussed in *Miller v Miller* (20). Of particular relevance to the present case is one well accepted qualification to the capacity of shareholders to ratify or excuse directors' breaches of duty: shareholders cannot sanction improper expropriation of a company's property by the directors (21). The principle underlying that qualification is the same as that recently applied in this Court in *Macleod v The Queen* (22).

25 The leading judgment in the Full Court was that of Doyle CJ, with whom Prior and Vanstone JJ agreed (23). Referring to *Pascoe*, Doyle CJ said:

> "This line of authority suggests that the informal assent by the shareholders of ALS to the grant of the mortgage to CBA is sufficient to prevent ALS complaining that in granting the mortgage the directors acted in breach of their duty to the company. The company was not insolvent at the time. There were no other shareholders. There was no other person with a claim to the

(14) *In re Duomatic Ltd* [1969] 2 Ch 365.
(15) Generally, see *Gower and Davies' Principles of Modern Company Law*, 7th ed (2003), pp 305-306. No difficulty of the kind referred to by Bowen CJ in Eq in *Re Compaction Systems Pty Ltd* [1976] 2 NSWLR 477 at 484-485 arises on the facts of the present case.
(16) In *Ho Tung v Man On Insurance Co Ltd* [1902] AC 232 the acquiescence of shareholders in a course of dealing validated conduct which otherwise would have been without the sanction of articles of association.
(17) Generally, see *Gower and Davies' Principles of Modern Company Law*, 7th ed (2003), pp 437-444; *Ford's Principles of Corporations Law*, 11th ed (2003), pp 374-378.
(18) *Bamford v Bamford* [1970] Ch 212.
(19) *Winthrop Investments Ltd v Winns Ltd* [1975] 2 NSWLR 666.
(20) *Miller v Miller* (1995) 16 ACSR 73.
(21) *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246 at 296.
(22) *Macleod v The Queen* (2003) 214 CLR 230.
(23) *Carabelas v Scott* (2003) 177 FLR 334.

property in question. There is no allegation that this was a dishonest or fraudulent transaction, although it is to be noted that it was alleged that there was no commercial advantage to ALS in the grant of the mortgage, beyond securing the money required to repay HBS. It is true that the grant of the mortgage contemplated the use of company assets to discharge a liability of Mr Carabelas, and in that sense contemplated a misappropriation of ALS' assets. But this was not a misappropriation contrary to the interests of any other person: cf *Macleod v The Queen*."

26 Doyle CJ concluded that the mortgage transaction did not involve a breach of s 229. Although he did not mention the matter specifically, it appears that he dealt with the second aspect of the alleged contravention of s 229, that is to say, the supposed discharge by novation of the debt to ALS by Mr Carabelas, on the basis that there was no such discharge. He could not have treated that transaction, had it occurred, as covered by the reasoning he applied to the entry into the mortgage. In the Full Court, the present respondents pursued their agency theory, which was again considered and rejected. The evidence, Doyle CJ said, was vague and incomplete, and the accounting entries made by Mr Vlassis appeared to reflect "surmise or assumption on his part" rather than an accurate record of any dealings that were otherwise established by evidence. As will appear, when Doyle CJ came to deal with the preference claims, which were based upon book entries made by Mr Vlassis, he rejected those claims on the ground that no transactions of the kind that the entries purported to record ever occurred. At least by implication, he reached the same conclusion about the alleged novation.

The s 229 claim

27 The second further amended statement of claim pleaded the case under s 229(7) of the Code as follows. In June 1988, ALS owed HBS $435,050. (The Full Court treated the correct sum as $435,040.) In July 1988, the Commonwealth Bank advanced $1.7 million to Mr Carabelas, of which $435,050 was used to pay off the debt owed by ALS to HBS. ALS became indebted to Mr Carabelas in the sum of $435,050. ALS granted an "all moneys mortgage" to the bank to secure Mr Carabelas' indebtedness to the bank. There was no commercial advantage to ALS in granting the all moneys mortgage to the bank except to the extent of the $435,050 used to repay the Company's debt to the building society. In October 1989, the Angas Street property was sold for $910,000, and the whole of the proceeds went to the bank. Mr Carabelas thereby became indebted to ALS in the sum of $474,950 ($910,000 minus $435,050). During the year ended 30 June 1990 "the defendants caused [ALS] and Barry Simpson, Citizac, Wamville, Tusport and Blackcroft and George Carabelas to novate the debt which George Carabelas owed to [ALS] by substituting for himself, Barry Simpson, Citizac, Wamville, Tusport and Blackcroft as debtors of the company." That allegation was followed by particulars. The particulars,

