Shadow directors and personal liability of third parties for company liabilities/breaches

Darren Pereira and James Hamilton
Partners

30 August 2011

Overview

- Definition of “director” - section 9 of the *Corporations Act 2001* (Cth)
- Elements of the definitions of de facto and shadow directors
- Risks for those who influence the decision-making of directors:
  - Shareholders
  - Lenders
- Aiding and abetting – risks for lenders
- Considering recent cases – Buzzle and Bell Group
- Precautions to minimise the risks

The definition of a director

holding redlich lawyers

- Section 9:

  “(b) director of a company means, unless the contrary intention appears, a person who is not validly appointed as a director if:

  i. they act in the position of a director; or

  ii. the directors of the company or body are accustomed to act in accordance with the person’s instructions or wishes.”

The definition of a director (continued)

"Subparagraph (b)(ii) does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the directors or the company."

What is a de facto director?

- *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR 565
    - Basic test - whether person is entrusted to exercise the company's powers and controls the company
    - It is unnecessary to show that the person has done acts which only a director can lawfully perform
    - Often a question of degree, requires consideration of duties performed in the context of the company's operations and circumstances

What is a de facto director? (continued)

- A necessary condition is that the person exercises top-level management functions
- How the person is reasonably perceived by outsiders will be relevant
- In small companies, whether the person has acted as the company in relation to matters of great importance to the company is relevant

What is a shadow director?

- Concept seeks to situate the true source of decision-making within the company
- Two model examples:
  - Bankrupt who installs his wife as a sole director of a company
  - Fraudster who uses an offshore company with nominee directors who carry out his instructions
- Shadow director “controls the mind of the Company”
- Appointed directors do as they are told. Do not exercise independent judgement

What is a shadow director? (continued)

- *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACR 1
  - A company which effectively controls the board of another company may be a shadow director
- *Ho v Akai* [2006] FCAFC 159
  - Definition of “director” seeks to identify those persons who have real influence in, or control over, company’s affairs
  - It is not necessary that such influence or control extends over the whole field of the company’s activities
  - Influence or control of a shadow director may be strategic in character

Elements of the definition of a shadow director

- *(a) Person*
  - Section 221(3) - only an individual can be a validly appointed as a director
  - Extended definition in section 9 means that a company can also be a director
  - Holding companies can be shadow directors of their subsidiaries
    - *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACR 1

Elements of the definition of a shadow director (continued)

- *(b) Instructions or Wishes*
  - Instructions and wishes are different from advice
    - Advice- an opinion or recommendation that may be rejected
    - Person may be required or compelled to follow instructions or wishes
  - A single instruction or wish is unlikely to satisfy the definition
  - Reference to *“instructions or wishes”* suggests that a number of acts is required
  - A single act is unlikely to result in the directors becoming *“accustomed to act”*
  - A single instruction or a wish of fundamental importance that results in an action being repeatedly taken may fulfil this requirement

Elements of the definition of a shadow director (continued)

- *(c) Directors of the body*
  - Implicit requirement that the instructions or wishes to be given to the board of directors as a whole?
  - Cf. *Re Lo-Line Electric Motors Ltd* BCLC 698, which suggests that a simple majority of directors is sufficient
  - Query if instructions given to a dominant managing director or nominee director may be sufficient

Elements of the definition of a shadow director (continued)

- *(d) Accustomed to Act*
  - Suggests ongoing control or interference in the company's internal affairs
  - It is unnecessary for the director to follow every direction or instruction received
  - *"Accustomed"* suggests that the directors must generally accept the instructions received

Elements of the definition of a shadow director (continued)

holding redlich
lawyers

- Professional Capacity or Business Relationship Exemption
  - Person should only give advice in the proper performance of functions
  - Advice outside that scope will not, in itself, render the adviser a shadow director
  - A Court will look at the reality of the relationship and will not be bound by the words used in an advice
  - It is relevant to consider the likely state of mind of members of the board

Shareholder as shadow director

- Body corporate can be a shadow director
- Requires repeated conduct of acting in accordance with instructions or wishes
- Need to consider whether the exception applies (ie. whether acting pursuant to a business relationship between the parties)
- *Std Chartered v Antico* case – found that nominee directors acted as directors of shareholder, not subsidiary
- Why did the line get crossed in *Antico* case?
  - exercised management and financial control
  - Board did not consider matters in own right, merely accepted wishes of parent

Lender as shadow director ?

