

CAN AN ADVISER TO A COMPANY BE A SHADOW DIRECTOR?

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Overview

Is there a risk that an adviser to a company may be deemed to be a shadow director?

This paper examines the circumstances in which a person may be found to be a shadow director and provides some practical tips on how advisers can avoid being shadow directors.

In particular, this paper will address the following:

- What is a shadow director?
- What activity constitutes being a shadow director?
- Determining factors established in the leading case, *Buzzle Operations v Apple*
- How to avoid being a shadow director
- Consequences
- Professional indemnity insurance

What is a shadow director?

- The definition of a director under section 9 the *Corporations Act 2001* is quite broad.
- The test for being a director is not based on your designation but is related to the function you perform.
- This means a director can include a person:
 - appointed as a director;
 - appointed as an alternate director;
 - who acts in the position of a director (even though not formally appointed); and/or
 - on whose instructions or wishes the directors of a company or body are accustomed to act.
- A person who falls within the third category is generally considered to be a **de facto director**.
- A person who falls within the last category is generally considered to be a **shadow director**.
- It is possible for a person to fall within both categories if they have never been formally appointed as a director but still exercise power and influence over the company.
- The recent case of *Grimaldi v Chameleon Mining NL (No. 2)* [2012] has held that only an individual (and not a corporation) can be a director of a company.

What activity constitutes being a shadow director?

- The current leading case on shadow directors is *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* [2011] NSWCA 109. In this case, the New South Wales Court of Appeal determined the factors that would make a person a shadow director.

Background on *Buzzle v Apple*

- Six resellers of Apple products decided to merge and form a new company called Buzzle Operations.
- Each of the resellers bought stock on credit from Apple Computer Australia Pty Ltd ('Apple').
- As part of the merger, the Apple resellers needed to transfer their stock to Buzzle.
- Apple had a charge over the stock to be transferred which meant that Apple needed to consent to the transfer.
- Apple agreed to the transfer. Buzzle entered into a new reseller agreement with Apple and Apple took a charge over Buzzle's assets.
- Apple and in particular, one of its finance directors, assisted Buzzle in the merger.

The activities of Apple and its finance director included:

- Participating in meetings on the merger
- Making suggestions about the merger and its structure
- Requesting financial information about the merger
- Questioning the Apple resellers' ability to pay the debt owed to Apple
- Raising concerns about Buzzle's financial position, management capabilities and accounting system
- Negotiating the new reseller agreement and security to be provided to Apple by the Apple resellers and Buzzle.

Instructions given by Apple to Buzzle

The board of Buzzle were accustomed to following Apple's instructions, including in relation to:

- The merger of the six reseller companies into Buzzle
- Buzzle's product range
- The appointment of accountants to conduct due diligence on the Apple resellers
- Buzzle's level of indebtedness
- The preparation of Buzzle's financial reports
- How Buzzle should apply its future cash-flows
- The security to be given by Buzzle to Apple
- Payment of money to Apple in relation to the Apple resellers' debts
- Collection of Buzzle's receivables
- Buzzle's post-merger business operations and functions.

Claim by liquidator against Apple and finance director

- Buzzle became insolvent but continued to trade.
- Shortly after, Apple appointed receivers to Buzzle under its charge.
- Buzzle ultimately went into liquidation.
- Buzzle's liquidator sought to claim \$57 million against Apple and its finance director.
- The liquidator argued that since Buzzle complied with instructions from Apple and its finance director, then Apple and the finance director were shadow directors and should be liable for insolvent trading.

Factors to determine whether a person is a shadow director

- The Court ultimately found that Apple and the finance director were not shadow directors of Buzzle and set out the following factors for determining whether a person is a shadow director:
 - There needs to be a causal connection between the alleged shadow director giving instructions and the company acting on it.
 - The person needs to have directed the company to act in accordance with their instructions or wishes over a period of time, and the company needs to be accustomed to following these directions for the person to be a shadow director. To show that the board was "accustomed to acting" there would need to be a pattern of behaviour and habitual compliance over a period of time.
 - The alleged shadow director does not need to exercise influence over the whole board. Influence over the governing majority is sufficient.

- A person will not be a shadow director where the person is giving advice in their professional capacity or the person has a professional business relationship with the company, even if the directors usually act on that advice.
 - Such advice must be given to directors in their capacity as directors rather than in a managerial capacity. For example, giving instructions to executives rather than directors would not make you a shadow director.
- After reviewing previous cases, the Court also set out the following **five principles** in relation to shadow directors:
 1. Not every person whose advice and instructions are followed by a board will be a shadow director.
 2. If the person has a genuine interest in giving advice to the board (such as a bank or mortgagee) then the mere fact that the board takes that advice to protect itself from the mortgagee's "wrath" does not make the mortgagee a shadow director.
 3. A shadow director does not need to have control over every facet of the company, nor does it matter that the company disregards the shadow director's advice from time to time.
 4. Even if a person is in a position of control over the company, it needs to be shown that the person actually exercised their control over the company to be found a shadow director.
 5. Where the board splits into a majority and minority faction, the person may be a shadow director if the influence controls the real decision makers.