however, did not give any further detail of any act or agreement on the part of any of the named parties which could have amounted in law to a novation. Rather, they simply referred to the journal entry GJ10, and recited that the financial statements of ALS for the year ended 30 June 1990 recorded Barry Simpson, Citizac, Wamville, Tusport and Blackcroft as debtors of ALS and did not record Mr Carabelas as a debtor of ALS. At the time of the novation, Barry Simpson, Citizac, Wamville, Tusport and Blackcroft were insolvent. Their debts to ALS were later written off. As a result of the foregoing Mr Carabelas obtained a benefit in that he was relieved of his debt to ALS of $474,950. In causing ALS to grant the all money mortgage to the bank and to "novate George Carabelas' indebtedness", Mr and Mrs Carabelas contravened s 229(2) and s 229(4). "By reason of the foregoing the company has suffered loss and damage in the said sum of $474,950."

28 The pleading explains why Williams J treated the alleged contravention of s 229 as involving a course of conduct. The supposed novation, and consequent discharge of Mr Carabelas' debt to ALS, was essential to the loss allegedly suffered, which was the amount of that debt. There was no allegation that the mortgage transaction of itself caused the loss sought to be recovered under s 229(7). The loss was claimed to be the loss of the debt of $474,950 which became owing to ALS by Mr Carabelas in October 1989. The mortgage transaction of July 1988 explained how that debt came to be owing, but it was the alleged discharge of Mr Carabelas' liability to ALS that was said to constitute the loss. The significance of this is that, if purported ratification of directors' breaches of duty had been raised as an answer to the claim under s 229(7), it would have arisen in relation to the alleged novation, not the mortgage. No such defence was pleaded.

29 In so far as the pleading alleged that the mortgage transaction itself involved a contravention by the respondents, in July 1988, of s 229, the considerations mentioned by Doyle CJ were relevant, not to any question of ratification, but to whether the provisions of sub-s (2) or sub-s (4) of s 229 applied. In particular, they were relevant to whether the respondents, as directors of ALS, in July 1988 exercised a reasonable degree of care and diligence, and whether they made improper use of their position. It may be that the reference to "informal assent" should have been to informed assent. The mortgage was executed under the seal of ALS, and bore the signatures of both respondents in their capacity as officers of the company. There was no suggestion of any want of formality, or of failure to comply with the articles of association. The validity of the mortgage was never in question. In July 1988, ALS, Mr Carabelas, and, so far as appears, the other companies controlled by Mr Carabelas, were solvent. The mortgage transaction did not render ALS insolvent. It had rights of contribution in respect of the contingent liability it undertook. Following the mortgage transaction, ALS had no significant creditors except Mr Carabelas and, contingently, the bank. Undoubtedly, by

procuring the mortgage to secure his own liabilities, Mr Carabelas gained an advantage for himself, but the issue was whether the transaction was improper, or involved a lack of reasonable care. The question whether corporate transactions of guarantee or third party mortgages involve breaches of directors' duties, or the particular kinds of breach referred to in s 229(2) or s 229(4), usually turn upon a close examination of the commercial context in which they occur (24). Before Williams J, probably because of the concentration by the parties on the agency theory, and because of the way the loss was identified in the pleadings, there appears to have been little investigation of that context insofar as it would have been relevant to whether, in July 1988, the mortgage transaction considered alone contravened s 229. In the Full Court, the opening sentence of the passage in the reasons of Doyle CJ quoted above could be taken to suggest that, at that stage, he was considering an issue of ratification. But there was no such issue on the pleadings. His conclusion was that the mortgage transaction did not contravene s 229. He said "there was in fact no breach of s 229". That is a different thing from saying that there was a breach but ALS could not claim compensation under s 229(7). The unanimous informed consent of the shareholders of ALS, the solvency of ALS and Mr Carabelas, and the absence of any adverse effect on the interests of third parties, were facts relevant to the propriety of the mortgage transaction. As to the other aspects of the commercial context, the evidence was thin, but the Full Court's conclusion that, in July 1988, there was no impropriety, and no want of reasonable care, has not been shown to be in error.

30 This, however, was not the critical point. It was not that which occurred in July 1988 that was the proximate cause of the relevant loss. The loss was said to arise from the novation which allegedly occurred at some unspecified time after the beginning of 1990, and which resulted in the discharge of Mr Carabelas' liability to ALS, and the loss of a valuable asset in the form of that debt.