Buzzle v Apple – Court of Appeal NSW

<u>Core Facts:</u>

- 7 major Apple resellers in Australia decided to merge and eventually float on the ASX
- Resellers needed Apple's consent as charge holder to allow the merger to occur
- June 2000 Apple consulted sees advantages and agrees to it

Lender as shadow director ?

Core Facts:

- Apple negotiates securities Buzzle will provide in return for credit
- Apple holds many meetings with the resellers about the transition into Buzzle
- September 2000 merger deed entered into.
- Charge granted by Buzzle to Apple.

Buzzle v Apple

Core Facts:

- Reseller's stock transferred to Buzzle and Buzzle becomes liable for that stock. Buzzle agrees to repay sellers for that stock. Resellers still owe Apple old stock balance of $8.9 million.
- December 2000 CFO of Apple becomes involved in merger issues.
- Buzzle business has IT problems. Apple becomes aware that debtors could not be reconciled and sales could not be entered from the stores.
- Buzzle trades insolvent from 6 January 2001
- February 2001 Apple appoints KPMG as its advisors and investigating accountants pursuant to the charge.

Buzzle v Apple

<u>Core Facts:</u>

- February 2001 KPMG reports that Buzzle insolvent. No ATO OSR or super payments had been made since the merger
- March 2001 receivers appointed to Buzzle by Apple
- February 2002 liquidators appointed to Buzzle
- Directors (bar 1) bankrupted by Apple
- Apple owed $12 million in the unsecured liquidation

Buzzle v Apple

Liquidator’s claim:

- Whether Apple and its directors were shadow directors of Buzzle and so from early 2001, liable for its insolvent trading:
  - Apple owed $12.3 million (unsecured)
  - Other creditors owed $5.7 million.

Buzzle v Apple

Apple's involvement

- Consented to the merger as a chargee over assets
- Entered into a new reseller agreement with Buzzle
- Invoiced Buzzle for stock transfer
- Insisted on restrictions on operating the credit which Buzzle agreed to
- Instructed Buzzle to appoint Deloitte to do due diligence on the companies and report to them. The directors followed that request. Buzzle's own accountant also recommended it.

Buzzle v Apple

Apple’s involvement

- CFO asked Apple finance director to spend 2 days at Buzzle offices to line up resources that “we in part manage” to supplement accounting clean-up
- Finance director made a powerpoint presentation to management stating Apple’s concern that Buzzle was trading insolvent. 11 precise corrective actions recommended by him. No evidence board acted on what he proposed.
- Apple approved appointment of a new financial controller for Buzzle and participated in the interview. That appointment actually not considered by the Board.

Buzzle v Apple

White J first instance – 53 page judgment, 14 days of hearing

Apple did not participate in making any of the decisions alleged against Apple by which it might have been a shadow director:

- Apple influenced the outcome but did not participate in decision making
- Arms length commercial negotiation
- Finance director not acting for Buzzle, acting in Apple's interest
- Apple insisting on a process taking place does not mean it made the decision or participated in it
- Even if Apple insisted on restrictions in operating credit – although Buzzle agreed, no evidence Apple participated in the decision other than by requesting it.
- A director acquiescing in third party demands does not mean the 3rd party participates in the decision making

Buzzle v Apple

Court of Appeal

- Agreed with White J. - Plaintiff's did not establish directors of Buzzle were accustomed to act on the instructions of Apple
- Merely imposing terms in commercial dealings which directors feel obliged to comply with, is not sufficient to make to third party who exercises such powers a shadow director, even if the directors are accustomed to comply with its demands.
- Directors are free to and would be expected to exercise their own judgement, as to whether to comply with such terms or reject them.
- *"If a [bank] has a genuine interest of its own in giving advice to the board... the mere fact that the board will tend to take that advice to preserve it from the mortgagee's wrath will not make the mortgagee a shadow director"* .

