Jumping at shadows — shadow and de facto directors

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Directors have a wide range of duties and obligations to a company and its shareholders. They may be held personally liable in certain circumstances, particularly if a company has failed to comply with its obligations or has breached certain rules. Therefore, it is critical to understand who falls under the definition of a "director" of a company.

Unfortunately, it is not as straightforward as simply examining ASIC records to determine the directors of a company. The individuals appointed to the position of director will, of course, be directors of the company. The purpose of this article is to examine the situations in which other persons, who have not been so appointed, may be deemed by the courts in Australia to be a director of a company. Consideration of these issues is important for inhouse counsel for two reasons:

- first, there is a risk that certain members of the inhouse counsel team could be deemed to be a director of the organisation that they work for, and
- second, inhouse counsel may be required to advise on the risks of a person in their organisation being deemed to be a director and to advise on the steps to reduce the likelihood of such a designation or, if such a designation may not be avoided, how to mitigate the risks to that person in their capacity as a deemed director.

Corporations Act

Section 9 of the Corporations Act 2001 (Cth) (the Act) provides that a director of a company or other body includes, unless the contrary intention appears, a person not validly appointed as a director, if:

- they act in the position of a director — commonly referred to as a "de facto director", or
- the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes — commonly referred to as a "shadow director".

These provisions in the Act potentially have major consequences for:

- key management — particularly CEOs, CFOs and general counsel;
- lenders — particularly at a time when a company is in financial difficulty and the lender becomes more involved in the business; and
- major shareholders — particularly those that, due to internal governance policies or tax consequences, choose not to appoint a director when they would otherwise be entitled to do so.

We examine each of these scenarios in more depth below.

Management

There is a risk that key management personnel, including CEOs, CFOs, general counsel and certain consultants, may be de facto or shadow directors if they overstep their usual role.

The Full Federal Court in *Grimaldi v Chameleon Mining NL (No 2)*[1] considered this issue. The salient facts of the case were:

- Chameleon Mining NL (Chameleon) engaged a company associated with Mr Phillip Grimaldi (Grimaldi) as consultant to, among other things, assist with fundraising and share placements;
- Grimaldi was integrally involved in Chameleon's management and entered into various key transactions on behalf of the company; and
- the executive directors knowingly and willingly used his skills and experience over a diverse range of matters.

The court held that Grimaldi was a de facto director as he performed functions that would properly be expected to be performed by a director.[2] As a consequence of the court's finding, Grimaldi was liable for various breaches of the Act by Chameleon and breach of his fiduciary duties to Chameleon.

The key conclusions from the case are:

- the nature and extent of the functions to be performed and on the constraints imposed on the person will be the decisive factor in determining if the person is a director — if the person has a general and unconstrained role that permits them to take an active part in directing the affairs of the company, it is more likely that the person is a director;[3] and
- the person does not need to be "in ultimate control" of the company and the person may still be subject to the direction and control of the board.[4]

It was also noted by the court that Grimaldi would also have been an "officer" under the Act, even if he wasn't a de facto director.[5] This can be contrasted with the James Hardie actions brought by ASIC, in which Peter Shafron, the General Counsel and Company Secretary, was held to be an officer, but not a de facto director, of James Hardie.[6]

Lenders

There are circumstances in which a lender may take effective control of a business by exerting sufficient commercial pressure, such that the debtor feels that they must act in accordance with the lender's instructions. In such a scenario, there is a risk that the lender, or the lender's representative, would be regarded as a shadow director of the debtor company.

The leading case on whether a lender may be a shadow director is *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd*.[7] In that case, it was alleged that Apple Computer Australia Pty Ltd (Apple) and its finance director were shadow directors of Buzzle Operations Pty Ltd (Buzzle), as the directors of Buzzle were accustomed to act in accordance with their instructions or wishes.

Buzzle was a retailer that sold products manufactured by Apple. A large proportion of Buzzle's stock was held on credit from Apple and Buzzle granted a charge over its assets in favour of Apple.

Buzzle was insolvent from November 2000, however it continued to trade until March 2001 when Apple appointed receivers. During that time, the company incurred an additional $18 million in debts to its creditors (including Apple) and made $12 million in repayments to Apple. The company was subsequently wound up and the liquidators claimed that:

- Apple and its finance director were personally liable for debts incurred by Buzzle while it was insolvent, as they were shadow directors of Buzzle; and
- the cash payments to Apple constituted uncommercial transactions and unfair preferences to a related party.

