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Potential Directorial Liabilities of Creditors in a Workout

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Acknowledgement

INSOL International is pleased to present the 17th Technical Paper titled “Potential Directorial Liabilities of Creditors in a Workout”. The paper was written by Mr. David Cowling, Partner – Litigation and Dispute Resolution, Clayton Utz.

As a result of the global economic downturn, many companies world-wide are experiencing financial difficulties and are looking at different restructuring options in order to restore financial stability. Some companies opt for formal restructuring procedures governed by domestic laws, but others consider informal workouts between the debtor company and its creditors as the preferred option.

In an informal workout situation, there is a legal risk that the creditors may be considered shadow directors if they become too involved in the affairs of their debtors. The degree of risk that a creditor faces will however vary in each case and a number of factors apply. Case law suggests that the person applying the commercial pressure will not be a shadow director if, at the end of the day, the directors are free to decide whether to comply with that pressure. Mere involvement in the company, or pressure to pay, will not automatically result in such a creditor being found to be a shadow director.

This paper highlights some of the sources of liability that creditors may face in an informal workout, and in particular discusses the concepts of shadow directorship and phoenix companies. It also discusses some of the leading case decisions from several jurisdictions.

INSOL would like to thank Mr. David Cowling for writing this excellent paper.

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Potential Directorial Liabilities of Creditors in a Workout

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1. Introduction

In the present economic climate, many companies are suffering from financial distress and face the prospect of insolvency. In these circumstances, lenders and other secured creditors have limited options in protecting their interests and ensuring the survival of the business. Some jurisdictions, including Australia, provide a regulated method of corporate restructuring through such statutory procedures as administration. However, unregulated or semi-unregulated forms of corporate restructuring, primarily informal work-outs, are becoming increasingly popular. The reasons for this may vary from jurisdiction to jurisdiction, from a belief on the part of creditors that the statutory provisions for restructuring may produce an unfavourable outcome for them, to a desire on the part of corporate management to avoid the stigma and/or personal liability that attaches to the invocation of statutory protections.

Although unregulated work-outs do have their advantages, the statutory procedures offer statutory protections to the participants. In choosing an unregulated work-out, creditors forsake those protections and expose themselves to legal risks. This paper examines some of the sources of the liability which creditors may face when they choose, and play an active role in, an informal restructuring process, with particular reference to the concepts of shadow directorships and phoenix companies.

2. Shadow directorships

2.1 Danger to creditors

In times of economic and financial crisis, creditors will be increasingly proactive in the financial affairs, operations and management of those debtors who are financially distressed or facing insolvency.

A creditor may, in the process of a work-out, meet regularly with the company's management and discuss spending, performance, cash flow, business plans and other corporate policies. Meetings may also be held with third parties, such as the company's auditors, shareholders and other creditors. Ultimately, the creditor may decide to continue to financially accommodate the company on certain conditions or engage in other work-out transactions. Creditors who choose to guide the company and partake in corporate decision-making and management in this way face the possibility of being characterised as a shadow director of the company.

Although there are a number of cases in which the Courts have held that a person was a shadow director, there have been few (if any) cases where a secured creditor, bank or lender has been held to be a shadow director. Nevertheless, the possibility of such a finding is an omnipresent one for creditors, and some guidance on what tests the Courts apply can be gained from a survey of the relevant case law.

2.2 "Shadow director" defined

"Shadow director" is a term generally used to describe a person who, although not formally appointed to a company board, "pulls the strings" of the official board.

The concept of the shadow director has a long history in English company law and is recognised in many common law jurisdictions in various incarnations.

♦ The views expressed in this article are the views of the author and not of INSOL International, London.

(a) *Australia*

"Director" is defined in section 9 of the *Corporations Act* 2001 (Cth) as follows:

(a) a person who:

(i) is appointed to the position of a director; or

(ii) is appointed to the position of an alternate director and is acting in that capacity; regardless of the name that is given to their position; and

(b) 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.

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 or body." (emphasis added)[1]

As in other jurisdictions, "shadow director" is the colloquial expression used to describe persons who fall within the highlighted portion of the definition in s 9(b)(ii). The practical importance and relevance of the statutory definition is that the Corporations Act imposes many duties and liabilities upon "directors" and by extension, therefore, upon shadow directors. Some of the more significant directorial duties include:

- the duty to exercise care and diligence (s 180);
- the duty to act in good faith and for a proper purpose (s 181 and 184));
- the duty not to improperly use their position to gain an advantage for themselves or someone else, or to cause detriment to the corporation (s 182 and 184);
- the duty not to improperly use information gained as a director to gain an advantage for themselves or someone else, or to cause detriment to the corporations (s 183 and 184); and
- the duty to prevent insolvent trading by the company (s 588G).

Breaches of these duties can result in the imposition of fines and compensation orders.

