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The Law of Shadow Directorships

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Abstract
This paper seeks to examine and critically analyse the law of shadow directorships. The characteristics that define a shadow director are considered in detail. Further consideration is given to the duties and obligations associated with shadow directorships and the circumstances in which a shadow director may be liable to compensate the company. The potential liability of corporate advisers, financiers, creditors and controlling entities is also discussed. In conclusion, the author submits that whilst the Corporations Law properly extends liability to corporate 'string-pullers', the words of the section fail to provide the necessary degree of certainty.

Keywords
shadow directors, de facto directors, fiduciary obligations, liability of directors, corporate law

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The author acknowledges and thanks Professor John Farrar of the Bond University School of Law for his assistance and guidance in the preparation of this paper. The author also thanks Dr Darryl McDonough, Clayton Utz, Brisbane, for his insightful comments on an earlier draft of this paper.

THE LAW OF SHADOW DIRECTORSHIPS

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Introduction

The existence of a separate and distinct corporate personality is one of the fundamental and central principles of modern company law.[1] Upon the incorporation of a company, a new legal entity is created.[2] This entity has been described as 'an artificial person composed of natural persons'.[3] However, an incorporated company attains an existence which is distinct from both its directors and shareholders.[4] The separate legal personality of a limited liability company was firmly established by the House of Lords in *Salomon v A Salomon & Co Ltd*.[5] This 'veil of incorporation' has obvious benefits for dynamic capitalist economies.[6] Limited liability promotes entrepreneurship and shareholder investment in potentially productive but uncertain enterprises.[7] However, the privileges of limited liability must be balanced against its costs.[8] Persons who extend credit to a company endure the risk of significant losses in the event of corporate misconduct or insolvency.

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* The author acknowledges and thanks Professor John Farrar of the Bond University School of Law for his assistance and guidance in the preparation of this paper. The author also thanks Dr Darryl McDonough, Clayton Utz, Brisbane, for his insightful comments on an earlier draft of this paper.

1 See Ford H A J, Austin R P and Ramsay IM, *Ford's Principles of Corporations Law* (9th ed) Butterworths (1999) Chapter 4; Farrar J H and Hannigan B, *Farrar's Company Law* (4th ed) Butterworths (1998), Chapter 6. With reference to the leading case of *Salomon v A Salomon & Co Ltd* [1897] AC 22, it has been stated that the 'rejection by the House of Lords of the doctrine of agency to impugn the non-liability of members for the acts of the corporation is the foundation of our modern company law': *MacLaine Watson & Co Ltd v Department of Trade and Industry* [1988] 3 WLR 1033 at 1098 per Kerr LJ.

2 Section 119 of the Corporations Law provides that a company comes into existence as a body corporate at the beginning of the day on which it is registered.

3 Henn H G and Alexander J A, *Corporations* (3rd ed) West Publishing, St Paul, Minn. (1983) at 145. Section 124(1) of the Corporations Law provides that a company has, both within and outside the jurisdiction, the legal capacity of an individual.

4 See *Salomon v A Salomon & Co Ltd* [1897] AC 22; *Macaura v Northern Assurance Co Ltd* [1925] AC 619; *Lee v Lee's Air Farming Ltd* [1961] AC 12.

5 [1897] AC 22. Per Lord McNaughten at 51: 'The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustees for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.'

6 Lipton P and Herzberg A, *Understanding Company Law* (8th ed) LBC (1999) 323.

7 *Ibid.* It is beyond the scope of this paper to consider the complete legal and economic consequences of limited liability. However, suffice it to say, the risk of business failure is transferred from the company's shareholders to the creditors of the company.

8 In *Metal Manufacturers Ltd v Lewis* (1988) 13 ACLR 357, Kirby P (dissenting) observed (at 359) that: 'There is little doubt that the separation of the corporation from the entrepreneurs behind it provided the 'essential impulse' to the most remarkable economic development of the last 200 years. Although those dealing with a corporation would sometimes suffer upon its insolvency and liquidation, a social judgement was made that their losses were the price occasionally to be borne, where the protective mechanisms of company law had earlier failed, upon the basis that the general immunity of directors, as of investors, from the liability for the debts of the corporation promoted the innovation, investment and risk-taking...'; cited in Tomasic R, Jackson J and Woellner R, *Corporations Law: Principles, Policy and Process* (2nd ed) Butterworths (1992) 107-108.

