LIABILITY FOR INSOLVENT TRADING—THE SHADOW DIRECTOR AND OTHER ISSUES

Gerard Breen, Partner
Brett Martelli, Solicitor, Commercial Litigation
Abbott Tout

The existence of a company as a separate legal entity with the limited liability of its members is open to abuse, both deliberate and accidental, especially by directors who incur debts on behalf of an insolvent company which will not be recovered. However, the commercial law is not indifferent to shareholders and creditors who are left out of pocket. The Australian Corporations Law imposes a specific duty to prevent insolvent trading by a company where the Director suspects or should suspect the company is insolvent (s.588G).

Compliance with the duty is ensured by a system of sanctions, including the Directors' personal liability for the company's debts. Thus the legislation aims at imposing on the director an obligation to carefully monitor the companies financial condition and providing a source of compensation for the company's creditors.

This article explains which individuals in a company can be held liable for the debts of an insolvent company as well as the reasonable grounds under which a director can be found to have prior knowledge of impending insolvency.

THE BASIS OF LIABILITY —INSOLVENT TRADING

Under s.588G of the Corporations Law, directors have a duty to prevent the company from incurring a debt where:

a. The company is insolvent at the time it is about to incur that debt, or would become insolvent by incurring that debt, or by incurring debts at that time, debts including that debt;

b. The Director is aware that there are reasonable grounds for suspecting that the company is insolvent or would become insolvent; or

c. A reasonable person in a similar position in a similar company would be so aware.

THE REQUIREMENT OF BEING A DIRECTOR

Under s.60(1) of the Corporations Law, various institutions or individuals may be held accountable as directors without ever being appointed as a director, often referred to as shadow or de facto directors. The essential difference between the two is that de facto directors hold themselves out as directors and therefore are easily identified, whereas shadow directors remain behind the scenes while exerting strong influence over the running of the company. In either case people who engage in a company's affairs may not decline responsibility for their actions for lack of formal appointment.

Shadow Directors

In relation to shadow directors, Australia has adopted the English definition, namely, a shadow director is a person in accordance with whose directions or instructions the company is accustomed to act. In practice, the plaintiff must establish there was a regular willingness and ability to exercise control, and an actuality of control, over the management and affairs of the company. The leading authority on the issue is *Standard Chartered Bank v Antico* (1995) 131 ALR.

In that case Pioneer International Limited (Pioneer) owned 42% of Giant Resources Limited (Giant) and had three nominees on the Board of Giant. Giant had a facility of $30 million with Standard Chartered Bank Australia Limited (Standard). As Giant's cash flow declined Pioneer provided funding but took a security interest in assets not already encumbered to Standard. Furthermore, Standard alleged that under the shadow directorship of Pioneer, Giant continued to borrow from Standard.

The Court held the mere fact Pioneer owned 42% of the Giant's shares and had three nominees on the board was insufficient in itself to hold Pioneer was either a shadow director or that it directly took part in the management of Giant. However, despite this, the court still found Antico and Pioneer were shadow directors. The principal reason was that the Court found the dual directors of both companies made strategic decisions concerning Giant without giving any separate consideration to the decisions as directors of Giant. Moreover, the following points put shadow directorship beyond doubt:

a. Pioneer's control was acknowledged in Giant's 1988 annual report, where it was noted that control of Giant had moved from Ariadne to Pioneer.

b. The Pioneer board directed its management to ensure that there would be proper financial reporting by Giant, and also full Pioneer access to financial records; and that this might involve changes in the management of Giant.

c. Pioneer determined which financial consultants were briefed to save the company, and that Pioneer representatives should be involved in the briefing process.

d. The Pioneer board repeatedly directed Pioneer management to strengthen the management team at Giant, and that the Giant board be reconstructed appointing a primary Pioneer director as chairman of Giant.

A Pattern of Control

Although Pioneer indicates the kind of things that will establish control by a shadow director, it does not emphasise the second element that there must be a 'pattern of control' (*Re Hydrodan (Corby) Ltd*). Under that principle sporadic examples of control and compliance will not amount to customary control. Equally then, a rare exercise of independent judgment will not negate the otherwise customary control of the shadow director (*Australian Securities Commission v AS Nominees Ltd* (1995)).

