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# Company Managers: Unexpected risks of liability when performing top level management functions

## **Abstract**

This article briefly reviews a number of duties which are imposed upon management and highlights how management were expressly removed from the significant statutory duty to prevent insolvent trading. This article explores circumstances whereby management may still be at risk of being subject to the duty to prevent insolvent trading.

## **Keywords**

role of management, duties, insolvent trading

## **Disciplines**

Business Organizations Law | Law

# COMPANY MANAGERS: UNEXPECTED RISKS OF LIABILITY WHEN PERFORMING TOP LEVEL MANAGEMENT FUNCTIONS

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## Introduction

The role of management in medium to large corporations has recently come under scrutiny. It is recognised that “the reality in most medium to large enterprises is that operational decision making devolves to managers and other individuals below board level who conduct the ongoing business of the corporation”.<sup>1</sup> As a result of this commercial reality, the HIH Royal Commission<sup>2</sup> raised concerns about the adequacy of the *Corporations Act 2001 (Cth)* (*Corporations Act*) to regulate these parties.

This article briefly reviews a number of duties which are imposed upon management and highlights how management were expressly removed from

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<sup>1</sup> Corporations and Markets Advisory Committee ‘Corporate Duties Below Board Level Discussion Paper, May 2005 at 1.

<sup>2</sup> Cited at *ibid* at 2.

the significant statutory duty to prevent insolvent trading. This article explores circumstances whereby management may still be at risk of being subject to the duty to prevent insolvent trading.

### **Common law and equitable duties**

Managers who perform top level management functions are subject to significant duties under common law and equity<sup>3</sup> (ie, 'general law') including the broad duty to act bona fide in the best interest of the company and the duty to act with care, skill and diligence. These general law duties are in addition<sup>4</sup> to duties imposed pursuant the *Corporations Act*.

### **Corporations Act duties**

Managers are subject to a number of significant statutory duties pursuant to ss 180 to 184 *Corporations Act* if they fall within the s 9 definition of 'officer' or 'senior manager', both of which encompass the following identical wording:

a person

(i) who makes, or participates in making, decisions that affect the whole or a substantial part, of the business of the corporation; or

(ii) who has the capacity to affect significantly the corporation's financial standing; ...

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<sup>3</sup> *Green v Bestobell Industries Pty Ltd* (1982) WAR 1, *Canadian Aero Service Ltd v O'Malley* (1973) 40 DLR (3d) 371.

<sup>4</sup> Section 185 *Corporations Act*.

As such, it is recognized that parties 'who have a very influential role in the operations of the company',<sup>5</sup> performing what may be regarded as top level management functions, would seem to fall within the ambit of the statutory definitions of 'officer' and 'senior manager'. A contravention of ss 180 - 183 by managers who fall within the ambit of 'officer' or 'senior manager' would have potentially far reaching consequences as these sections are civil penalty provisions. A contravention of a civil penalty provision may result in a pecuniary penalty order of up to \$200,000 per contravention, compensation orders and possible disqualification from managing a corporation. Furthermore, a contravention of ss 180 - 183 recklessly or with dishonest intent may also result in up to 5 years' imprisonment.

### **Duty to prevent insolvent trading**

Managers who fall within the statutory definition of 'officer' or 'senior manager' may feel relieved that they are not subject to what some regard as the most significant statutory duty designed to prevent blatant abuses of the principle of *Salomon v Salomon & Co Ltd*,<sup>6</sup> namely, the duty to prevent insolvent trading.<sup>7</sup> This duty was introduced as a result of the inadequacies of existing statutory and general law duties to deter and penalise such abuses.

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<sup>5</sup> Hanrahan P, Ramsey I and Stapledon G, *Commercial Applications of Company Law* (7<sup>th</sup> ed, CCH, 2006) 202.

<sup>6</sup> [1897] AC 22.

<sup>7</sup> Section 588G(1) *Corporations Act*.

The statutory duty to prevent insolvent trading initially applied to both 'directors' and 'persons who take part in management'. However, as a result of reforms,<sup>8</sup> 'persons who take part in management' were removed from the ambit of this important duty. As a consequence, managers may believe that they are safe from this significant statutory duty. This article explores circumstances whereby managers may, unexpectedly, still be at risk of falling within the ambit of the duty to prevent insolvent trading.

As 'persons who take part in management' have been excluded from the duty to prevent insolvent trading provisions, in what possible circumstances, if any, can managers conceivably be at any risk of falling within the ambit of this significant duty? After all, the duty to prevent insolvent trading today only applies to 'directors', defined pursuant to s 9 *Corporations Act*, as follows:

'director' of a company or other body means:

(a) a person who:

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

(ii) is appointed to the position of alternate director and is acting in that

capacity;

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<sup>8</sup> *Corporate Law Reform Act 1992* (Cth). Reforms came into effect 23 June 1993. Remarkably, at the same time management were removed from the duty to prevent insolvent trading, a new defence was introduced pursuant to s 588H(3) whereby directors could escape potential liability under these provisions, if they could prove reasonable reliance upon others, which encompassed senior management. It seems puzzling that there was a new defence, which permitted directors to escape liability under these provisions by successfully arguing a defence of reliance upon senior management, when at the same time senior management were removed from the ambit of the duty to prevent insolvent trading.