Despite criticism of the House of Lords' decision,[9] the *Salomon* principle has been consistently applied in subsequent cases.[10] However, there has been increasing recognition that the inflexible application of the separate entity doctrine and limited liability may result in undesirable consequences.[11] It has further been recognised that the *Salomon* principle governing risk allocation is not always appropriate.[12] Both the courts and legislature have attempted to draw a distinction between legitimate and illegitimate risk taking.[13] Given the directors' position of power - and the perceived vulnerability of shareholders and creditors - the general trend has been to increase the accountability of directors and of other persons involved in the management of companies.[14] Olney J commented on this trend in *Chew v NCSC (No 2)*[15]:

> The making of laws in relation to companies and the persons who are involved in the formation and management of companies could be described as one of the contemporary growth industries. I think it is fair to say, however, that since the introduction of the concept of limited liability the potential for companies and the dealing in interests in them to be used as a means of defrauding both the gullible and the greedy has been recognised and so it is that over a long period of time as the wit of man has been applied to the pursuit of material gain through the use of companies it has been necessary for the law to become more and more complex to the extent that in these times few if any could honestly claim to have a complete understanding of all the intricacies of the regulatory provisions that now apply. Be that as it may, one theme which prevails throughout the whole complex structure of company law is that those in a position to take advantage of the special position they may exercise in the promotion or management of companies must always act with the utmost care, diligence and honesty so that those who are less well informed are not unfairly taken advantage of.[16]

In order to protect the interests of shareholders and creditors - and to generally regulate corporate conduct in the public interest[17] - the law subjects directors to

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9 See (1897) 13 *LQR* 6; and (1944) 7 *MLR* 54, in which Professor Otto Kahn-Freund described the *Salomon* decision as 'calamitous'.

10 Although *Salomon v A Salomon & Co Ltd* [1897] AC 22 was not specifically cited, the decision of the Federal Court in *Bond v Australian Broadcasting Tribunal* (1989) 89 ALR 185 is a recent illustration of the effects of the separate legal identity of the corporation. It should be noted that the courts have recognised a limited range of circumstances in which they will 'lift the corporate veil'; see generally Ford H A J and Austin R P, *Ford's Principles of Corporations Law* (9th ed) Butterworths (1999) para [4.350] et seq.

11 Lipton and Herzberg, above n 6 at 31.

12 In *Quintex Australia Finance Ltd v Schroeders Australia Ltd* (1991) 9 ACLC 109, Rogers CJ Comm D, of the Supreme Court of New South Wales, suggested that the whole issue of the separateness of the corporate entity should be re-examined in the context of modern commercial contracts. With respect to corporate groups, Rogers CJ Comm D observed (at 111) that 'Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bear the liability… As well, creditors of failed companies encounter difficulty when they have to select from amongst the moving targets the company with which they consider they concluded a contract. The result has been unproductive expenditure on legal costs, a reduction in the amount available to creditors, a windfall for some, and an unfair loss to others. Fairness or equity seems to have little role to play.' Quoted in Baxt R, 'Tensions Between Commercial Reality and Legal Principle - Should the Concept of the Corporate Entity be Re-examined?' (1991) 65 *ALJ* 352.

13 Lipton and Herzberg, above n 6 at 323.

14 Lipton and Herzberg, above n 6 at 323; Ford, above n 1 at para [7.060].

15 (1985) 3 ACLC 212.

16 (1985) 3 ACLC 212 at 218.

17 In Tomasic R and Bottomley S, *Directing the Top 500: Corporate Governance and Accountability in Australian Companies*, Allen & Unwin (1993) the authors put forward a strong argument to suggest (at 86)

strict fiduciary and statutory duties.[18] The general law fiduciary obligations of a director are reinforced by the statutory duties contained in s 232 of the Corporations Law.[19] However, of particular concern for directors is the personal liability that attaches to a breach of these duties. In certain circumstances, the court may hold that a director is liable to compensate the company for any loss or damage suffered as a result of the director's breach.[20]

The law imposes an onerous burden upon company directors.[21] There are also significant consequences for directors who fail to discharge their obligations.[22] It is therefore of paramount importance to recognise who the courts will hold to be a director.[23] The Corporations Law has extended the definition of 'director' to include not only '*de jure* directors',[24] but also those persons who purport to act as directors.[25] Under s 60(1)(a) of the Corporations law, any person who holds himself out as a company director[26] cannot escape duty or liability by declining formal appointment.[27] Section 60(1)(b) further extends the definition

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that 'there are limits to the extent to which formal legal rules may be used to control corporate and individual misconduct covered by the Corporations Law'. It is further suggested that the conduct of companies is more closely related to the personal ethics of the directors rather than the provisions of the law: see generally Tomasic and Bottomley, op cit, Chapter 6 - 'Ethics and Accountability'.

18 Ford, above n 1 at 281. The general duties of directors and those specifically attracted by shadow directors are considered below.