(b) *United Kingdom*

In the United Kingdom, "shadow director" is defined in section 251(1) of the *Companies Act* 2006, as "*a person in accordance with whose directions or instructions the directors of the company are accustomed to act*." A person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity (s 251(2)).

[1] Paragraph (b) of the definition of "director" does not apply in provisions where "the contrary intention appears" (introductory words of s 9). Interestingly, according to a note to the definition, such a contrary intention appears in, inter alia:
- s 205B (which requires a company to notify ASIC of the name, date of birth, etc of each director);
- s 249C (which allows directors to call a general meeting);
- s 251A(3) (which requires minutes of a circular resolution to be signed by a director).

It is clear why s 205B and 251A(3) would not apply to companies which fall within para (b). However, it is not so clear why they would not apply to individuals who are shadow directors, and there is no clearly contrary intention in s 249C.

A body corporate is not to be regarded as a shadow director of any of its subsidiary companies for the purposes of:

- Chapter 2 (general duties of directors),
- Chapter 4 (transactions requiring members' approval), or
- Chapter 6 (contract with sole member who is also a director),

by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions.

Section 170 of the *Companies Act* 2006 provides that general duties, as specified in ss 171 to 177, are owed by a director to the company. The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply (s 170(5)). The general duties include:

- the duty to act within powers (s 171),
- the duty to promote the success of the company (s 172),
- the duty to exercise independent judgment (s 173),
- the duty to exercise reasonable care, skill and diligence (s 174),
- the duty to avoid conflicts of interest (s 175),
- the duty not to accept benefits from third parties (s 176), and
- the duty to declare interest in proposed transaction or arrangement (s 177).

The consequences of a breach of the general duties in ss 171 to 177 are the same as would apply if the corresponding common law rule or equitable principle applied and are enforceable in the same way as any other fiduciary duty owed to a company by its directors (s 178).

The duty under section 182 (duty to declare interest in existing transaction or arrangement) applies to a shadow director as to a director, with some modifications (s 187). A shadow director is treated as a director for the purposes of the following provisions, which require members' approval (s 223):

- directors' long term service contracts (ss 188 and 189),
- substantial property transactions, (ss 190 to 196),
- loans and quasi-loans to directors and credit transactions (ss 197 to 214), and
- payments for loss of office (ss 215 to 222).

Shadow directors are also to be included in the register of the company's directors (s 162). If the company fails to deliver an annual return, the company and every director, including shadow directors, have committed an offence (ss 858 and 859).

Similar definitions can be found in section 22(5) of the *Company Directors Disqualification Act* 1986 and section 251 of the *Insolvency Act* 1986. The *Company Directors Disqualification Act* 1986 permits disqualification orders to be made against shadow directors involved in fraud or breach of duty (s 4). The court and the Secretary of State are empowered to disqualify shadow directors in other circumstances: ss 6, 7 and 8. Under the *Insolvency Act*, where a company is being wound up, a shadow director will have committed an offence if he or she:

- engages in fraud or forgery (s 206);

- engages in misconduct such as failing to deliver up books and records to the liquidator (s 208);
- makes any material omission in any statement relating to the company's affairs (s 210);
- makes any false representation or commits any other fraud for the purpose of obtaining the consent of the company's creditors (s 211);
- engages in wrongful trading (s 214); and
- breaches the restriction on re-use of insolvent company names (s 216 - a key anti-phoenix company provision).

(c) *New Zealand*

In New Zealand, a director includes a person in accordance with whose directions or instructions a director may be required or is accustomed to act and a person in accordance with whose directions or instructions the board of the company may be required or is accustomed to act: s 126(1)(b)(i) and (ii) of the *Companies Act* 1993 (NZ). Shadow directors must comply with the duties of directors to act in good faith and in the best interests of company (s 131), to exercise their duty of care (s 137), to exercise their powers for a proper purpose (s 133), to disclose their interests (s 140), to avoid certain transactions (s 141), to disclose share dealings (s 148) and to prevent reckless trading (s 135).

Under s 383 of the *Companies Act*, if a shadow director acted in a reckless or incompetent manner in the performance of his or her duties as director, or is guilty of fraud or breach of duty to the company or a shareholder, the Court can order disqualification.