Buzzle v Apple

- Court of Appeal
- Many things Apple or its FD gave instructions to or expressed as wishes are things directors said in evidence they would do anyway
- There must be habitual compliance over a period of time.
- Director matters must be distinguished from management matters
- It is sufficient that the governing majority of the board are accustomed to act – the real decision makers
- There are no reported cases where a secured creditor has been found to be a de-facto or shadow director of the borrowing company even if the directors have taken a keen interest in or exercised a marked degree of supervision over the affairs of the debtors

Aiding and Abetting

Statute based

- 3rd Party can be liable for certain directors breaches of Corporations Act if “involved”:
  - Sec 181 – lack of good faith or proper purpose
  - Sec 182 – misuse position to gain advantage or cause detriment
  - Sec 183 – misuse information obtained as a director

Aiding and Abetting

Statute based

Section 79 of the Corporations Act defines "**involved**" as:

"If and only if:

a) has **aided**, **abetted**, **counselled** or **procured** the contravention; or

b) has **induced**, whether by threats or promises or otherwise, the contravention; or

c) has been in any way, by act or omission, directly or indirectly, **knowingly concerned in**, or **party to**, the contravention; or

d) has **conspired** with others to effect the contravention."

Aiding and Abetting

Section 79 - Case Law:

- Must know the purpose of the director of officer
- Must know essential matters which make up the contravention : York v Lucas
- Need not know that matters are a contravention

Aiding and Abetting

Example of section 79:

- ASIC v Somerville: NSW 2009
- Solicitor advises on restructure, recommends it prepares documents and arranges their execution – form of phoenix transaction

Aiding and Abetting

- In Equity
- Barnes v Addy: 1874 UK
  2 limbs:

1. Knowing **receipt** of property applied inconsistently with a trust or from a breach of fiduciary duty;
2. Knowing **assistance** of a dishonest or fraudulent breach of trust or fiduciary duty.

See Farah Constructions v Say-Dee P/L 2007 HCT

Liability of financiers – the Bell case

Knowing Receipt case (subject to appeal)

Bell Group:-

- Unsecured loans with group guarantees
- Financial troubles
- 1990 bank refinancing
- Securities from group members including non-guarantors
- Sale of assets to pay banks
- 1991 provisional liquidator to BG
- Banks enforce securities

Liability of financiers – the Bell case

Found:

- Group insolvent at time
- Directors knew or should have known
- Breach of fiduciary duty to refinance that way
- Bank knew of this – liable as knowing recipient

Precaution and tips

- Precautions to take (**for Directors**)
  - Directors must exercise independent judgement
  - Directors of group companies must consider the circumstances and interests of each entity separately
  - Ensure that separate board meetings are held for each group entity, ie. avoid grouping of board meetings

Precaution and tips

holding redlich lawyers

- Precautions to take (**for Shareholders**)
  - hold board meetings with written minutes considering the issues from the Company's perspective
  - recommendations need to be put to board to consider (but remembering that conditions can be stipulated e.g. *Apple* case)
  - care must be taken not to take over management control

Precaution and tips

- Precautions to take (**for Lenders**)
  - Directors should always have ultimate responsibility for decision making
  - Consultants and advisers, even if they report to the lender, should be seen to be engaged by the borrower company
  - Ideally the company should select and appoint the independent accountant
  - The lender should refrain from giving directions to the independent accountant
  - The lender should not insist that the company comply with the independent accountant's recommendations
  - Stringent controls should not be exercised personally by the lender or its officers
  - Negotiation for financial accommodation should be only overseen

holding redlich lawyers

Darren Pereira and James Hamilton

Tel: (02) 8083 0487 and (02) 8083 0475

Email: darren.pereira@holdingredlich.com.au

Email: james.hamilton@holdingredlich.com.au

Melbourne

Level 6, 277 William Street
Melbourne VIC 3000

GPO Box 2154
Melbourne Vic 3001

DX: 422 Melbourne

Tel: +61 (0)3 9321 9999
Fax: +61 (0)3 9321 9900

Sydney

Level 65, MLC Centre, 19 Martin Place
Sydney NSW 2000

GPO Box 4118
Sydney NSW 2001

DX: 529 Sydney

Tel: +61 (0)2 8083 0388
Fax: +61 (0)2 8083 0399

Brisbane

Level 1, 300 Queen Street
Brisbane Qld 4000

GPO Box 490
Brisbane Qld 4001

Tel: +61 (0)7 3135 0500
Fax: +61 (0)7 3135 0599