19 Section 232(11) expressly states that section 232 'has effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person by reason of the person's office or employment in relation to the corporation and does not prevent the institution of any civil proceedings in respect of a breach of such a duty in respect of such a liability.'

20 The circumstances in which a director will be held liable to pay compensation to the company (or company creditors) are considered below.

21 According to Tomasic and Bottomley, much has been written about the burden imposed upon directors by the law of directors' duties. In their survey of company directors, all respondents were asked whether they agree with the view that the legal duties of directors were onerous. Whilst there was general agreement that the duties were onerous in nature, the authors distinguished three categories of attitudes amongst the respondents: (i) that the duties were 'conceptually onerous' but limited in practice due to the lack of enforcement; (ii) that the duties were onerous, but not unreasonably so; and, (iii) that the duties were so onerous that they were considered as 'obstacles' in the management of a company rather than obligations. See Tomasic and Bottomley, above n 17 at 75.

22 It should be noted that the Corporations Law is concerned with imposing duties on all those who take part in the management of companies — not only directors. As such, many duties are imposed upon 'officers' of the company. 'Officer' is defined in s 9 of the Corporations Law to include directors, secretaries, executive officers, employees and managers of insolvent companies such as receiver managers and liquidators under a voluntary winding up: Lipton and Herzberg, above n 6 at 305.

23 Such a question is not only important to those acting as directors — it may also be relevant to the creditors of an insolvent company seeking redress for their losses.

24 Markovic defines a '*de jure* director' as a director who has been validly appointed in the position pursuant to the company's articles of association: Markovic M, 'The Law of Shadow Directorships' (1996) 6 *Aust Jnl of Corp Law* 323 at 323. See also the judgement of Millett J in *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 in which he distinguishes between *de jure*, shadow, and de facto directors.

25 Section 60(1) of the Corporations Law. Similar extended definitions of 'director' are contained in the companies legislation of many common law jurisdictions including Singapore, Hong Kong, New Zealand and the United Kingdom: Koh P M C, 'Shadow Director, Shadow Director, Who Art Thou?' (1996) 14 *C&SLJ* 340 at 340.

26 Whilst s 60(1)(a) does not use the expression, such persons are commonly referred to as 'de facto' directors.

27 Koh, above n 25 at 340. Section 60(1)(a) provides that a director includes 'a person occupying or acting in the position of director of a body, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position'. In *Corporate Affairs Commissioner (NSW) v Drysdale* (1978) 141 CLR 236; 22 ALR 161, the High Court held that persons who knowingly assume, whether dishonestly or not, to act in a particular role cannot escape the liability for acts done in that role that would have been incurred by a person properly appointed to that role: Ford and Austin, above n 1 at 255 - 256. Ford and Austin (at 256) liken the duties and liability of a de facto director to the equitable duties of a trustee *de son tort* under the law of trusts.

of 'director' to include 'shadow directors'[28] - that is, those persons who remain behind the scenes whilst exerting influence over the administration of company affairs.[29] Clearly, any person who wishes to 'dabble in the affairs of a company' must conduct themselves 'in accordance with the standards expected of all company directors.'[30]

Despite the 'self-explanatory'[31] nature of the statutory definition, there is considerable uncertainty regarding the ambit of s 60.[32] Whilst de facto directors will generally be betrayed by their very conduct,[33] the identification of shadow directors presents an arduous task. This may, at least in part, be attributed to a lack of judicial guidance.[34] However, recent decisions by Australian, New Zealand and English courts have shed substantial light on 'the law of shadow directorships'.[35]

This paper seeks to examine and critically analyse the law of shadow directorships. The characteristics that define a shadow director are considered in detail. Further consideration is given to the duties and obligations associated with shadow directorships and the circumstances in which a shadow director may be liable to compensate the company. The potential liability of corporate advisers, financiers, creditors and controlling entities is also discussed. In conclusion, the author submits that whilst the Corporations Law properly extends liability to corporate 'string-pullers', the words of the section fail to provide the necessary degree of certainty.

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28 The Corporations Law does not specifically make reference to the term 'shadow directors'. However, s 741(2) of the *Companies Act* 1985 (UK) clearly distinguishes this class of directors by providing a separate definition of a 'shadow director'. According to Koh, above n 25 at 340, the distinction between 'de facto' directors and 'shadow' directors was clarified by Millett J in *Re Hydrodam (Corby) Ltd* [1994] BCC 161 at 163. Previously, the terms were frequently used interchangeably — see *Re Tasbian (No 3) Ltd* [1991] BCC 435.