(d) *Hong Kong*

The Hong Kong Companies Ordinance Cap 32 also imposes liability on shadow directors and prohibits certain activity. "Shadow director" in relation to a company, is defined in s 2 as "*a person in accordance with whose directions or instructions the directors or a majority of the directors of the company are accustomed to act*." Among other things, shadow directors:

- cannot act as investment advisers for the purposes of s 49BA;
- are liable for failing to comply with the annual return provisions in ss 107 and 109;
- cannot take loans from the company and the relevant company cannot give a guarantee or security in connection with a loan to a shadow director (s 157H). Standard exemptions to these rules do not apply to shadow directors;
- are liable for the concealment of any property of the company or debt due to, or from, the company if the company is wound up (s 271(1)(d));
- are liable for not delivering up to the liquidator all the property, books and papers of the company (s 271(1)(b) and (c));
- are liable for fraudulent removal of property of the company within a year of the company being wound up (s 271(1)(e));
- are liable for any false representation or other fraud for the purpose of obtaining the consent of the creditors of the company to an agreement with reference to the affairs of the company or to the winding up (s 271(1)(p);
- are to be included in the register of directors pursuant to s 158;
- are to make disclosure pursuant to s 161C(2A) of the particulars of loans, guarantees and other transactions entered into by the company;

- can be the subject of a disqualification order for fraud pursuant to s 168G, and for being unfit to manage a company, where the company has gone insolvent pursuant to s 168H.

- are liable for any debt or liability of the company arising when a company is deemed to be dormant pursuant to s 344A; and

- can be liable for the default, refusal or contravention of any provision of the Companies Ordinance (which he or she knowingly or willfully authorises or permits) under s 351.

(e) *Singapore*

Shadow directors are deemed to be directors under s 4(1) of The Singapore *Companies Act* (Cap 50, 2006 Rev Ed):

> *"director" includes any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act…"*

Shadow directors are therefore subject to the same requirements, liabilities and offences as other directors under the *Companies Act.* These include frauds by officers (s 406), responsibility for fraudulent trading (s 340), liability for not keeping proper accounts (s 339), concealed property or debt of the company when it is wound up (s 336), obtaining approval of the company for the issue of shares (s 161), prohibitions on company loans and guarantees to directors (s 162), keeping a register of shareholdings (s 164), the general duty to make disclosure (s 165) and to notify the stock exchange of acquisitions (s 166).

Pursuant to section 149 of the *Companies Act*, the Court can make a disqualification order if the person has been a director of a company which has gone into insolvent liquidation, and his or her conduct makes him or her unfit to be a director or take part in the management of a company.

2.3 Case law relevant to secured creditors, banks, & advisers in corporate restructuring

Although there is potential liability for secured creditors, banks and advisers when they become involved in assisting or guiding a company through a period of financial difficulty, there is little case law specifically on this issue. As Justice Vinelott has remarked, "*the dividing line between the position of a watch-dog or adviser imposed by an outside investor and a de facto or shadow director is difficult to draw*" (*Re Tasbian Ltd (No 3), Official Receiver v Nixon* [1991] BCLC 792, at 802). Significantly, Justice Chesterman stated in *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd* (2003) 178 FLR 1, at [264]:

> "*It is, I think, significant that there is no reported case in which a secured creditor has been held a de facto or shadow director of the borrowing company despite there being innumerable examples over the decades of creditors who have taken a keen interest in, and exercised a marked degree of supervision over, the affairs of their debtors*."

(a) *Australia*

The first Australian decision in which the courts considered the current extended definition of "director" was *Standard Chartered Bank of Australia v Antico* (1995) 38 NSWLR 290. In *Standard Chartered Bank*, Pioneer was the largest shareholder in Giant, with a 42% interest. The Chairman, Managing Director and Deputy Managing Director of Pioneer were each appointed as non-executive directors of Giant. Standard Chartered Bank made available to Giant a bill acceptance and discount facility of $30 million. On the termination date, $30 million was owing under the facility. The Bank made available to Giant an overdraft facility of $30 million which was used to pay out the bill acceptance and discount facility. When Giant obtained the overdraft facility, it failed to disclose to the Bank that Giant was already in default under another finance agreement, and that Pioneer had taken security over some of Giant's assets to secure advances by Pioneer to Giant.

Pioneer advanced funds ($24 million) to Giant to cover Giant's operating expenses. Pioneer obtained security over shares held by Giant. The Pioneer board resolved that no further

financial support would be given to Giant. At that time, Pioneer had advanced a total of $91.4 million to Giant. Giant was eventually wound up, and the Bank received nothing from the winding up. The Bank sought to recover from Pioneer under the insolvent trading provisions on the basis that it was a director of Giant.

Justice Hodgson considered that the mere fact that Pioneer indirectly owned 42% of the shares of Giant, and had three nominees on the board, was insufficient to make Pioneer a shadow director. However, there were additional circumstances which his Honour took into account, including (at 324-328):

- Pioneer had effective control over the management and financial affairs of Giant.
- Pioneer imposed on Giant requirements for financial reporting consistent with the financial reporting required for the Pioneer group.
- The major strategic questions concerning Giant were decided by Pioneer.
- The decision to fund Giant, to the basis of security provided by Giant, was effectively made by Pioneer, and simply accepted by Giant.