31 If such a novation, and consequent discharge of liability, had in fact occurred, then it would have involved a contravention of s 229(4), although whether Mrs Carabelas was a party to that contravention may be another matter. However, there was not shown to have been any transaction of novation. To discuss whether there was informed assent of, say, Mrs Carabelas to the novation would require some hypothesis as to what exactly occurred. The appellants were unable to give particulars of any transaction. All they could do was rely upon book entries made by Mr Vlassis. Those entries, however, were made upon a different basis. They purported to account for the dealings between Mr Carabelas and his companies on the discredited agency theory. They did not purport to record any transaction of novation. Journal

(24) See *Walker v Wimborne* (1976) 137 CLR 1; *Charterbridge Corporation v Lloyds Bank Ltd* [1970] Ch 62; *ANZ Executors & Trustee Co Ltd v Qintex Australia Ltd* [1991] 2 Qd R 360.

entry GJ10 purported to correct GJ2, not to show that a subsequent transaction altered the state of Mr Carabelas' loan account.

32 If a novation of the kind alleged had occurred, then it would have involved a contravention of s 229(4), at least by Mr Carabelas, assuming he had in some way used his position as a director to effect the transaction. It would have involved a discharge of his liability to ALS, and a substitution of the liability of a number of insolvent companies. Clearly, that would have been improper. That is not something that could have been ratified effectively by Mr and Mrs Carabelas. If a novation had occurred as alleged, it would have involved expropriation of the property of ALS by Mr Carabelas: a form of abuse of power that could not have been ratified by the self-interested consent of Mr Carabelas and the acquiescence of Mrs Carabelas (25). In any event, ratification was not pleaded as a defence. The question whether, if the alleged novation had involved a contravention of s 229, the involvement of Mr and Mrs Carabelas, by some process of ratification, waiver, or otherwise, could have operated to prevent ALS from enforcing its rights under s 229(7) did not arise on the pleadings, and was not dealt with in the reasoning of Williams J or the Full Court. The wider issue of the relationship between s 229(7) and the general principles of equity concerning release of fiduciaries from their obligations or liabilities by acquiescence, ratification, or waiver on the part of those to whom such obligations or liabilities are owed did not arise. While, in some circumstances, the informed assent of all the shareholders to a transaction might be a fact relevant to a question of impropriety, the provisions of s 229 creating offences operate according to their terms. Where ratification operates to protect a director from civil liability to a company it does so upon the principle that "those to whom [fiduciary] duties are owed may release those who owe the duties from their legal obligations and may do so either prospectively or retrospectively, provided that full disclosure of the relevant facts is made to them in advance of the decision" (26). The shareholders of a company cannot release directors from the statutory duties imposed by sub-s (2) or sub-s (4) of s 229. In a particular case, their acquiescence in a course of conduct might affect the practical content of those duties. It might, for example, be relevant to a question of impropriety. A company's right to recover under s 229(7) depends upon the existence of a contravention. If such a contravention has occurred, the question whether a company has lost its right of action under s 229(7) because of some binding decision on the part of its shareholders to release the potential defendants is another matter, and one that did not arise in this case.

33 The claim under s 229 fails for want of proof of the alleged novation, which was critical to the alleged loss.

(25) *Macleod v The Queen* (2003) 214 CLR 230.
(26) *Gower and Davies' Principles of Modern Company Law*, 7th ed (2003), p 437.

The preference claims

34 This aspect of the appeal may be dealt with briefly. It was decided by the Full Court on the facts, and the appellants have been unable to show error in the Full Court's reasoning. As with the supposed novation, the preference claims appear to have been founded upon an attempt to take at face value certain book entries made by Mr Vlassis, in circumstances where the evidence provided no justification for concluding that the entries reflected the true facts, and where there was evidence to cast doubt on those entries.

35 Doyle CJ summarised the evidence as follows. When ALS was wound up in April 1994 its books of account were not up to date. Mr Carabelas gave Mr Vlassis general instructions to prepare accounts for the years ending 30 June 1992 and 30 June 1993, but left it to Mr Vlassis to decide how that should be done. Mr Vlassis considered it to be desirable to prepare accounts for ALS and the other companies in such a way as to show that the other companies had no assets requiring administration, so that they could be de-registered rather than wound up. To this end, Mr Vlassis took the following steps. Mr Carabelas was shown in the books of ALS as a creditor, and in the books of the other companies as a debtor. (The status of Mr Carabelas as a creditor of ALS assumed the correctness of journal entry GJ10. The falsity of that assumption is presently immaterial.) Mr Vlassis thereupon engaged in a process of "netting off" amounts owed by Mr Carabelas to his companies and amounts owing to Mr Carabelas by his companies. This was done by a series of journal entries that were not shown to Mr Carabelas. According to the liquidator, these entries reflected, or resulted in, transactions which he challenged as preferences. These "transactions" did not involve any resolutions of directors or shareholders, or any cheques being drawn, or money changing hands. Doyle CJ said they "involved nothing more than entries in the records of the various companies".