29 Koh, above n 25 at 340. Section 60(1)(b) provides that a director includes 'a person in accordance with whose directions or instructions the directors of the body are accustomed to act'. Although a body corporate cannot be appointed as a director, it is possible for a corporation to be caught be this extended statutory definition. The circumstances in which a corporation may incur liability are considered below.

30 Koh, above n 25 at 340.

31 Fidler P, 'Banks as Shadow Directors' [1992] 3 *Journal of International Banking Law* 97 at 97, observes that 'the definitions are self-explanatory' and that only the reference to 'in a professional capacity' calls for comment. Although Fidler was referring to the UK legislation, the provision is substantially similar to that of the Corporations Law. It is suggested that upon critical examination of the statutory definition, many other issues justify consideration.

32 Markovic, above n 24 at 323.

33 Koh, above n 25 at 340.

34 Baxt R, 'Liability of Shadow Directors for Insolvent Trading - Australian Authorities Start to Bite' (1996) 14 *C&SLJ* 121 at 121 states that 'the law relating to shadow directors in Australian company law has been quite 'negligible'insofar as decision of the court are concerned.' This is further highlighted by Loose P, Yelland J and Impey D, *The Company Director; Powers and Duties* (7th ed) Jordans (1993), at 222 where it is stated that 'it cannot be pretended that the judges have thrown much light on the outer limits of 'shadow status''; cited by Markovic, above n 24 at 323.

35 Markovic, above n 24 at 323.

Director's Duties and Liability[36]

General Law Fiduciary Obligations

The relationship between director and company is that of a fiduciary. As such, a director owes certain fiduciary duties to the company.[37] These duties include:

- the duty to act bona fide in the interests of the company;
- the duty to exercise powers for their proper purpose;
- the duty to retain discretionary powers; and
- the duty to avoid conflicts of interest.[38]

Directors also owe a common law duty to exercise care, diligence and skill.[39]

Whilst the powers of management are generally conferred upon the board of directors collectively,[40] the fiduciary obligations are owed by individual

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36 It is beyond the scope of this paper to undertake a detailed examination of the duties and obligations of company directors. However, in order to fully appreciate the significance of shadow directorships it is necessary to consider the associated duties and obligations. Therefore, the duties of directors (including shadow directors) are briefly considered. This is not intended to be a thorough analysis of the law relating to directors' duties; but rather, a succinct summary of relevant general law and statutory provisions.

37 The relationship of director and company has often been compared to that of trustee and beneficiary. Whilst both are fiduciary relationships, the intrinsic risk of commercial enterprise requires that directors be given a greater degree of freedom in the management of a company. In *Re City Equitable Fire Insurance Co* [1925] 1 Ch 407, Romer J observed: 'It has sometimes been said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship to the company the statement is true enough. But if the statement is meant to be an indication by way of analogy of what those duties are, it appears to me to be wholly misleading. I can see but little resemblance between the duties of a director and the duties of a trustee of a will or marriage settlement.'

38 The general principle regarding the exercise of powers conferred on directors was enunciated by Lord Green MR in *Re Smith and Fawcett Ltd* [1942] Ch 304 where it was stated (at 306) that directors 'must exercises their discretion bona fide in what they consider - not what the court may consider - to be in the interests of the company, and not for any collateral purpose.' The duty is subjective in nature; generally there will be no breach of duty where the directors honestly believe that they are acting in the best interests of the company. However, a number of cases has held that directors may breach their duty, even if acting in what they genuinely consider to be an honest manner, if they fail to give proper consideration to the interests of the company: Ford, above n 1 para [8.080].

39 The common law previously adopted the position that so long as a director acted honestly, he or she would not be liable in damages unless guilty of gross negligence: *Re City Equitable Fire Insurance Co* [1925] 1 Ch 407. However, the decision of the New South Wales Court of Appeal in *Daniels & Ors v Anderson & Ors* (1995) 13 ACLC 614 represented a paradigm shift in the law of directors' duties. The Court discarded each of the propositions enunciated by Romer J in *Re City Equitable Insurance Co.* Burnett B, (ed) *1999 Australian Corporations Law*, CCH (1999) at 278, citing *Daniels v Anderson* (1995) 13 ACLC 614 at 652-666, summarises the current law: '(1) A director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience. That duty involves becoming familiar with the business of the company and how it is run, and ensuring that the board has sufficient means to audit the management of the company so that it can satisfy itself that the company is being properly run. (2) The amount of time that a director should devote to the company is determined by the director's duties and responsibilities. It is not a matter of tailoring the duty to match the number of board meetings. (3) The question of reliance on company officers should be treated as part of the general issue of directors' duties. In other words, whether a director could rely on company officers was not something that could be decided apart from the director's general duties to the company. Directors have a duty to be generally familiar with the business and financial conditions of the company, and to devote a sufficient amount of time and energy to overseeing the company's affairs; that duty cannot be met solely by relying on other persons.'

