Insolvent Trading - Shadow Director's Liability

Standard Chartered Bank of Australia Limited v Antico & Ors (1995) 13 ACLC 1381.

In *Standard Chartered Bank of Australia Limited v Antico & Ors*, Hodgson J of the Supreme Court of New South Wales held that Pioneer International Ltd was a shadow director of Giant Resources Ltd, and therefore liable for an insolvent trading debt of Giant. Pioneer provided loans to Giant, and in return Pioneer took security over Giant's assets and exercised control over Giant. The decision demonstrates the quite serious implications for lenders and insolvency practitioners where a lender (in this context, during an informal workout) seeks to exercise *positive control* over the activities of the borrower.

Facts

Giant was involved in mineral exploration and mining in Australia, Canada and South Africa. During the period November 1987 to February 1988 Pioneer acquired a 42% interest in Giant through a chain of subsidiary companies. As a result Pioneer became the most significant shareholder in Giant, the next most significant holding being 10%. Subsequently the Chairman of Pioneer (Antico), the Managing Director of Pioneer (Quirk) and the Deputy Managing Director and Finance Director of Pioneer (Gardiner) were each appointed as non-executive directors of Giant.

In October 1988 Standard Chartered Bank made available to Giant a bill acceptance and discount facility of $30 million. On the termination date of 31 March 1989 $30 million was owing under the facility. On 25 July 1989 Standard Chartered 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 Standard Chartered 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 to Giant during the period October 1988 to November 1989 to cover Giant's operating expenses. By 13 March 1989 Pioneer had advanced $24 million to Giant. On 30 June 1989 Pioneer obtained security over shares held by Giant. On 28 November 1989 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.

On 1 December 1989 Giant advised its creditors that it could no longer meet its debts as they fell due. A summons to wind up Giant was presented in April 1990, and Giant was subsequently wound up. Standard Chartered received nothing from the winding up.

Standard Chartered commenced proceedings against Antico, Quirk, Gardiner and Pioneer to recover the principal, interest and/or damages owing under the overdraft agreement. Standard Chartered sought to recover these amounts on the basis of the insolvent trading provisions (s.556 of the Companies Code), or for misleading conduct in relation to representations made to Standard Chartered concerning Giant's financial position (section 52 and 75B of the *Trade Practices Act*).

Pioneer as a shadow director of Giant

The Court concluded that by operation of section 556 the directors of Giant were personally liable to pay the interest due under the overdraft agreement entered into on 25 July 1989. The further question then arose as to whether Pioneer was jointly and severally liable in respect of this debt.

For the purposes of the insolvent trading provisions of the Companies Code, persons other than appointed directors can be liable for insolvent trading. Section 5 of the Companies Code provides:

> *"'director' in relation to a corporation, includes:*
>
> *(a) any person occupying or acting in the position of director of the corporation, by whatever name called and whether or not validly appointed to occupy or duly authorised to act in the position; and*
>
> *(b) any person in accordance with whose directions or instructions the directors of the corporation are accustomed to act."*

Section 556 of the Companies Code can also attach liability for insolvent trading to a person who might otherwise escape the section 5 definition of a "*director*". It provides that "*any person ... who took part in the management of the company*" is within the scope of the section.

Decision of the Court

The Court found that the mere fact Pioneer indirectly owned 42% of the shares in Giant and had three nominee directors on Giant's board was not sufficient to make Pioneer either a director or a person who took part in the management of Giant. In the absence of evidence to the contrary, it would be assumed that actions of the nominee directors were undertaken on behalf of Giant, and not as officers or agents of Pioneer.

Hodgson J listed circumstances which would not on their own amount to assuming the position of a director or taking part in the management of a borrower company:

- a holding company controlling the composition of subsidiary companies;
- a lender imposing conditions on loans as to

how funds are to be applied and requiring disclosure of affairs of the borrower;
- a lender requiring security for a loan and then later requiring the sale of property over which the security is given.