36 The first "transaction" involved entries in the records of ALS and another company according to which ALS reduced by $71,787.22 the amount of the debt it owed to Mr and Mrs Carabelas by paying the debt they owed to another company. This involved a like reduction in an amount owed by the other company to ALS.

37 The second "transaction" involved a series of entries the effect of which was that ALS reduced its debt to Mr and Mrs Carabelas by $67,826 by paying a debt that they owed to another member of the group. An amount owed by the other company to ALS was reduced by the same amount.

38 The third "transaction" involved entries which purported to record that ALS reduced the debt it owed to Mr and Mrs Carabelas by paying a debt in the sum of $93,763.75 that ALS owed to another group member.

39 Counsel for the present respondents argued in the Full Court that there was no evidence that these entries recorded any actual

transactions, that once the order for winding-up was made the directors of ALS had no power to authorise any such transactions, that the evidence did not show that they purported to authorise such transactions, that if any such transactions had occurred they occurred after the winding-up, that there were no transactions that amounted to preferences, and that there were merely a number of incorrect book entries. Doyle CJ agreed. The trial judge, he noted, was understandably reluctant to allow the present respondents to impeach entries made in the records of ALS. However, "the evidence indicates that there was no transaction before the winding-up began, that these entries record or reflect". The trial judge had not relied on estoppel or any other principle that would prevent Mr and Mrs Carabelas from relying upon the facts disclosed by the evidence. The proper conclusion, on the facts, was that the journal entries were not a true record of any transaction and that there was no transaction that was binding on ALS or the other companies.

40 The reasoning of the Full Court on this issue was correct.

A proposed amendment

41 In the course of argument in this Court, faced with the possibility that it might be concluded, upon analysis of the facts, that there had never been any legally effective discharge of the debt owed by Mr Carabelas to ALS following the sale of the Angas Street property, counsel for the appellants sought leave to amend the statement of claim by making a claim in debt against Mr Carabelas. Perhaps because the state of Mr Carabelas' loan account with ALS was unclear, the proposed amendment sought, in the alternative, a taking of accounts between ALS and Mr Carabelas. It is not apparent why such a claim was not propounded in the first place, at least as an alternative. It might raise questions of limitation periods. Further, as has been noted, an attempt by the respondents in the Full Court to amend their defence to raise certain liabilities of ALS to Mr Carabelas failed. This Court does not have all the information that would enable it to do justice to the amendment application. The matter should be remitted to the Full Court of the Supreme Court of South Australia to enable that question to be pursued.

Conclusion

42 The matter should be remitted to the Full Court of the Supreme Court of South Australia to enable that Court to consider the proposed amendment to the statement of claim foreshadowed in this Court and to deal with any issues arising out of any amendment that may be permitted. Save to that extent, the appeal should be dismissed with costs.

43 GUMMOW AND HAYNE JJ. We agree with the reasons given by the Chief Justice and Heydon J and with the order proposed. This appeal is resolved by recognising that the damage alleged to have been suffered by Angas Law Services (ALS) only arises upon an alleged novation

which did not take place. The result is that the debt owed by Mr Carabelas to ALS still exists.

44 However, detailed submissions were made to this Court respecting s 229 of the *Companies (South Australia) Code* (the Code). In these circumstances, it is appropriate to consider the provenance and place of that provision in the Code and, in particular, to say something further respecting the meaning of the term "improper" in s 229(4) and its application to the grant of the mortgage by ALS. The abbreviations follow those in the reasons of the Chief Justice and Heydon J.

Sections 229 and 542 of the Code

45 Section 229 appeared in Div 2 (headed "Directors and Other Officers") of Pt V (headed "Management and Administration") and with the sidenote "Duty and liability of officers". It may be compared with s 542 which appeared in Pt XIV (headed "Miscellaneous").