Importantly, his Honour recognised that:

> "*a holding company is not a director of its subsidiaries, merely because it has control of how the boards of its subsidiaries are constituted; that it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of the borrower's affairs; and that it is even less uncommon for lenders to require security for a loan, and then to require the sale of property over which the security is given. Certainly, these factors on their own would not amount to assuming the position of a director, or taking part in the management of a borrower company*." (at 327)

However, in the special factual circumstances discussed above by which control over the subsidiary board was manifested, his Honour concluded that Pioneer was a director of Giant.

The risks associated with a company or individual's involvement in the implementation of a rescue package or corporate restructure of a struggling company were clearly demonstrated in *Ho v Akai Pty Limited (In Liquidation)* (2006) 24 ACLC 1526. The Akai group of companies suffered financial difficulties. The group's parent (Akai Holdings) came to an arrangement with Grande Holdings Limited (Grande Holdings) for the latter to provide a rescue package or acquire the Akai brand for use in its own electronic business. Part of the arrangement involved a member of the Grande group – Grande Group Limited (GGL) – managing the business of Akai Holdings and its subsidiaries, including Akai Australia.

Mr. Ho was the president and chief executive officer of Grande Holdings and had indirect control of 75 percent of the shares in the company. An insolvent trading action was launched against Mr. Ho, GGL and Grande Holdings. An application was made to have that action set aside. On the set-aside application, the issue for determination by the Court was whether Grande Holdings and Mr. Ho were arguably shadow directors of Akai Australia.

The Full Federal Court held that although he was not involved in the day-to-day management of the company, Mr. Ho's involvement in the company's affairs was of a strategic nature in relation to both its affairs and its participation and place in the rescue package. There was also evidence that the directors of Akai accepted instructions from, and felt responsible to, officers of Grande Holdings. As a result, it was arguable that Mr. Ho and Grande Holdings were both shadow directors of Akai.

Despite this, Australian courts have been reluctant to find that lenders involved in a corporate restructure or workout situation are shadow directors. In *Emanuel Management*, the liquidator of the Emanuel group of companies brought an action against Foster's Brewing Group alleging, amongst other things, that the officers and employees of Foster's were de facto and/or shadow directors of Emanuel and had breached their directors duties and were liable for insolvent trading. The merchant banking division of Foster's Brewing Group Ltd, Elders Finance Group or EFG, had advanced money to Emanuel for a property purchase. Following

default by Emanuel on the loan, EFG engaged in negotiations with Emanuel as part of a work-out and advanced further moneys to allow Emanuel to meet their financial obligations until sales could be effected and the proceeds applied to reduce debt and meet running costs. The liquidator claimed that EFG involved itself in Emanuel's affairs well beyond supervising the marketing of the properties charged with the payment of their debt and accordingly, its officers became shadow directors of Emanuel.

Justice Chesterman considered evidence of regular joint meetings between executives of EFG and the Emanuel directors. His Honour found that the minutes contained no reference to instructions or directions given by the EFG officers to the Emanuel personnel. The discussions which took place at the meetings were concerned with sales of property, the extent of the debt to EFG, and conditions on further advances. For example, at one such meeting, EFG stated it would provide support for two months and then conduct a detailed review of its facilities with Emanuel, and there would be a rigorous marketing program to reduce borrowings. His Honour held that these communications were nothing more than "*a mortgagee indicating the terms on which it had decided it would continue to provide a level of financial support to its mortgagor* (at [315])." Even if in some instances an EFG officer could be considered as having issued a command, there was no evidence that those commands were, in fact, complied with. There was actually evidence that EFG's directions were ignored. His Honour found that "*there is certainly no evidence of a regular, or common, or habitual deference to EFG's instructions with respect to matters involving the "top level management" of the Emanuel group* (at 357])"

Although EFG was the principal financier, the Emanuel group had a substantial property portfolio financed by and mortgaged to other financiers. It was of significance, in his Honour's opinion, that EFG's conduct in relation to Emanuel was no different from the conduct of other financiers towards Emanuel. They too had loans on which their borrower had defaulted and assessed that the best prospect of return was for Emanuel to sell the mortgaged properties. His Honour considered that once a borrower was in asset or loans management, lenders such as ANZ or Westpac would typically:

- require a much higher degree of control by the bank over the operation of the account;
- require a much higher degree of administration and management;
- require frequent meetings with the borrower or regular discussions about management and operations;
- require visits by bank staff to the borrower's premises to assist to get information for the bank;
- require a much higher level of reporting and provision of information by the borrower than would normally be the case;
- require a very high degree of disclosure of information from the customer;
- require information as to the borrower's overall financial position, total and projected cash flow position, position *vis a vis* other financiers, available assets, progress about the sale of property, sales and marketing strategies, business plans, and past financial performance and anticipated future financial performance;
- require the borrower obtaining advice or independent expert assistance;
- monitoring of the pace and direction of the borrower's performance of its asset realisation strategies, and if necessary indicate what they wanted to occur;
- leave the borrower in no doubt as to what the lender required of the borrower as to these matters if the lender's forbearance was to continue; and
- if further advances were made, the purposes for which they might be used were strictly controlled.