At first instance and on appeal, it was held Apple was not a shadow director of Buzzle. Key findings included:

- a person did not become a shadow director merely because they imposed conditions on their commercial dealings with the company with which the directors felt obliged to comply;[8]
- there must be a causal connection between the instruction or wish of the person and the action taken by the directors;[9]
- the directors of a company are free and would be expected to exercise their own judgment as to whether it is in the interests of the company to comply with the terms upon which the third party insists, or to reject those terms. If, in the exercise of their own judgment, they habitually comply with the third party's terms, it does not follow that the third party has given instructions or expressed a wish as to how they should exercise their functions as directors;[10]
- for Apple or its finance director to be a shadow director, the directors of Buzzle must have been "accustomed to act" in accordance with its or his instructions or wishes. This requires habitual compliance over a period of time;[11]
- if a person has a genuine interest of their own in giving advice to the board, such as a bank or mortgagee, the mere fact that the board will tend to take that advice to preserve it from the person's wrath will not make the person a shadow director;[12] and
- the shadow director must have the potential to control and the power to control must have been put into practice.[13]

Notwithstanding the decision in this case, it is critical for lenders to be aware of the consequences if they are found to be shadow directors. The issue is most likely to arise when the debtor is close to insolvency. If a lender is found to be a shadow director in those circumstances, the consequences may be even more severe and may include the lender being responsible for debts incurred by the debtor.

An additional implication that may be taken from this case is that the directors of a company may not simply acquiesce to every decision of a lender, even if the company is in financial distress. The directors must act in the best interests of the company, must comply with their duties to the company's creditors when near to insolvency and must not trade while insolvent.

Major shareholders

There are instances in which a major shareholder that would, in the usual circumstances, have the right to appoint a director, may elect not to do so. There may be tax or other consequences if they appoint a director or their internal risk and governance policies may not permit them to do so. However, if that shareholder still exerts significant control over the operations of a company, then there is a risk that the shareholder (or the shareholder's representative) may be regarded as a de facto or shadow director, particularly if the company's board routinely seeks advice from the major shareholder and unerringly follows that advice. The scenario is similar to the case of a lender discussed above.

Recommendations

If a member of the inhouse counsel team is asked to provide recommendations to minimise the likelihood that a person is deemed to be a shadow or de facto director, practical steps that can be advised include:

- the person should seek to give advice, rather than direct the affairs or operations of the company;
- if the person is engaged as a consultant for particular tasks, the person should limit their role to the strict parameters of their engagement and not engage in any further activities;
- there should be clear guidelines around the person's role and responsibilities;
- the person should ensure that the board does not abdicate its responsibilities, that it still holds director meetings at which the person's advice is considered and that minutes of the meeting are taken; and
- the person could recommend that an independent board member is appointed or that the company seek independent advice.

If there is still doubt as to whether a person is a de facto or shadow director, there are several steps that may be taken to assist in mitigating the risks to the person. These include:

- seeking an indemnity from the company in favour of the person — this will assist if actions are brought against the director personally, however will not protect against liability if the company or the person breaches certain statutory obligations[14] or if the Act renders the indemnity void;[15] and
- reviewing the company's directors and officers insurance policy to ensure that it covers shadow and de facto directors (or request that the company enter into such an insurance policy). In certain cases insurance is not prohibited where an indemnity would be. However it is not a panacea as insurance may not cover wilful breaches of duty or contraventions of ss 182 or 183 of the Act.[16]

Conclusion

Perhaps the most important message is for inhouse counsel to consider if there is a risk that they or someone in their organisation may be a de facto or shadow director. If such a risk is present, the steps recommended in this article will go some way to mitigating the risk of designation as a shadow or de facto director and the personal risks if such a designation is unavoidable.

The consequences of being a de facto or shadow director can be significant. Designation as such can result in significant pecuniary penalties and disqualification orders if the de facto or shadow director breaches their fiduciary duties or is otherwise liable to the company, its shareholders, creditors or other third parties.

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Footnotes

1. *Grimaldi v Chameleon Mining NL (No 2); Chameleon Mining NL v Murchison Metals Ltd* (2012) 200 FCR 296; 287 ALR 22; [2012] FCAFC 6; BC201200621.
2. Above, n 1, at [61]–[62].
3. Above, n 1, at [45].
4. Above, n 1, at [47].
5. Above, n 1, at [62].

6. *Shafron v Australian Securities and Investments Commission (ASIC)* (2012) 247 CLR 465; 286 ALR 612; [2012] HCA 18; BC201202608.
7. *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2011) 81 NSWLR 47; 277 ALR 189; [2011] NSWCA 109; BC201103281.
8. *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2010) 238 FLR 384; 77 ACSR 410 at 464; [2010] NSWSC 233; BC201001741.
9. Above, n 8.
10. Above, n 8, at 464.
11. Above, n 8, at 465.
12. Above, n 7, at 77.
13. Above, n 7.
14. For example, certain obligations under the Act and the Competition and Consumer Act 2010 (Cth).
15. Section 199A and 199C of the Act provides that an indemnity is void to the extent that it covers a liability owed by the person to the company, fines or penalties payable by the person under the Act, liabilities to third parties which did not arise out of conduct in good faith.
16. Section 199B of the Act.