46 Section 542 provided for the making of orders for the payment of money or transfer of property to a corporation, and for the recovery of loss and damage suffered by a corporation, where "a person is guilty of fraud, negligence, default, breach of trust or breach of duty in relation to a corporation" (s 542(2)(a)). This provision was the then current incarnation of the misfeasance provisions first introduced in England as s 165 in the winding-up provisions of the *Companies Act 1862* (UK) (27). Section 165 had used the expression "Misfeasance or Breach of Trust in relation to the Company".

47 The case law construing s 165 and its successors decided that (i) the reference to breach of trust was better understood as being to breaches of fiduciary duty, directors, for example, being fiduciaries but not trustees of the assets of the company (28); and (ii) the provision gave a summary remedy for enforcing in a liquidation, not a new species of liability, but only such liabilities as might have been enforced by the company itself as by its liquidator by means of an ordinary action (29).

48 On the other hand, s 229 of the Code had a distinct source in measures of corporate law reform first introduced in the State of Victoria. It provided for both civil and penal remedies and its application, so far as relevant to this appeal, turned upon notions of impropriety.

The text of s 229

49 At the time of the execution of the mortgage by ALS, s 229(4) of the Code was in these terms:

> "An officer or employee of a corporation shall not make improper

(27) 25 & 26 Vict c 89.

(28) *In re City Equitable Fire Insurance Co* [1925] 1 Ch 407 at 426; *Federal Commissioner of Taxation v Linter Textiles Australia Ltd (In liq)* (2005) 220 CLR 592.

(29) *In re City Equitable Fire Insurance Co* [1925] 1 Ch 407 at 527; *Walker v Wimborne* (1976) 137 CLR 1 at 7, 14-15; *Spies v The Queen* (2000) 201 CLR 603 at 635-636 [93].

use of his position as such an officer or employee, to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

Penalty: $20,000 or imprisonment for 5 years, or both."

Section 229(4) was accompanied by s 229(3), which was concerned with the improper use of information. Section 229(3) stated:

"An officer or employee of a corporation, or a former officer or employee of a corporation, shall not make improper use of information acquired by virtue of his position as such an officer or employee to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation.

Penalty: $20,000 or imprisonment for 5 years, or both."

50 Section 229(7) provided for the recovery of profits and damage suffered by the company:

"Where a person contravenes or fails to comply with a provision of this section in relation to a corporation, the corporation may, whether or not the person has been convicted of an offence under this section in relation to that contravention or failure to comply, recover from the person as a debt due to the corporation by action in any court of competent jurisdiction –

(a) if that person or any other person made a profit as a result of the contravention or failure – an amount equal to that profit; and

(b) if the corporation has suffered loss or damage as a result of the contravention or failure – an amount equal to that loss or damage."

51 These provisions now appear in the *Corporations Act 2001* (Cth) as s 182 (use of position – civil obligations), s 183 (use of information – civil obligations), s 184(2) (use of position – criminal offence) and s 184(3) (use of information – criminal offence). The criminal offence provisions in force now require "dishonesty" rather than impropriety.

52 "Officer", for the purposes of s 229 of the Code, was widely defined in s 229(5) to include, among other persons, a liquidator of the corporation and a receiver of property of the corporation. Nothing turns on this definition. It was not disputed that Mr and Mrs Carabelas were the sole directors and shareholders of ALS. No question arises in this case respecting any other individual falling within the broad definition of "Officer".

53 It was also not disputed that Mr Carabelas gained an advantage, the loan, by the granting of the mortgage by ALS. Thus, the only element of s 229(4) that was to be considered, assuming ALS suffered loss or damage (s 229(7)), was whether the conduct was an improper use of position. Further, as explained in the reasons of the Chief Justice and Heydon J, the issue was not one of ratification (characterised as curing a breach), but of whether there was in fact any breach of s 229(4) in the first place.

54 Contravention of s 229(4) is not established by merely showing that the officer engaged in conduct that resulted in an advantage to himself, or a detriment to the corporation. There must be the element of

impropriety. What is meant by "improper" should be considered by reference to the legislative history, relevant authorities and matters of principle.

Legislative history of s 229

55 The progenitor of s 229(3) and (4) is s 107(2) of the *Companies Act 1958* (Vic) (the 1958 Act). This dealt only with the use of information by an officer of a company. Section 107 provided:

> "(1) A director shall at all times act honestly and use reasonable diligence in the discharge of the duties of his office.
>
> (2) Any officer of a company shall not make use of any information acquired by virtue of his position as an officer to gain an improper advantage for himself or to cause detriment to the company.
>
> (3) Any officer who commits a breach of the foregoing provisions of this section shall be guilty of an offence against this Act and shall be liable to a penalty of not more than Five hundred pounds and shall in addition be liable to the company for any profit made by him or for any damage suffered by the company as a result of the breach of any of such provisions.
>
> (4) Nothing in this section shall prejudice the operation of any other enactment or rule of law relating to the duty or liability of directors or officers of a company."