His Honour then examined the particular actions taken by other lenders in relation to the Emanuel group and concluded as follows:

> "*This is not to say, of course, that a mortgagee can never come to the situation where it is controlling so much of the activities of a mortgagor company that it becomes de facto director. The reasons described by Millett J in his article show that that situation will not ordinarily arise where the mortgagee is engaged in a "workout" with its mortgagor with a view to maximising the return on mortgaged property for the mutual benefit of both. The point presently to be made is that if EFG's conduct amounted to instructing or directing the board of the Emanuel group then so did those other financiers whose conduct with respect to their mortgaged properties was not qualitatively different. It is an unlikely result that the board of the Emanuel group was subject to the simultaneous direction and instruction of three or four separate lenders*" (at [380]).

Justice Chesterman held that the officers of EFG were not shadow or de facto directors of Emanuel. The case is authority for the proposition that it is not sufficient to create a shadow directorship that a lender takes a close interest in, and exercises significant supervision over, the affairs of a debtor.

The recent case of *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2010] NSWSC 233 exemplifies the type of claims a secured creditor can be exposed to when involved in a debtor's business. In that case, however, the Supreme Court determined that Apple and its finance director, John Likidis, were not acting as shadow directors of Buzzle, but were merely engaged in arms length commercial dealings.

Apple had entered into Reseller Agreements with retailers of their products (Resellers), pursuant to which the Reseller purchased stock on credit. Each Reseller had granted a charge over its assets to Apple. A group of the Resellers decided to merge their individual businesses in the expectation that the merged business would be more profitable than the sum of the individual businesses. They intended, that a short time after Buzzle was established, its holding company would be floated on the ASX and shares would be issued to members of the public.

Apple's consent was needed to the merger because Apple had a charge over the assets to be transferred to Buzzle. The Resellers were dependent on Apple's agreeing to enter into a Reseller Agreement with Buzzle. Apple participated in discussions, meetings and communications with the Resellers and made clear to Buzzle its financial expectations and requirements in order to obtain Apple's consent and co-operation. Apple consented to the merger, entered into a Reseller Agreement with Buzzle (under which it provided stock on credit) and took a charge over Buzzle's assets.

The proposed float did not proceed and Buzzle's business failed. Apple appointed receivers, and ultimately Buzzle was wound up and a liquidator was appointed.

The liquidator of Buzzle contended that Apple was closely involved in the merger and that as a result of its negotiations and involvement with Buzzle:

- The charge taken by Apple over Buzzle's assets was invalid pursuant to section 267 of the *Corporations Act* 2001 because Apple was an "officer" or "person associated" with Buzzle and had taken steps to enforce the charge within six months of its creation; and

- Apple had become a shadow director of Buzzle (that is, the directors of Buzzle were accustomed to act in accordance with the instructions or wishes of Apple and Mr Likidis). Consequently, it was argued, Apple was liable for insolvent trading debts which Buzzle incurred (approximately $50 million).

Throughout the negotiations with Buzzle, Apple had raised concerns about the merger, which were ultimately addressed by Buzzle. However, the Resellers were aware that Apple's consent to the merger was required and to obtain it, Buzzle had to satisfy Apple's concerns. The Court held that the fact that Apple could refuse consent, which in turn put pressure on Buzzle, did not mean that it had participated in the decision.

Justice White emphasized that, where a third party imposes conditions on their commercial dealings with a company, with which the directors feel obliged to comply, the third party is not necessarily a shadow director (at [242]). Third parties can insist on terms in commercial dealings with companies in return for their support, and successfully obtain compliance with those terms, as this does not involve an instruction or express wish as to how the directors are to exercise their powers (at [243]). Directors are free to exercise their own judgment as to whether it is in the interest of the company to comply or to reject those terms.

Ultimately, the Court rejected all of the liquidator's claims. Most significantly, Justice White expanded on the proposition that a third party who exercises superior bargaining power in commercial dealings with the company is not automatically a shadow director.

The case highlights the potential claims that may be made against secured creditors where they have become involved in the business decisions of the debtor. To fight off such claims, the secured creditor must be able to show they have dealt with the debtor at arm's length and merely applied commercial pressure to the company. In this respect, the court has given secured creditors some protection against such claims, especially in the current economic climate where creditors are increasing their involvement in their debtors' businesses.

(b) *United Kingdom*

The English courts have held that it is possible for a bank to be a shadow director. In *Re a Company (No. 005009 of 1987) ex parte Copp and another* [1989] BCLC 13, the court considered the definition of shadow director under s 251 of the *Insolvency Act* 1986. After losing a major customer, the company experienced serious trading difficulties causing it to reach its unsecured overdraft limit. The Bank investigated and reported on the company's difficulties, and the company granted a debenture to the Bank. Various steps were taken in implementation of the recommendations contained in the report, and it was claimed that the taking of those steps by the company and its directors caused the Bank to be a shadow director of the company. An important circumstance which was relied upon by the liquidator was that the bank was aware, at an early stage, that the company was insolvent with no reasonable prospect of avoiding insolvent liquidation.