In the Securities case, over the course of five years and the transactions at issue, the Court found that the directors were not total puppets, they occasionally exercised discretion and the alleged shadow director's control did not extend to all board decisions. However, the Court held that s.60(1)(c) does not require there be directions or instructions embracing all matters involving the board. Rather it only requires that as and when the directors are directed or instructed, they are accustomed to act. On that issue the Court considered the directors had acted according to the shadow director's general atmosphere of control in which his priorities were contrary to their company's. It appears from these cases if the evidence establishes an atmosphere of dominance coupled with the insolvent company acting primarily in the interests of the shadow director, the allegation will be difficult to refute.

It will of course be open to accused shadow directors to assert that the subsidiary's repeated compliance with 'advice' is not blind compliance, but rather justified recurring agreement. Unfortunately, there will probably be situations where that defence is genuine but the adviser is still caught by the legislation. In light of that, professionals with direct involvement and influence in the affairs of a company would be well advised to obtain professional indemnity insurance. Where this defence is raised, the chances of that argument extricating the alleged shadow director will probably depend on the balance between the board acting contrary

It will of course be open to accused shadow directors to assert that the subsidiary's repeated compliance with 'advice' is not blind compliance, but rather justified recurring agreement. Unfortunately, there will probably be situations where that defence is genuine but the adviser is still caught by the legislation.

to the interests of the shadow director compared with the instances of control coupled with servility.

INCURRING OF DEBTS

For the most part the issue will be uncontentious that the company freely incurred a debt that is currently payable. However, there has been argument about the situation where a debt is forced on the company, or where the debt is contingent on a future event. For example, in relation to tax liabilities and guarantees respectively.

The former issue is analysed in terms of whether the incurring of the debt incorporated an element of choice. For companies it was argued that to 'incur' a debt it must act voluntarily, and in a positive manner having chosen to do so. That raised the problem of tax liabilities which companies have no option to pay. The leading case is *Shephard & ANZ Banking Group* (1997) 41 NSWLR 431. In that case it was held that although the paying of the tax and payroll liabilities was not optional, the company or director still voluntarily incurred the debt by continuing on a course which it knew would give rise to the debts. As a result of a positive act of employing a person, continuing to employ and obtaining a policy of insurance for that person. On this approach, it appears any defence based on the freedom principle is now closed.

Turning to the latter issue of guarantees and money due in the future. Before any duty or liability may arise the company must have incurred a debt. Normally this will not be difficult to establish as the debt will be due. However, the issue is more complicated in relation to contingent debts such as guarantees where it is debatable whether the debt is incurred at the date of the guarantee, the date of default by the principal debtor or the time at which the guarantee becomes payable. At this point the courts appear content to decide the issue 'case by case, depending principally upon the terms of the agreement between the parties, express or implied' (*Rema Industries v Coad* (1992) 107 ALR 374). Having said that, there appears to be a trend, in the absence of an anomalous result, to find the debt was incurred at the date of entering into the agreement or guarantee (*Hawkins v Bank of China* (1992) 26 NSWLR 562).

INSOLVENCY

Obviously, the entire scheme is predicated on the company being insolvent at the time the debt is incurred or becomes insolvent by incurring that debt. Insolvency is defined in s.95A of the Corporations Law that a company will be insolvent if it is unable to pay all of its debt as and when they become due and payable, or conversely, a company is insolvent if it is unable to pay all its debts as and when they become due. Thus the test principally relies on the cash flow position of the company not the balance between its assets and liabilities.

REASONABLE GROUNDS TO SUSPECT INSOLVENCY

For the director to be liable, at the time of incurring the debt, the directors must have either:

1. Been aware of reasonable grounds for suspecting the company is insolvent or would become insolvent; or

2. Ought to have been aware of reasonable grounds for suspecting the company is insolvent or would become insolvent.

Reasonable Grounds

The amount of evidence of insolvency necessary to constitute reasonable grounds for suspecting insolvency is uncertain. As with any

phrase of that nature, it is impossible to define the kind and amount of evidence of insolvency that will constitute 'reasonable grounds' to suspect the same. Over time a passage of decisions will determine where any given set of facts will fall on the spectrum. Having said that, it is a relatively simple test for directors to ask themselves when the debt is incurred, will the company still be able to pay its debts. The more difficult issue is when there is evidence to indicate debts cannot be paid, but the director is not aware of it, or does not recognise it as such. The objective standard therefore suffers from the flaw that the directors may escape accountability where they were not aware of the evidence.