Who is making the board's decisions?

- The following distinction needs to be made:
 - If the board is acting on advice because the board has considered the advice and made its own decision that acting on the advice is in the best interests of the company, then the person will not be deemed a shadow director.
 - If the board is acting on the advice without first evaluating it because it has simply deferred decision making to that person or it considers the advice given as a sufficient reason to act, then the person may be deemed a shadow director.
 - For example, Buzzle claimed that it did not have any choice but to follow Apple's instructions. However, this was not because Buzzle had deferred its decision

making to Apple. Rather, it is because Buzzle knew that the merger could not occur if it did not follow Apple's instructions.

The Court's Decision

- After applying the above principles, the Court found that even though Apple was accustomed to having Buzzle comply with its instructions, neither Apple nor the finance director were found to be shadow directors. Even though Apple and the finance director exercised power as creditors of Buzzle and applied pressure to Buzzle's board, Buzzle could still exercise its own judgment and could decide whether to comply with Apple's instructions.

Could an adviser be a shadow director?

- The question of whether a person is a shadow director will depend on the particular facts of the case.
- Intention is irrelevant. You do not need to have the intention to act as a director to be considered a shadow director. Nor does the company need to intend for you to act as a director for you to be considered a shadow director.
- As an adviser, you will not be a shadow director so long as the advice you give to the company or directors is in the proper performance of your functions attaching to your professional capacity, or your business relationship with the directors or the company.
- You will not be a shadow director simply because the company or directors follow your advice.
- However, there is a risk that you could be a shadow director if you act **outside the scope** of your **professional or business relationship** with the directors or the company.

How to avoid being a shadow director for a company

- To avoid being a shadow director for a company, ensure that you:
 - Give advice rather than directions or instructions to the company.
 - Confine your role to the professional capacity in which you have been retained.
 - Provide advice that is within the scope of your professional or business relationship with the directors or the company.

- If you are still concerned that you could be a shadow director, it would also be prudent to ensure, as far as practicable, that:
 - You clearly communicate and record in writing the basis upon which you are to be involved in the company's decision-making process and the advice and assistance to be provided by you to the company.
 - Communications between you and the company are recorded in writing to prove how the board has made decisions in the event that allegations of being a shadow director arise.
 - The company has an independent board of directors to ensure that board are left to make their own decisions in relation to the advice you have given.
 - The directors of the company seek independent advice (such as legal and accounting advice) in circumstances where you and the company have conflicting interests.

Consequences of being a shadow director

- Once a company goes into liquidation, the liquidator will usually look to commence proceedings against some or all of the former directors of the company based on a breach of their duties.
- In identifying the directors, the liquidator will not just look at the validly appointed directors as potential defendants but will also look at those people who were involved in the management of the company as shadow directors.
- If a person was found to be a shadow director, they would have all the same legal obligations, duties and liabilities as any other director of a company.
- This means a shadow director has the same obligations as a director validly appointed, such as to act in good faith in the best interests of the company and with reasonable care and diligence.
- It also means that a shadow director can be found liable for breaching director's duties, such as insolvent trading or unreasonable director related transactions.

Will your Professional Indemnity Insurance cover you if you are found to be a shadow director?

- This will largely depend on your professional indemnity ('PI') insurance policy.
- Generally a PI insurance policy protects professionals against legal liability for claims which arise from the advice or services provided to clients.
- A policy in the name of a corporation will extend to its directors and employees.
- You would need to look at the activities that are covered by the policy, whether any exclusions apply to those activities under the policy and the types of claims that are covered.
- PI policies cover civil liability claims which arise from an insured's conduct of their professional business or the provision of professional services. The four branches of civil law are tort law (such as negligence), contract law, statutory law and equity.
- While the PI policy will generally cover all four branches, the policy will only respond to civil liability claims that arise from the provision of professional services by the insured as stated in the policy schedule.
- This means that if you are acting outside the scope of the professional services you should be providing, then you may not be covered by the PI policy. However, this will depend on the terms of the policy.

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Nothing in this paper is to be considered as legal advice in respect of any particular circumstance. **Readers are encouraged to contact Christina Cavallaro on 02 9265 3092 or cavallaro@eakin.com.au or Mark Doble on 02 9265 3045 or doble@eakin.com.au for further information or for specific advice.**

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