Three months later the company went into insolvent liquidation. The liquidator claimed that the Bank was liable for wrongful trading as a shadow director under s 214 of the *Insolvency Act* 1986. On the application to strike out, Knox J held that it was not obviously unsustainable that the Bank was liable as shadow director of a company on the grounds that the bank had used its position as debenture holders to play a controlling role in the affairs of the company. However, in a subsequent hearing, the liquidator abandoned the claim against the bank.

However, intervention by a lender will fall short of creating a shadow directorship where the lender is acting to safeguard its own interests. In *Re PFTZM Ltd* [1995] 2 BCLC 354, the Court held that a lender acting in the exercise of its rights as a secured creditor is not, without more, a shadow director of an insolvent debtor. In that case, a group of bankers and financiers refinanced a company that ran a hotel and country club, taking a 125 year lease of its premises as security and leasing it back to the company for 25 years. When the company ran into trouble, it was agreed between the company and the financiers that weekly management meetings would be held concerning the trading of the company's business which would be attended by two of the financiers. All the company's income was paid into an account in the name of the financier which released funds only for specific items of expenditure which had been identified and approved at management meetings. The financier had the ultimate say over who got paid and how much. The liquidator sought an order examining the financier's officers with a view to making them liable as shadow directors by reason of their involvement in the management of the insolvent company.

Judge Baker QC refused the order, stating at 290-1:

> "*In this case the involvement of the applicants here was thrust upon them by the insolvency of the company. They were not accustomed to give directions. The actions they took, as I see it, were simply directed to trying to rescue what they could out of the company using their undoubted rights as secured creditors*."

At 368 his Honour said:

> "*The central point ... is that they were not acting as directors of the company, they were acting in defence of their own interests. This is not a case where the directors of the company ... were accustomed to act in accordance with the directions of others ... it is a case where the creditor made terms for the continuation of credit in the light of threatened default. The directors of the company were quite free to take the offer or leave it*."

The threat of shadow directorship is usually considerably reduced by the professional adviser exemption, which carves out an exception for advice given in a professional capacity or as a result of a business relationship with the directors, members of the board or the body. Often, insolvency experts, be they lawyers or accountants, are involved a company's financial affairs and operations where the company is failing. The risk for advisers is in overstepping their role as adviser and assuming control of the company's affairs, decisions and management.

An example of the blurred boundary between adviser and shadow director is the decision of *Re Tasbian Ltd (No 3)* [1992] BCC 358, which concerned an advisor, Mr Nixon, who was a chartered accountant and "company doctor". The question for the Court was whether leave should have been granted to the Official Receiver to apply out of time for a disqualification order against Mr Nixon. That depended on whether there was a fairly arguable case that Mr Nixon was a de facto or shadow director of Tabsian. Mr Nixon was introduced as a consultant to Tasbian by a finance company, Castle, which was the majority shareholder and lender to Tasbian, on the security of a debenture. Tasbian never made a profit, and it was Mr Nixon's role to "fix" the company and increase profitability.

It was alleged that Mr Nixon was a shadow director or de facto director on the basis that he had assumed effective control of the company. The evidence supporting this finding was that he had been appointed and paid by Tasbian, required all Tasbian cheques to be countersigned by him, negotiated an informal moratorium with creditors, negotiated with Inland Revenue and other third parties, became a signatory on Tasbian's bank account and controlled the company's finances.

The issue for the Court of Appeal was whether Mr Nixon was controlling the company's affairs in a manner going beyond the province of a company's professional advisor. The Court of Appeal held that there was enough evidence to disclose an arguable case that Mr Nixon was a shadow or de facto director. The case represents the danger for advisers in rescue operations, especially where the adviser asserts a form of negative control, such as requiring the countersigning of cheques. Lenders who appoint their own officers as advisers are particularly vulnerable.

(c) *New Zealand*

Although the New Zealand courts have recognised that it is possible for such liability to arise in certain circumstances, liability as a shadow director has never been imposed on a bank in New Zealand. In *Krtolica v Westpac Banking Corporation* (9 January 2008, unreported, Auckland High Court, Stevens J), Mrs Krtolica gave a guarantee to Westpac in respect of money and obligations owed by the Seamart group of companies. The claims against the bank arose out of the bank's active support for and participation in a creditor preference regime in conjunction with Seamart after Seamart became insolvent. It was alleged that Westpac, in running the creditor preference regime, was acting as a shadow director of Seamart, and was thereby liable for reckless trading. There was no evidence of a relationship between Westpac and the sole director in which he was accustomed to act in accordance with Westpac's instructions. Accordingly, the High Court found Westpac was not a shadow director.