40 See Article 66, Schedule 1 Table A. But see now s.226A(1) (replaceable rule).

directors.[41] The fiduciary nature of directors' duties requires them to maintain standards that may be well above those applied to other business relationships. Thus, if a director gains a benefit from breaching his or her fiduciary duties, the director will be accountable to the company even if, in business terms, 'the level of the benefit received is reasonable and in line with what the director would have received had he or she been a third party dealing with the company at arm's length.'[42]

Section 232 of the Corporations Law

The general law fiduciary obligations are supplemented by similar statutory duties contained in s 232 of the Corporations Law. These duties are expressly stated to operate in addition to the general law obligations of directors.[43] The duties imposed under s 232 are contained in the following provisions:

- section 232(2) requires officers of a corporation, in the exercise of their powers and in the discharge of the duties of their office, to at all times act honestly;

- section 232(4) requires officers of a corporation, in the exercise of their powers and in the discharge of their duties, to exercise a degree of care and diligence that a reasonable person in a like position would exercise in the corporations circumstances;[44]

- section 232(5) prohibits officers or employees or former officers or employees of a corporation from making improper use of information acquired by virtue of their position to gain, either directly or indirectly, an advantage to themselves or any other person, or to cause detriment to the corporation; and

- section 232(6) prohibits officers or employees of a corporation from making improper use of their position to gain, either directly or indirectly, an advantage to themselves or any other person, or to cause detriment to the corporation.[45]

Section 232(6B) declares these subsections to be civil penalty provisions. As such, Part 9.4B of the Corporations Law provides for civil and criminal consequences of contravention. The civil penalty provisions empower the court to make orders that a person be prohibited from managing a corporation or that the person pay a pecuniary penalty of up to $200,000 to the Commonwealth.[46] Criminal sanctions may also apply where the contravention is committed with a

41 Lipton and Herzberg, above n 6 at 266.
42 Burnett above n 39 at 282, citing *Cummings & Anor v Claremont Petroleum NL* (1993) 11 ACLC 125.
43 Section 232(11). See above n 19.
44 Section 232(4) explicitly imposes an objective test and was rewritten in order to reflect what parliament saw as the current attitude of Australian courts: Burnett, above n 42 at 291.
45 Section 232(1) contains a definition of 'officer' for the purposes of s 232, and includes, inter alia, directors, secretaries, executive officers, receivers, administrators, liquidators and trustees.
46 Section 1317EA(3).

dishonest intent.[47] The court may also order that a person pay compensation to the company for any profits made or losses suffered by the company.[48]

Section 588G of the Corporations Law

Section 588G of the Corporations Law provides that a director is under a duty to prevent his or her company from engaging in insolvent trading. The section applies to circumstances in which a company incurs a debt whilst insolvent, or becomes insolvent by incurring that debt; and, at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent.[49] A director contravenes this section if he or she fails to prevent the company from incurring the debt and

- the director is aware at that time that there are such grounds for so suspecting; or

- a reasonable person in a like position in a company in the company's circumstances would be so aware.[50]

Section 588H provides four alternative defenses available for directors who would otherwise be in breach of s 588G. A director will not be liable for insolvent trading if, at the time the debt was incurred

- the director had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if it incurred the debt;[51]

- the director had reasonable grounds to believe, and did believe:

  (i) that a competent and reliable person was responsible for providing to the director adequate information about whether the company was solvent; and

  (ii) that that person was fulfilling that responsibility; and

  expected, on the basis of the information provided by that other person, that the company was solvent and would remain solvent even if it incurred the debt;[52]

- the director, because of illness or for some other good reason, did not take part in the management of the company;[53] or

47 Section 1317FA(1).
48 Sections 1317HA and 1317HD.
49 Section 588G(1).
50 Section 588G(2).
51 Section 588H(2).
52 Section 588H(3).
53 Section 588H(4).

- the director took all reasonable steps to prevent the company from incurring the debt.[54]

Section 588G(3) declares the section to be a civil penalty provision. As such, there are civil and criminal consequences of contravention similar to those that attach to a breach of the s 232 duties. Section 588M(2) provides that a company's liquidator may recover compensation from company directors for debts incurred by the company in breach of s 588G. In certain circumstances company creditors may also institute proceedings against the directors for the recovery of debts incurred in breach of s 588G.[55]

Other Statutory Provisions

There are many provisions of the Corporations Law that impose duties and liabilities upon company directors. In addition to the civil penalty provisions of sections 232 and 588G, directors may be liable for a range of other pecuniary penalties.[56] Provisions imposing liability on company directors range from fraudulent trading[57] to wrongful payment of dividends.[58] Clearly, directors should be wary of the potential liability flowing from their actions.

