

CLIENT UPDATE

■■ CORPORATE INSOLVENCY

■■ RESTRUCTURING

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Evolution of director liability

It has long been established that directors owe no duties to creditors of their company; but they owe duties to their company. This long held maxim has come under challenge in *Phoenix Constructions Queensland Pty Ltd v Coastline Constructions Pty Ltd and McCracken [2011] QSC 167*.

In this matter, a company director was ordered to pay \$1.5 million damages to a creditor of his company – Phoenix Constructions Queensland – ('PCQ') for an alleged breach of duties owed by him to the company as its director.

PCQ's damages claim arose out of a failed construction joint venture agreement in Townsville. McCracken was the sole director of the company, which then went into liquidation.

The Court found that he had breached his duties as a director and it then ordered that he pay damages under Section 1324(10) of the Corporations Act 2001 to PCQ for the loss the company had caused to PCQ.

Section 1324(10) is a very broad provision and gives the Court power to not only grant an injunction against a person, but also 'either in addition to or in substitution for the grant of the injunction, order that person to pay damages to any other person'.

This decision is now subject to an appeal, but the argument opened by this case threatens to create a new set of liabilities for company directors.

If the original decision stands, the implications are significant, and include the possibility that company Directors and Officers Insurance policies will not be available to directors to respond to such claims, as they do not generally cover liabilities arising from improper use of knowledge or position or wilful breaches of duty in relation to the company.

We should note that the decision is recent, novel and subject to appeal, but it serves as a current reminder that there appears to be an ever-increasing momentum towards making directors responsible for the debts of their companies.

Directors beware before signing documents

Company directors are regularly presented with a wide range of documents to be signed, and it is becoming even clearer that they must be fully conversant with what they are signing.

Recent court cases have provided examples where directors have not exercised proper care and consideration before putting their signature to a document.

What do directors need to do?

In short, directors need to be aware of their duties at common law, under statute and under the company's constitution.

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When making decisions or exercising their powers, directors should:

- take care to closely read and critically consider information provided to them;
- closely read board minutes to ensure that they accurately reflect business discussed, the reasoning for decisions and outcomes of meetings;
- if they are attending meetings by phone, ensure that they have all the relevant board papers and other information, including, for example, any slides that will be presented;
- for listed companies, recognise the importance of media communications, particularly ASX announcements, as being significant investor communications requiring their supervision;
- review company communications policies and procedures to ensure that the board considers significant announcements; and
- re-assess their indemnities and their Directors and Officers Insurance cover.

Asset protection for your business

We are often asked for comment by directors and their advisers regarding effective strategies to protect a director's personal assets, but rarely are we asked to comment on company asset protection.

We find the most effective strategies to employ in order to protect company assets in the event of failure are:

- do not have the key business assets in the name of the entity exposed to trading risk;
- do not make loans from the trading entity to the asset-owning entity;
- try to limit the extent that assets are pledged as security for trading facilities – where possible, seek to avoid broad security grabs as are often required by banks when providing funding; and
- constantly review your structure and seek legal and accounting advice before you buy or sell an asset.

Is the Bank a stakeholder or the enemy?

In these re-emerging times of diminished business confidence and tightening liquidity, it can be reasonably expected that the banks will again be passing the ruler over many underperforming businesses.

After this examination, clients in difficulty in some cases find their file being managed by a specialist banker with significant training and experience in insolvency management.

This close management often results in the question, 'is the bank managing my business?'



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This very issue was addressed in the recent NSW Court of Appeal decision of *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Ltd [2011] NSWCA 109*.

In this matter, Apple was a secured creditor of Buzzle. When Buzzle ran into financial difficulties, Apple, through one of its financial officers, attended Buzzle's premises and provided advice to Buzzle while the company continued to trade.

The company eventually failed; Apple appointed a receiver and Buzzle subsequently went into liquidation.

The liquidator considered that Buzzle had been trading while insolvent and brought proceedings against Apple, alleging:

- certain repayments by Buzzle to Apple were voidable uncommercial transactions; and
- Apple and its finance director were 'shadow directors' of Buzzle and therefore liable for insolvent trading.

The liquidator was unsuccessful in the first instance and at appeal, but the appeal judgement helps set the scene for future argument.

The Court held that despite the influence Apple had over the decisions made by Buzzle, it did not satisfy the test in the statutory definition of a shadow director.

The guidance given by the Court extended to explain that:

- in order to establish that an entity is a shadow director, it must be shown that there is a causal connection between the entity expressing a wish or giving instructions. The ultimate question is 'who is making the board's decisions?'
- If an entity such as a bank or mortgagee has a genuine interest in giving advice to the board, the mere fact that the board will tend to take that advice to preserve itself from the consequences of the mortgagee's wrath is not sufficient to establish shadow directorship. This is particularly so if the mortgagee is simply acting in accordance with its contractual rights. The directors will generally make their own decision that to follow the mortgagee's wishes is in the best interests of the company.

There is a fine line walked by bankers diligently managing the conduct of customers in financial difficulty versus becoming a shadow director.

This case affirms that merely issuing instructions or advice will generally not be sufficient to be categorised as a shadow director, even where the company feels it has no choice but to comply or face enforcement action.

That said, we recommend that secured creditors should always be alert to the possibility that a workout may turn sour, and that liquidators will be reviewing their conduct and any payments received.



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Directors lose bid for legal protection

Over the past three or so years, there have been ever-increasing calls by stakeholders representing the interests of company directors to soften the Australian insolvent trading laws that are perceived as harsher than comparative laws in countries such as the UK, Canada, New Zealand and the USA.

A reform of the Corporations Act that had been proposed was the creation of a business judgement rule that would prevent directors being made personally liable for pursuing viable restructuring options in good faith.

In September 2011, it was announced by the Parliamentary Secretary with responsibility for Corporate Law that reforms of the Corporations Act to introduce a business judgement rule would not be pursued by the Australian Government.

The Government's view was that there was a distinct lack of evidence to suggest that a more relaxed insolvent trading regime helped to allow more companies to trade out of insolvency and survive in the longer term.

The take out for Australian company directors is to remain vigilant for signs of insolvency, and seek to avoid incurring liabilities and proceed into external administration when it is determined that the company is insolvent.

About us

Heard Phillips aims to be the first choice for critical SME insolvency, restructuring and forensic accounting matters in South Australia.

Our firm seeks to deliver superior quality outcomes for clients through our credible and reliable practitioners, who take pride in displaying the highest level of respect to all stakeholders.

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