(d) *Asia*

The concept of shadow directorship has also been the subject of judicial consideration in various Asian jurisdictions.[2] For example, in *Cepatwawasan Group BHD v Tengku Dato' Kamal Ibni Sultan Sir Abu Bakar* (unreported, High Court of Malaya, 19 December 2007), the Malaya High Court considered whether former directors of a company were liable as shadow directors for alleged misappropriation of funds through the execution of sham sale and purchase transactions. Some of the directors had resigned before the transactions were entered into. There was no evidence of directions or instructions from the former directors to the current directors in respect of the sham sale and purchase transaction, nor was there a pattern of the directors' adhering to the defendants' directions in respect of the management of the company. The evidence adduced comprised primarily of disparate incidents involving various employees, inferences and perceptions (for example, that the sham sale and purchase agreement was entered into days after the resignation of the defendants as directors, the suspicious movement of funds, the shredding of documents, certain employees were asked to resign, etc). However, even considered in totality, these factors were insufficient for the High Court to find a de facto or shadow directorship.

3. Phoenix companies

3.1 Impact on Australian commercial environment - relevance to creditors

Some company directors may decide to restructure the company in an illegal manner, largely by engaging in phoenix activity. This generally involves, as discussed below, the company's failing to pay its debts, the directors' transferring assets to a new company, the company entering into liquidation, and the business rising again in the new company. The danger for creditors lies potentially in their involvement in phoenix transactions. Australian courts have recently shown themselves willing to hold those who facilitate phoenix activity as accountable as the directors who initiate such activity.

3.2 What is phoenix activity?

A precise definition of what constitutes phoenix activity is inherently difficult to achieve. This was noted by the Parliamentary Joint Committee on Corporations and Financial Services in its report on corporate insolvency laws in 2004.[3] The purpose of the phoenix activity provides a general guide as to what is illegal or fraudulent phoenix activity and what is legitimate corporate activity. ASIC formulated a definition in a research report published in 1996 entitled *Phoenix Activities and Insolvent Trading*. The definition adapts the definition used by the Victorian Law Reform Committee in its 1994 report titled *Curbing the Phoenix Company.* Phoenix activities were those where an incorporated entity either:

(a) Fails and is unable to pay its debts; and/or

(b) Acts in a manner which intentionally denies unsecured creditors equal access to the entity's assets in order to meet unpaid debts; and

(c) Within 12 months another business commences which may use some or all of the assets of the former business, and is controlled by parties related to either the management or directors of the previous entity.

What this usually involves is one corporate entity carrying on a business, accumulating debts and liquidating to avoid repayment. The business then rises from the ashes in a new corporate entity controlled by the same person or group of people.

A typical fraudulent phoenix arrangement might be structured as follows[4]:

- a closely held private group is set up, consisting of several entities one of which has the role of hiring the labour force for the business;

[2] See also *Aktieselskabet Dansk Skibsfinansiering v Wheelock Marden & Co* (unreported, Court of Appeal, Hong Kong, Bokhary JA, Mayo J, 17 November 1994), *Omega Holdings Sdn. Bhd. v Dato' Tiah Thee Kian and Ors* [2002] 7 CLJ 125.
[3] Parliamentary Joint Committee Report on Corporations and Financial Services 2004, *Corporate Insolvency Laws: A Stocktake*, The Commonwealth of Australia, Canberra, par 8.2.
[4] Commonwealth of Australia, "*Proposals Paper: Action against fraudulent phoenix activity*" November 2009, p. 2.

- the labour hire entity will usually have a single director who is not the ultimate 'controller' of the group;
- the labour hire entity has few, if any, assets and little share capital;
- the labour hire entity fails to meet its liabilities and is placed into administration or liquidation by the ATO;
- a new labour hire entity is set up and the labour moved across to work under this new entity; and
- the process is repeated, with little disruption to the day-to-day operation of the overall business and the financial benefits from the unpaid liabilities are shared amongst the wider group.

Clearly, phoenix activity leaves a host of victims in its wake. The Commonwealth, States and Territories are deprived of revenue through the avoidance of tax liabilities. Trade creditors are often left as unsecured creditors when the assetless company goes into liquidation, or if the company goes into administration, must settle for less than they are owed in a deed of company arrangement.

Phoenix activity also poses a danger from a creditor's perspective if they become involved in phoenix activities and transactions. Clearly, the extent of a third party's involvement in phoenix activity will depend on the facts of the case and the particular transactions that are involved in phoenix activity. Involvement in one discrete aspect of a phoenix company's transactions may not be sufficient for third party liability.

3.3 Current measures

There is no definition of, or offence provision specifically relating to, phoenix activity in the *Corporations Act* 2001 or any other Australian law.