Shadow Directorships

Statutory Definition of 'Director'

Strictly speaking, the Corporations Law does not define the term 'director'.[59] However, s 60(1) provides that certain persons are to be included in references to a 'director'.[60] As such, s 60(1) provides an inclusive rather than exhaustive definition.[61] Section 60 states that:

> **60(1)** Subject to subsection (2), a reference to a director, in relation to a body, includes a reference to:
>
> (a) a person occupying or acting in the position of director of the body, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position;

54 Section 588H(5).
55 Section 588M(3). The section provides that a creditor may recover an 'amount equal to the amount of the loss or damage'.
56 The prescribed penalties for breaches of various provisions of the Corporations Law are contained in Schedule 3 of the Corporations Law.
57 Section 596.
58 Sections 254T, 256D(3). See also section 232(4); Ford above note 1 para [18.110].
59 Markovic, above n 24 at 325.
60 With reference to the UK legislation, Browne-Wilkinson VC noted in *Re Lo-Line Electric Motors* [1988] BCLC 698 at 706 that 'it is not possible to treat a de facto director [presumably the same applies to a shadow director] as a 'director' for all the purposes of the 1985 [Companies] Act. Thus in ss 282 (minimum number of directors), 291 (directors' share qualifications), 293(2) (age limits), and 288 (register of directors) the word 'directors' must be referring to *de jure* directors alone. On the other hand, in some sections the word 'director' must include a person who is not a *de jure* director.' It follows that the same would apply to the corresponding provisions of the Corporations Law.
61 Markovic, above n 24 at 325. See also the judgment of Browne-Wilkinson VC in *Re Lo-Line Electric Motors* [1988] BCLC 698 at 706

(b) a person in accordance with whose directions or instructions the directors of a body are accustomed to act;

(c) in the case of a body incorporated or formed outside of Australia;

(i) a member of the body's board;

(ii) a person occupying or acting in the position of member of the body's board, by whatever name called and whether or not validly appointed to occupy, or duly authorised to act in, the position; and

(iii) a person in accordance with whose directions or instructions the members of the body's board are accustomed to act.

60(2) A person shall not be regarded as a person in accordance with whose directions or instructions:

(a) a body's directors; or

(b) the members of the board of a body incorporated or formed outside Australian;

are accustomed to act merely because the directors or members act on the advice given by the person in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors or the members of the board or with the body.

60(3) For the purposes of subsection (1), if there are no positions of director (by whatever name called) in relation to a body, the reference in paragraph (1)(a) to a position of director of the body is a reference to a position the holder of which has control, or shares control, over the general conduct of the affairs of the body.

The concept of the shadow director, as encapsulated by s 60(1)(b), has a long history in English company law.[62] Furthermore, a similar provision was contained in each of the state Companies Acts. Although entrenched in the companies legislation, the concept of the shadow director has not been the subject of detailed judicial consideration. It would appear that, until recently, the issue of shadow directorships had not arisen in any reported decision.

Before attempting to explain the elements of s 60(1)(b), it is of assistance to review the limited number of cases relating to shadow directorships. Given the similar provisions of the United Kingdom and New Zealand[63] companies

62 As Justice Millett pointed out in 'Shadow Directorships, a Real or Imagined Threat to Banks' (1991) 1 *Insolvency Practitioner* 14 at 15, 'a similar definition of shadow director has been in every Companies Act (UK) since the Companies Act, 1929.' Cited in Markovic, above n 24 at 324.

63 The decisions of the Privy Council in *Kuwait Asia Bank E.C. v National Mutual Life Nominees Ltd* (1990) 5 NZCLC 66,590 and the High Court of New Zealand in *Dairy Containers Ltd v NZI Bank Ltd* (1995) 7 NZCLC 96,669 were based on the *Companies Act* 1955 (NZ) which contained a definition similar to the Australian provision. However, following the introduction of the *Companies Act* 1993 (NZ) the definition

legislation, the decisions of those jurisdictions may be given some weight when considering the Australian law.

Case Law - Shadow Directorships

Re a Company (No 005009 of 1987) ex parte Copp[64]

This is the first reported decision in which the English courts considered the definition of 'shadow director' under s 251 of the Insolvency Act 1986 (UK). The facts of the case, as outlined by Knox J, were substantially as follows.[65] The company had been trading profitably until the end of 1986 when it lost a major customer. There was a steep fall in the company's profitability and its liquidity following the loss of this customer. The company's overdraft limit was reached and it was at this point in time that the company's bank first became aware of the decline in the company's financial position. Previously the bank had had confidence in the company's financial standing and had not taken security in respect of the overdraft. The overdraft limit in early 1987 stood at £300,000.