Enquiries/Knowledge

This potential injustice thus brings into the fray the second limb which makes directors liable if a reasonable director 'in a like position in a company in the company's circumstances would be so aware'. That begs the question what enquiries a reasonable director would make to ensure awareness of a solvency problem. The following list of enquiries and attributes might be expected from a reasonable director:

- Ensuring that in a large company at least one of the directors is talented in corporate finance management.

- Being able to read and understand the company's balance sheet and profit and loss statement.

- Ensuring skilled people carry out the company's accounting.

After that, the critical issue will be whether the reasonable director would fear or determine insolvency on the evidence that emerges.

In resolving that question an important issue is whether some directors are more equal than others. Although the Corporations Law does not specifically impose a greater standard of skill and ability regarding whether directors should have suspected insolvency from the evidence, the courts seem prepared to vary what directors ought to have suspected, depending on whether an executive or non-executive director was involved. Nevertheless, it is also apparent a minimum standard applies to all directors so that non-executive directors cannot entirely evade liability (*Rema Industries v Coad* (1992) 107 ALR 374 and *Kenna v Kenna* (1999) NSWSC 533).

In *Coad*, the company was undercapitalised and substantial debts were incurred to *Rema*. The first director was responsible for the day-to-day management of the company. He argues there was no reasonable cause to expect the company would not be able to pay its debts as they fell due, believing that the company would become successful after the passing of legislation which would give the company a major commercial advantage.

The second director, who was not involved in the day-to-day management of the company, said that from time to time he had asked the first director about the financial position of the company. He assumed the first director had the appropriate expertise and accounting support to form reasonable opinions regarding the business. Although the financial summaries were not entirely optimistic, he was influenced by positive assurances from the first director. In finding that the second director had reasonable grounds to suspect insolvency and that a reasonable director in his position would have suspected insolvency, the Court considered although he

The objective standard therefore suffers from the flaw that the directors may escape accountability where they were not aware of the evidence.

Accordingly, it is imperative that if a director suspects that the company may be insolvent to properly assess and turn their mind to the question of whether the company is continuing to trade whilst insolvent.

was not a working director, indeed, he had hardly any knowledge of the company's affairs, he ought to have informed himself far more fully than he did about the financial affairs of the company, including its trading relationship with its main debtor, if he was to fulfil his duties as a director.

The court found similarly in *Kenna*, which involved the directors of a property development company. Kenna was mainly responsible for the financial management side of the company while Brown's principal responsibilities involved carpentry and supervision of the building works. During 1994 and 1995, the company experienced financial difficulties. In June 1995 a liquidator was appointed. The company had received cash in 1994 and 1995, which had been given to Kenna who had neither banked it nor recorded it in the company's records. Brown had previously raised an issue with Kenna concerning the receipt of cash payments. The company was financially stretched during the latter part of 1994. Additional funding was needed in order to stay in operations and no further funding was available. The company still took on additional projects in 1994 and 1995 without the necessary additional funding.

The Court found in *Kenna* that a reasonable director (Brown) would have suspected insolvency. In coming to that conclusion the court took account of the fact he knew the company was financially stretched (although it did not know the full extent) and he did not properly consult others to ascertain the true state of the company's financial situation. Although Brown relied on an accountant to explain the financial statements to him each year, and he had been assured by the accountant that any financial problems concerning the company would be bought to his attention, he was aware that the company was financially stretched in the latter half of 1994 and yet it still took on further projects without further capital or consultation with Brown. Those facts taken together should have alerted Brown to the need for a sensible communication and also for appropriate action to address the situation.

CONCLUSION

Provided the requirements outlined in this article have been satisfied, under ss.588M and 588R the Court may order the director to personally pay compensation to the company or its creditors. Accordingly, it is imperative that if a director suspects that the company may be insolvent to properly assess and turn their mind to the question of whether the company is continuing to trade whilst insolvent. Obviously, if the director properly addresses such a situation at an early stage it is unlikely that they will face any liability at a future date under the Corporations Law. In other words, the key is to turn one's mind to the question of solvency as soon as it arises.

Gerard Breen and Brett Martelli's article first appeared in Abbott Tout's *Legal Update* (December 2001). It appears with permission.