Directors involved in fraudulent phoenix activity may be in breach of directors' duties and other provisions of the *Corporations Act* 2001, including:

- s 180-184, which set out the basic duties of a director to his or her company;
- s 588G, which provides the duty of a director not to allow a company to incur debts when insolvent;
- Part 5.8A, which renders a person liable to compensate for loss of employee entitlements where an arrangement or transaction is entered into for the purpose of avoiding the payment of those entitlements; and
- s 206F, which allow for disqualification of directors who have been involved in multiple corporate failures. However, it must be noted that an inherent limitation of this provision is that it requires there to have been at least two liquidations before ASIC can take disqualifying action.
- A creditor could incur liability for phoenix activity in its capacity as a shadow director if it actively participated in the activity. However, as a result of Somerville's case (see below), there is an additional potential source of liability: s 181-183 attach liability to anyone who "is involved in" a director's contravention of those sections. In Somerville's case, a solicitor who advised company directors on structuring phoenix companies was held to have such liability.

3.4 Somerville's case

ASIC v Somerville [2009] NSWSC 934 demonstrates the potential liability of third parties and advisers in relation to phoenix activity. ASIC instituted proceedings against directors of various companies in breach of their directors duties pursuant to sections 181, 182 and 183 of the

Corporations Act. Mr Somerville, a solicitor, was alleged to have been personally involved in the breaches within section 79 of the Act and was accordingly liable for the breaches. Each case involved the director of an original company seeking advice from Somerville because the company was suffering or about to suffer financial problems. Each company was under the threat of insolvency or insolvent. The companies each sought advice from Somerville as to its position and available options, and he (or his firm) provided it.

In the transactions which followed, the old company ceased to trade, a new company was formed and an agreement prepared by Somerville or his firm was entered into between the old company and the new company transferring the assets of the old company to the new company.

Those agreements for sale and purchase were similar and all included clauses under which:

- the vendor company agreed to transfer its business, or the assets of its business, to the purchaser company;
- the consideration was the issue of 100 “V” class shares in the purchaser company carrying the right to receive all dividends declared by the company until a fixed amount had been paid;
- the vendor company would receive payments invoiced prior to the settlement and apply those to debts of the vendor company;
- the trade creditor debts of the vendor company would remain with the vendor;
- employees would be terminated and the purchaser company would offer re-employment on the same terms; and
- plant and equipment on lease or hire would be transferred to the purchaser and leases of premises assigned.

No dividends were paid on the “V” class shares. As a result, the purchaser company effectively acquired all the assets of the vendor company for no payment. The purchaser company obtained the employees, premises and equipment of the vendor company free of all liabilities (other than liabilities under lease or hire purchase agreements). These liabilities included debts to trade creditors, taxation debts and debts for insurance premiums.

Acting Justice Windeyer concluded that Mr Somerville had advised on and recommended the unlawful transaction. His role included preparing, obtaining and arranging execution of the relevant documents. It was clear to his Honour that Mr Somerville had "*aided, abetted, counselled and by carrying out the necessary work procured the carrying out of the transaction*" (at [48]). As the transactions would not have occurred without his involvement, there was a direct causal link between his involvement and the breach. Accordingly, Mr Somerville was liable for the breaches. This case should act as a warning to advisers in corporate restructuring of the risk of giving unlawful financial and legal advice.

4. Conclusion

There is no doubt that the current economic environment presents new challenges for creditors. Where a creditor is faced with a struggling debtor, there are few available options. The statutory avenues offer the greatest protection to creditors, who should be aware of the risks that informal restructuring processes represent. Secured creditors may be liable for insolvent trading and other breaches of directors' duties, depending on the level of involvement in the business of their debtors. The case law suggests that creditors are entitled to apply commercial pressure on their debtors in order to protect their interests as long as the debtor directors are free to decide whether to comply with that pressure. This would appear to give creditors a wide ambit, however, in order to prevent or defend shadow directorship claims, creditors must ensure that they have negotiated and communicated with their debtors at arm's length at all times. Essentially, creditors must be careful to only offer advice and make recommendations, not participate in management decisions, the day-to-day running of the business or negotiations with third parties. A creditor can indicate the terms upon which it will continue to financially accommodate or support the debtor, but should not instruct or direct the board to adopt a particular strategy. Unfortunately, the point at which

providing assistance with respect to the management and operation of the business is considered as instructions to the board of directors is unclear. Creditors should be aware of potential claims and of the distinction between creditor and director.

Similarly, creditors and advisers should be alert to the nature of phoenix activity, as the case law makes clear that facilitation or involvement in phoenix activity will not be tolerated. Obviously, phoenix activity could not occur without the support of creditors, who are often paid out from the new entity if they continue their support. There are many transactions that may form a part of phoenix activity, and creditors and advisers should be able to identify and investigate for their own protection what may be improper conduct.