The bank, when appraised of the difficulties, commissioned a report form its own financial services section on the affairs of the company and started, at much the same time, to exert pressure for security for its overdraft. The company subsequently granted a debenture in favour of the bank in respect of the overdraft. The company entered into insolvent liquidation three months after the creation of the debenture.

Various steps were taken by the company and its directors to implement the recommendations that were contained in the bank's report. The company's liquidators claimed that, in the prevailing circumstances, these steps sufficed to make the bank a shadow director of the company. The liquidators further claimed that the bank was aware, at an early stage, that the company was insolvent and had no reasonable prospect of avoiding insolvent liquidation.

The question before Knox J was whether the claim was, on the facts, obviously unsustainable. Knox J refused to strike out the claim that the bank was liable for wrongful trading;[66] his Honour held that the liquidator's allegation that the bank was a shadow director was not obviously unsustainable.[67] Knox J's judgment contributed little to the understanding of shadow directorships. However, the case generated significant concern in the banking community.[68]

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of director was amended. The New Zealand statutory definition of shadow director will be considered below.

64 [1989] BCLC 13

65 *Ibid* at 18.

66 Section 214 of the Insolvency Act 1986 (UK) prohibits wrongful trading. Section 214(7) expressly extends liability to include shadow directors.

67 [1989] BCLC 13 at 21.

68 Farrar J H and Hannigan B, *Farrar's Company Law* (4th ed) Butterworths, London (1998) 342: Following Knox J's judgment there were calls 'for an amendment to the definition to make it clear that it is not applicable to financial institutions in such cases. The argument in favour of such an exclusion being that the effect of treating banks as shadow directors will be to impede their rescue efforts when a company is in difficulty.'

At the subsequent hearing of the case (reported as *Re MC Bacon Ltd*[69]), the liquidator abandoned the claim against the bank. The presiding judge, Millett J, stated that the claim was 'rightfully abandoned'[70] thereby suggesting that he was not persuaded of the argument that the bank was a shadow director.[71]

Kuwait Asia Bank E.C. v National Mutual Life Nominees Ltd[72]

This was an appeal to the Privy Council from the New Zealand Court of Appeal. The main issue before the court ultimately involved procedural matters relating to the service of a statement of claim outside of the jurisdiction. However, the court also considered the definition of director under s 2 of the Companies Act 1955 (NZ). The facts of the case, as relevant to the issue of shadow directorship, were as follows.[73] The Kuwait Bank and Kumutoto Holdings Ltd held a beneficial interest in about 80 per cent of the shares in A.I.C. Securities Ltd ('AICS'). By agreement between the bank and Kumutoto there were five directors of AICS, three nominated by Kumutoto and two by the bank. The bank nominated House and August, both of whom were employed by the bank.

In August 1986, AICS became insolvent and went into liquidation. The unsecured depositors of AICS brought an action against the plaintiff for breach of trust, alleging that the plaintiff failed to perform its duties under the trust deed with diligence and competence. The depositors' claim amounted to $14.5 million, and the plaintiff thought it prudent to settle the litigation by paying $6.75 million.

The plaintiff subsequently brought proceedings seeking contribution from several defendants. Originally its claim was against the auditors of AICS. Later it brought proceedings against the directors and company secretary of AICS. That action was subsequently consolidated with the original proceedings. In July 1988, the plaintiff sought leave to join the bank as a defendant in the consolidated proceedings. That leave was granted and it was the subsequent service of proceedings on the bank outside New Zealand that was the subject of the appeal to the Privy Council.

The plaintiff pleaded four causes of action against the bank.[74] The plaintiff alleged, inter alia, 'that House and August were persons occupying a position of directors of AICS who were accustomed to act in accordance with the bank's directions, and that therefore the bank was a director of AICS within the meaning of section 2 of the Companies Act, and was accordingly liable for any loss occasioned to the plaintiff by the acts or omissions of House and August.'[75]

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69 [1990] BCLC 324.
70 *Ibid* at 326.
71 See also the extra-judicial statement of Justice Millett in 'Shadow Directorship - a Real or Imagined Threat to Banks' (1991) 1 *Insolvency Practitioner* 14.
72 [1991] 1 AC 187.
73 *Ibid* at 202-203.
74 The causes of action pleaded included (i) that the bank was vicariously liable for the actions of its nominees; (ii) that House and August were agents of the bank; (iii) that the bank owed a duty of care; and (iv) that the bank was a shadow director of A.I.C.S.
75 [1991] 1 AC 187 at 203.