Section 3(1) of the 1958 Act defined "Officer" as including a director and any other officer whatsoever of a company.

56 It is apparent that, unlike in s 229(4), the word "improper" in s 107(2) attached to the element of advantage for the officer. It is also apparent that, in addition to serving the purpose of conferring on the company a cause of action against the officer (sub-s (3)), s 107 also served the purpose of imposing both criminal and civil liability.

57 The Second Reading Speech introducing the Bill that became the 1958 Act noted that s 107 was the first statutory provision of its kind in either Australia or the United Kingdom (30). It attempted to set standards of honesty (sub-s (1)) and propriety (sub-s (2)), and give remedies (sub-s (3)) for any breach of those standards.

58 The provision was introduced as a result of the report of the Statute Law Revision Committee of Victoria, which examined the provisions of the *Companies Act 1938* (Vic) with respect to certain actions taken by the directors of Freighters Ltd (31). The impugned actions arose from Freighters' acquisition of Australian Machinery Co and the directors' formation of companies that would re-sell products produced by Freighters. First, in order to raise the necessary moneys to fund the acquisition of Australian Machinery, Freighters issued shares.

(30) Victoria, Legislative Assembly, *Parliamentary Debates* (Hansard), 9 September 1958, p 324.

(31) Victoria, Statute Law Revision Committee, *Report upon the provisions of the Companies Acts (re Freighters Limited)*, 3 September 1957.

However, rather than offering the shares pro rata to existing shareholders for the market price of 50s, the directors of Freighters, without informing the shareholders, themselves took up the necessary shares at a reduced price of 40s. Secondly, the board of directors took over personal responsibility for distributing some of the products of Freighters by forming separate companies for this purpose. This action was taken also without informing the shareholders. The net result was that the directors fixed the prices at which Freighters' products were to be sold to the newly formed companies for resale by them. Thus the directors dealt with Freighters through the cloak of those companies (32).

59 It also later transpired that the inspector appointed by the Attorney-General of Victoria to investigate these activities faced difficulties ascertaining the full facts because of his limited powers (33). Thus, the Statute Law Revision Committee's primary focus was on recommending provisions regarding disclosure of interests and provisions regarding powers of investigation with respect to preventing what is now called "insider trading".

60 Although the Minister's Second Reading Speech attributed s 107 to the report produced by the Statute Law Revision Committee, no recommendation of this kind was in fact made. Rather, the report provided specific provisions concerning share transactions and the like. An explanation of the clauses of the Bill was incorporated in Hansard by resolution of the House. It stated, with respect to s 107, that (34):

> "[i]t was decided to introduce this provision rather than the particular provisions suggested by the Statute Law Revision Committee as it was thought that a more general provision would be more effective."

The explanation went on to say:

> "To a large extent the clause is declaratory of the existing law, but it is believed that a restatement of the principles of honesty and good faith that should govern directors' conduct, clearly set out in the Act, will be an effective deterrent to misconduct and will free the courts from the technicalities of the existing law in dealing with all forms of dishonesty and impropriety by directors."

61 What those technicalities were was not explained. Some hint of what was meant is gleaned from the evidence of Professor F P Donovan of the University of Melbourne, given before the Statute Law Revision Committee. He suggested that, without affecting any general law right

(32) Victoria, *Report of the Inspector Appointed to Investigate the Affairs of Freighters Limited Pursuant to the Provisions of the Companies (Special Investigations) Act 1940*, 4 October 1956, pp 4-20.

(33) Victoria, *Report of the Inspector Appointed to Investigate the Affairs of Freighters Limited Pursuant to the Provisions of the Companies (Special Investigations) Act 1940*, 4 October 1956, pp 25-26.

(34) Victoria, Legislative Assembly, *Parliamentary Debates* (Hansard), 9 September 1958, p 331.

which the company might have to recover profits made by directors from dealings in the company's shares as a direct result of their position, a specific remedy might be given to the company to recover any profits made in respect of undisclosed shareholdings. Although not couched in terms specific to the *Freighters* case (dealings in shares), s 107, in addition to criminal liability, provided this remedy. Professor Donovan went on to say that the purpose of the suggestion was to ensure that the company had some real remedy against directors who had abused their position. His concern was that the general law rules might not be adequate to cover that sort of case (35).