(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;

This article briefly explores, in what circumstances, if any, will managers be at risk of falling within para (b)(i) of the s 9 definition of 'director'. It is acknowledged that parties who fall within the words 'act in the position of a director' pursuant to para (b)(i) of the s 9 definition of 'director' have attracted the label 'de facto director'.<sup>9</sup> Managers who are at risk of de facto director status, will, therefore, also be at risk of being subject to the duty to prevent insolvent trading provisions of the *Corporations Act* whereby they may be held to be personally liable for company debts incurred while in breach of this duty. The vast majority of managers probably have no idea of this possible risk, which potentially may have far reaching consequences for them.

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<sup>9</sup> Ford HAJ, Austin RP and Ramsey IM, *Ford's Principles of Corporations Law* (11<sup>th</sup> ed, Butterworths, 2003) 310 acknowledge, '[t]he term director is defined in s 9 [*Corporations Act*] to include "de facto" ... directors.'

### **De facto director status**

To assess the risk of de facto director status to company managers, we must clarify the ambit of the statutory definition of de facto director. The phrase 'de facto director' in fact is not included in part (b)(i) of the s 9 statutory definition of 'director'. How then have the simple words 'act in the position of a director' in part (b)(i) of s 9 been interpreted? Madgwick J in *Deputy Commissioner of Taxation v Austin* succinctly commented:

The variety of commercial and corporate life is such that it seems to me unprofitable to attempt a general statement as to what is meant by 'acting as a director'. Whether a person does so act will often be a question of degree, and requires a consideration of the duties performed by that person in the context of the operations and circumstances of the particular company concerned.<sup>10</sup>

In what circumstances, if any, will managers be at risk of falling within the statutory definition of de facto director?

### **Top level management**

It is recognized that, '[c]orporate law has traditionally treated corporate decision making as the preserve of directors. In some smaller corporations, this may still be the case. However, the reality in most medium to large enterprises is that operational decision making devolves to managers and others individuals below board level who conduct the ongoing business of the

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<sup>10</sup> (1998) 16 ACLC 1555, 1559.

corporation'.<sup>11</sup> Are managers to whom operational decision making devolves at risk of falling within the statutory definition of de facto director?

The basic position with respect to the risk of company managers falling within de facto director status is set out well by Millett J (as he was then) in *Re Hydrodan (Corby) Ltd* :

It is not sufficient to show that he was concerned in the management of the company's affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level.<sup>12</sup>

Therefore, managers who perform functions which 'can properly be performed by a manager below board level' are clearly not at risk of falling within the statutory definition of de facto director. These functions may entail regular attendance by managers at board meetings. In *Bridgeport-Advisers and Asset Managers Pty Ltd*<sup>13</sup> Barrett J stated, referring to Mr Hooper (chief executive officer) and Mr May (chief operating officer) who regularly attended board meetings:

There was at all material times, a board of directors that functioned in the usual way. Its composition changed over the relevant period, but its existence and operations did not. Mr Hooper and Mr May attended board meetings as a matter of course. On occasions, they were asked to leave while the directors discussed certain matters, and did so. On that evidence,

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<sup>11</sup> Corporations and Markets Advisory Committee 'Corporate Duties Below Board Level Discussion Paper', May 2005 at 1.

<sup>12</sup> [1994] 2 BCLC 180 at 183.

<sup>13</sup> [2005] NSWSC 757.

there is no suggestion that either of them acted in the position of director. Regular attendance at board meetings at the request of the board (and withdrawal as and when requested by it) does not in any way point to a conclusion of de facto directorship.<sup>14</sup>

What if it is alleged that an executive committee effectively manages a company and not the board of directors? This was the claim in *Re Farmer Furniture Pty Ltd.*<sup>15</sup> It was alleged that a director who resigned and subsequently became a member of the company's executive committee was a de facto director. Furthermore, it was argued that '[t]he company was run by an executive committee (and not by the board of directors) of which the respondent [Bedford] was a member'.<sup>16</sup> As such, it was claimed that Bedford, a former director, was still clearly involved in running the company. At issue was whether this degree of involvement by Bedford in the management of the company constituted Bedford becoming a de facto director. White J held that the 'applicant had not established on a balance of probabilities that the respondent was a de facto director of the Company'.<sup>17</sup> Critical facts in the finding included:

The respondent did have the power to hire and fire staff within the sphere activity (retail sales) ... but this power was not exclusive to directors and other members of the staff, who were not directors of the Company, had such power within their respective areas...

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<sup>14</sup> [2005] NSWSC 757 at [29].

<sup>15</sup> (1998) 16 ACLC 1,110.

<sup>16</sup> (1998) 16 ACLC 1,110 at 1,114.

<sup>17</sup> (1998) 16 ACLC 1,110 at 1,125.