However, the Court concluded that in the circumstances existing at the relevant times, for the purposes of section 556, Pioneer was a person who took part in the management of Giant, and Pioneer was also a director of Giant. In respect of strategic matters concerning Giant the three directors Antico, Quirk and Gardiner made decisions in their capacity as directors of Pioneer and failed to give any separate consideration to those decisions in their capacity as directors of Giant. The directors of Giant simply accepted the decisions which had been effectively made by Pioneer.

The following circumstances supported this conclusion:

- Pioneer had effective control of Giant. Although it held only 42% of the shares in Giant, it was by far the most significant shareholder. The next most significant share holdings were 10%, 6%, 6% and 3%. The fact of control by Pioneer was acknowledged in Giant's 1988 annual report.
- Pioneer imposed financial reporting requirements upon Giant. Pioneer supplied the cash flow form to be used by Giant, and the Pioneer board directed management to ensure that there would be proper financial reporting by Giant, and also that Pioneer be given full access to all financial records.
- The views of Pioneer delayed a takeover and an asset sale by Giant.
- At the time when Giant was considering purchasing Pioneer's mineral assets, negotiations with third parties for finance to be provided to Giant for the purchase were conducted by Pioneer and not by Giant. The transaction was abandoned when the Pioneer board resolved that it was not in the best interests of either company to proceed.
- Pioneer exercised management and financial control over Giant. In exchange for agreeing to finance Giant's operating expenses, Pioneer required Giant to appoint a specific firm of accountants; that Giant only enter new financial commitments after obtaining Pioneer's approval; and that all payments by Giant must be approved by Pioneer's general manager of finance.
- The decision to fund Giant and to take security over Giant's assets was effectively made by Pioneer and simply accepted by Giant.

Accordingly, Pioneer was liable along with the appointed directors for insolvent trading by Giant.

The Court held that the only insolvent trading debt was the interest payable on the overdraft facility from the date the facility was granted until the beginning of the winding up. Standard Chartered was, therefore, awarded damages of $3,053,324.32 being the interest on the overdraft facility during the period 25 July 1989 to 27 April 1990, plus the sum of $2,176,603.00 as interest on the first amount for the period since the commencement of winding up.

The Corporations Law

Since the events in *Standard Chartered* the Companies Code has been replaced by the Corporations Law. This decision is relevant to the Corporations Law as the definition of "*director*" under section 60(1) of the Corporations Law is substantially the same as definition in section 5 of the Companies Code.

Related decisions

Other recent cases show that the shadow director concept has application outside the confines of loans to subsidiary companies.

In the Federal Court decision of *Australian Securities Commission v AS Nominees Ltd* (1995) Finn J held that Windsor, a powerful personality who controlled the actions of directors, was himself a director of the companies. In that case the directors of various companies within a group relied heavily upon instructions received from Windsor, who founded the companies but was not an appointed director. Finn J held that Windsor was a director of the companies, and was, accordingly, subject to the duty of care and diligence imposed on directors by subsection 232(4) of the Corporations Law.

In *Dairy Containers Ltd v NZI Bank Ltd* (1995), Thomas J in the New Zealand High Court held that had the facts of the case been different, the Dairy Board of New Zealand would have been found to be a director of Dairy Containers Ltd.

Lessons for Lenders

Lenders should be aware that they may ultimately be liable for the insolvent trading activities of a corporate borrower if they seek to control major operating decisions of the borrower. However, neither a lender nor its engaged insolvency practitioner will generally be exposed to the risk of liability for insolvent trading and breach of fiduciary duty if *negative control* is retained over a company's directors.

In the management of any loan:

- Ultimate responsibility for decision making should always be left in the hands of the borrower's directors.
- All consultants and advisors to the borrower company, even if reporting to the lender, should be seen to be engaged by the borrower.
- If stringent internal controls are recommended, they should not be exercised personally by the lender or its officers.
- Negotiation for financial accommodation should be only overseen.
- Advisors should act as observers and counsellors at board meetings and not purport to exercise votes at board meetings or meetings of shareholders.

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