62 These materials, together with s 107(4) which preserved "the operation of any other enactment or rule of law relating to the duty or liability" of directors and company officers, suggest that s 107 was designed to encourage good corporate governance by provision of deterrents. It did so by imposing criminal and civil liability with respect to actions that would be considered dishonest or improper. The standards of dishonesty and impropriety were to be determined by reference to the existing law. By "existing law" was meant the civil law; the joinder of civil and criminal remedies meant that the section could not be described simply as declaratory of the law as a whole.

63 The 1958 Act was repealed by the First Schedule to the *Companies Act 1961* (Vic), which enacted the Uniform Companies Act (the UCA). The UCA re-enacted s 107, without substantial amendment, as s 124.

64 Section 124(2) was amended in 1971 by s 8 of the *Companies Act 1971* (Vic). The amendment was a result of the Fourth Interim Report of the Victorian Company Law Advisory Committee (36). The amended section provided:

> "An officer of a corporation shall not make improper use of information acquired by virtue of his position as such an officer to gain directly or indirectly an advantage for himself or for any other person or to cause detriment to the corporation."

The amendment recognised that the word "improper" used in juxtaposition to the word "advantage" (s 107 of the 1958 Act) incorrectly assumed that an authorised use of information which resulted in a detriment to the corporation was within the provision (37). Thus the provision took its modern form.

(35) Victoria, Statute Law Revision Committee, *Minutes of Evidence accompanying the Report upon the provisions of the Companies Acts (re Freighters Limited)*, 12 June 1957, p 26.

(36) Victoria, Company Law Advisory Committee, *Fourth Interim Report to the Standing Committee of Attorneys-General* (1970), p 6 [24].

(37) Victoria, Company Law Advisory Committee, *Fourth Interim Report to the Standing Committee of Attorneys-General* (1970), p 5 [15].

Authorities

65 The defendants in *R v Byrnes* (38) had been convicted of offences against s 229(4) of the Code. The question in this Court was whether an element of intention was necessary to establish improper use of position within the meaning of s 229(4). The South Australian Court of Criminal Appeal had held that s 229(4) required an element of criminal intent. In that case, the trial judge had found that there was no such intent. Rather the defendants mistakenly believed that their actions would be of benefit to the company. This Court allowed the Crown appeal, holding that intention or purpose is only a necessary element of the second limb of s 229(4), namely, that the officer acted in order to gain an advantage for himself or another person, or cause a detriment to the company (39). The Court said that intention or purpose does not form part of the requirement of improper use of position, yet it may be relevant in assessing impropriety (40). An officer who honestly believed his or her actions did not amount to improper use could nevertheless be found to have improperly used his or her position. The test, as noted in the joint judgment of Brennan, Deane, Toohey and Gaudron JJ, for determining whether an action is improper is objective (41):

> "Impropriety does not depend on an alleged offender's consciousness of impropriety. *Impropriety consists in a breach of the standards of conduct that would be expected of a person in the position of the alleged offender by reasonable persons with knowledge of the duties, powers and authority of the position and the circumstances of the case.* When impropriety is said to consist in an abuse of power, the state of mind of the alleged offender is important: the alleged offender's knowledge or means of knowledge of the circumstances in which the power is exercised and his purpose or intention in exercising the power are important factors in determining the question whether the power has been abused. But impropriety is not restricted to abuse of power. It may consist in the doing of an act which a director or officer knows or ought to know that he has no authority to do."

(Emphasis added.)

For present purposes, the second sentence is particularly important. The question in each case is what content is to be given to the standards of conduct that would be expected of the officer, having

(38) *R v Byrnes* (1995) 183 CLR 501. See Austin, Ford and Ramsay, *Company Directors: Principles of Law and Corporate Governance* (2005), §§9.14-9.18.
(39) See *Chew v The Queen* (1992) 173 CLR 626 at 633.
(40) *R v Byrnes* (1995) 183 CLR 501 at 512, 513-515.
(41) *R v Byrnes* (1995) 183 CLR 501 at 514-515 (footnote omitted).

regard to the position occupied by the officer in the company and the circumstances surrounding the impugned conduct (ie, the commercial context (42).)

66 In oral submissions on the present appeal, the liquidator submitted that it is "a basic principle of corporate law" that its assets be dealt with for the purposes of the corporation and not for the purpose of "appropriation" by those who control and own all the issued shares. The corporators necessarily acted improperly if they so acted as to bring about the appropriation of the company's assets as their own. The liquidator contended that any act of "appropriation" caused by an officer of the corporation is a breach of the standard of propriety required by s 229(4) of the Code. (The liquidator properly disavowed any reliance on the doctrine of ultra vires; this had been drastically modified in 1985 by legislation giving to companies incorporated or deemed to be incorporated under the Code "the legal capacity of a natural person" (43).)