The respondent was an authorised cheque signatory of the Company, but so were other employees of the Company (not being directors)...

The respondent attended meetings of the Executive Committee of the Company after his resignation as a director, but he did so in his capacity as Assistant General Manager (Retail) and not in the capacity of a director.

After his resignation as a director, the respondent did not attend any meetings of directors of the Company and he was not regarded by the directors of the Company as a director thereof.<sup>18</sup>

It is recognised that, in major corporations, while the board of directors provides strategic policy direction, 'many significant decisions are made by management without reference to the board'.<sup>19</sup> Are these managers at risk of de facto director status? Madgwick J in *Deputy Commissioner of Taxation v Austin* acknowledged that:

directors may under the company's constitution be 'entitled to delegate their powers and functions' to other officers or employees of a company; in the case of a large company, this would appear inevitable. But that is not to say that those others necessarily then act in the capacity of a director (nor that a director who has delegated a substantial part of his or her authority ceases to act in that capacity).

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<sup>18</sup> (1998) 16 ACLC 1110, 1116.

<sup>19</sup> *Corporate Duties Below Board Level*, Corporate and Markets Advisory Committee Discussion Paper, May 2005, 3.

This then raises the question, in what circumstances, if any, will these 'other officers' be at risk of de facto director status. His Honour succinctly added:

Whether a delegate or intermeddler is acting as a director will depend upon the nature of the functions or powers which are exercised and the extent of their exercise.<sup>20</sup>

With respect to his Honour's words 'the nature of the functions or powers', it is therefore arguable that managers who frequently exercise wide powers in performing a broad range of top level management functions, which powers are normally undertaken by directors, may be at risk of de facto director status. In contrast, managers who exercise wide powers in performance in a specific field of expertise (for example, marketing, finance, human resource management, etc) may therefore be less likely to be at risk. With respect to his Honour's words 'the extent of their exercise', this also suggests that the longer the period that managers exercise wide powers in a broad range of top level management functions, the greater their risk of falling within de facto director status.

### **Holding out**

Management (and employees) who hold themselves out (or allow themselves to be held out) as a director and perform the usual functions of a director are clearly at significant risk of falling within the statutory definition of de facto director. In *Austin and Partners Pty Ltd v Spencer*,<sup>21</sup> Windeyer J held that

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<sup>20</sup> (1998) 16 ACLC 1555, 1559.

<sup>21</sup> Unreported NSW Supreme Court 1 December 1998. See (April 1999) *Australian Company*

although Spencer joined Austin and Partners Pty Ltd as an employee, he nevertheless was always treated as a director of the company. Spencer signed letters under the heading of directors, attended all board of directors meetings, participated in the decision making process of the board and was essentially always treated as a director. This case clearly had extreme facts in support of de facto director status.

What then is the position of a party who is not actively involved in the day to day operations of a company? This was the circumstances of Mrs McArthur in *Commonwealth Bank of Australia v McArthur*.<sup>22</sup> Mrs McArthur held all the issued shares in Concert Music Retailers Pty Ltd in equal proportion with her son. However, she 'performed only minor services in the day to day conduct of the company'.<sup>23</sup> Dodds-Streeton J held Mrs McArthur was a de facto director. Critical facts included that she permitted herself to be held out to third parties as a director, 'was closely involved in the high level management of the company's affairs, was informed and aware of all significant developments and was an active participant with Mr McArthur in the decision-making at management level'.<sup>24</sup>

Both cases should be a strong warning to parties involved in 'high level management' who hold themselves out or permit themselves to be held out as a

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*Secretary* 124.

<sup>22</sup> [2003] VSC 31.

<sup>23</sup> [2003] VSC 31 at [184].

<sup>24</sup> [2003] VSC 31 at [186-7].

director. However, it must be acknowledged that holding oneself out (or permitting oneself to be held out) as a director are extreme facts which to date have only occurred in smaller companies.

## **Conclusion**

Managers who are at risk of falling within the statutory definition of de facto director will be at risk of falling within the ambit of the duty to prevent insolvent trading provisions. There has been a number of cases in Australia and the United Kingdom where managers have been held subject to obligations because of their de facto director status. However, all these cases concerned to smaller companies. There is no case authority where a manager in a major corporation has been held, or even alleged to be, a de facto director.

Finally, a number of key legal issues and risk factors concerning claims of manager de facto director status highlighted in this article include:

- Performance of top level management functions which can properly be performed by managers below board level is not sufficient to establish de facto director status.
- Specialist managers appear to be at less risk than managers performing a wide range of management matters.

- Regular attendance by managers at board meetings alone is not enough to establish de facto director status.
- Where managers perform top level management functions and allow themselves be held out as directors, this is cogent evidence in support of de facto director status.
- The risk of de facto director status may increase the more important the management functions undertaken, the broader the range of management matters performed, the more frequent the exercise of these management functions and the longer the length of time the functions are undertaken.

In summation, managers who perform a broad range of top level management functions over an extended period of time, particularly in smaller companies, are at greater risk than managers in major corporations.