67 This proposition concerning "appropriation" is too broad. It insufficiently allows for the significance from case to case of the commercial context, and assumes a standard of conduct that is inflexible. The starting point must be the general duty of a director to act in the best interests of the company (44). The best interests of the company will depend on various factors including solvency. In *Kinsela v Russell Kinsela Pty Ltd (In liq)*, Street CJ said (45):

> "In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company, are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration."

68 Nothing said in *Macleod v The Queen* (46) suggests the contrary. It was decided in *Macleod* that the "consent" of a single shareholder company could not cure what otherwise would be a breach of s 173 of the *Crimes Act 1900* (NSW). Section 173 created an offence where a

(42) This term was used in *Grove v Flavel* (1986) 43 SASR 410 at 420 and applied in *R v Byrnes* (1995) 183 CLR 501 at 514.

(43) See s 67 of the Code as substituted by the *Companies and Securities Legislation (Miscellaneous Amendments) Act 1985* (Cth), s 48.

(44) *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 at 289, 300-301.

(45) *Kinsela v Russell Kinsela Pty Ltd (In liq)* (1986) 4 NSWLR 722 at 730.

(46) *Macleod v The Queen* (2003) 214 CLR 230.

director or officer of a body corporate fraudulently took or applied any of the property of the body corporate for his own use or benefit, or for any use or purpose other than that of the body corporate. Gleeson CJ, Gummow and Hayne JJ said (47):

> "The self-interested 'consent' of the shareholder, given in furtherance of a crime committed against the company, cannot be said to represent the consent of the company."

69 In the present case, the mortgage was granted by ALS whilst it was solvent and at a time when there appeared to be no real chance of insolvency. In its internal memorandum concerning the loan application, the bank noted that Mr Carabelas, by reference to the properties held by his companies including ALS, was in "a very strong financial position". Further, the granting of the mortgage was authorised by the shareholders of ALS. The combination of these two factors, solvency and authorisation, indicates that the standards of propriety expected of the directors was not breached.

70 KIRBY J. I agree with the orders proposed by Gleeson CJ and Heydon J and with their reasons.

71 As to the additional observations contained in the reasons of Gummow and Hayne JJ, I prefer to reserve my opinion until a case arises where it is essential to enter upon them.

72 Thus, whilst it is true to say that a contravention of s 229(4) of the *Companies (South Australia) Code* is not established by *merely* showing that an officer of a corporation engaged in conduct that resulted in an advantage to that officer, or a detriment to the corporation (48), the circumstances of the conduct by such a person may not need to go much further in order to establish "impropriety". That is a word, like "dishonesty", which always involves a practical judgment based on all the facts and circumstances of the case. Amongst them, the acquisition by an officer of a corporation of a personal advantage, secured at the cost of the corporation, would often be powerful evidence of wrongdoing, especially if full disclosure and formal consent were not duly observed when that was the prudent and proper course.

73 The fundamental reason for the social and economic success of the corporation is the separate existence and personality it derives from the law, distinct from its shareholders, its officers and its employees. The present was a relatively simple case where Mr Carabelas – even, it seems, to the exclusion of his wife, the other shareholder – was the effective sole shareholder and moving spirit of the company, Angas Law Services Pty Ltd. However, I would not wish to say anything in this case that might be understood, in different circumstances, to permit a shareholder to act without proper regard to the separate legal existence of the corporation. Especially where doing so was open to be

(47) *Macleod v The Queen* (2003) 214 CLR 230 at 240 [30].
(48) Reasons of Gummow and Hayne JJ at [54].

construed as being exclusively for personal advantage, as, for example, to redirect a tax debt of interest to the shareholder to insolvent companies.

74 Because they are sufficient to sustain the orders proposed within the findings below that were unchallenged in this appeal, I agree with the reasons of Gleeson CJ and Heydon J.

1. *Remit the matter to the Full Court of the Supreme Court of South Australia to consider the amendment to the statement of claim foreshadowed in this Court and to deal with any issue arising out of any amendment that may be permitted.*
2. *Except as provided in order 1, appeal dismissed with costs.*

Solicitors for the appellants, *Cowell Clarke Commercial Lawyers*.

Solicitors for the respondents, *von Doussas*.

CL