The Privy Council held that the statement of claim did not disclose any cause of action against the bank.[76] Lord Lowry, delivering the opinion of the Judicial Committee, stated that:

> In the present case House and August were two out of five directors, the other three being appointees of Kumutoto. And there is no allegation (and it is also inherently unlikely) that the directors in these circumstances were accustomed to act on the direction or instruction of the bank.
>
> The only rights and remedies of the plaintiff were against AICS for breach of contract and against the directors of AICS who owed a duty to the plaintiff... House and August were directors but the bank was not a director. The bank never accepted or assumed any duty of care towards the plaintiff. In the absence of fraud or bad faith on the part of the bank, no liability attached to the bank in favour of the plaintiff for any instructions or advice given by the bank to House and August. Of course, it was in the interests of the bank to give good advice and to see that House and August conscientiously and competently performed their duties both under the trust deed and as directors of AICS. [77]

This statement has consistently been cited as authority that before the bank could be treated as a director under section 2(1) of the Companies Act 1955 (NZ),[78] *all* the directors of the company had to be accustomed to act on the bank's directions or instructions.[79] However, it is suggested that the words of Lord Lowry do not provide unequivocal guidance in this regard.[80]

Re Hydrodam (Corby) Ltd[81]

The proceedings arose following the liquidation of Hydrodam (Corby) Ltd, a wholly-owned indirect subsidiary of Eagle Trust plc.[82] The company liquidator made an application in the County Court against 14 defendants alleging that they had been guilty of wrongful trading and seeking orders against them under s 214 of the Insolvency Act 1986 (UK). The defendants included Eagle Trust itself, one of its subsidiaries and all its directors.[83] The defendants to the application before Millett J were two Eagle Trust directors. They sought to have the liquidator's claim against them struck out as disclosing no reasonable cause of action. Hydrodam (Corby) Ltd only had two validly appointed directors (two Channel Island companies); the two defendants had never been appointed directors of the company. The liquidator asserted that the defendants were de

76 *Ibid* at 224.
77 [1991] 1 AC 187 at 223-224.
78 Section 2(1) of the Companies Act 1955 (NZ) provides that a director includes 'a person in accordance with whose directions or instructions the persons occupying the position of directors of a company are accustomed to act.'
79 Markovic, above n 24 at 330.
80 The requirements of the statutory extended definition are considered below.
81 [1994] 2 BCLC 180.
82 *Ibid* at 180-181.
83 Whilst s 741(3) of the Companies Act 1985 (UK) provides that a body corporate is not to be treated as a shadow director of any of its subsidiaries by reason only that the directors of the subsidiary are accustomed to act in accordance with its directions or instructions, no such proviso exists in the case of proceedings under s 214 of the Insolvency Act 1986 (UK).

facto or shadow directors of Hydrodam (Corby) Ltd by virtue of s 251 of the Insolvency Act 1986 (UK).

The question before Millett J was whether the defendants were directors of Hydrodam (Corby) Ltd as contemplated by s 214 of the Insolvency Act 1986 (UK). Millett J commenced by differentiating between the three kinds of directors: (i) a *de jure* director is one who has been validly appointed to the office; (ii) a de facto director is one who, although not validly appointed as a director, purports to act, and is held out by the company as a director; and, (iii) a shadow director, by contrast, does not purport to be a director, and is not held out by the company as a director. 'On the contrary, a shadow director claims not to be a director, and shelters behind those who appear to be directors, whether de facto or *de jure*.'[84]

The defendants conceded that the liability imposed by s 214 extended to defacto directors as well as to *de jure* and shadow directors. Millett J considered this concession to be correct; however, he observed that an allegation that a defendant acted as a de facto or shadow director, without distinguishing between the two, was 'embarrassing'. Millett J held that the liquidator's claim of a de facto directorship must fail — the liquidator had pleaded nothing to suggest that there were, in addition to the two Channel Island companies, any other persons who claimed, or were held out by Hydrodam (Corby) Ltd, to be directors.

Having dealt with the issue of de facto directorship, Millett J considered whether the defendants might be shadow directors as defined by s 251 of the Insolvency Act 1986 (UK). The liquidator's case was based on the assertion that Eagle Trust was a shadow director of Hydrodam (Corby) Ltd; and that the defendants were directors of Eagle Trust. It was alleged that as a director of Eagle Trust, each defendant was collectively responsible for Eagle Trust's conduct and was accordingly a shadow director of the Hydrodam (Corby) Ltd. Millett J did not accept this argument and stated that:

> The liquidator submitted that where a body corporate is a director of a company, whether it be a *de jure*, de facto or shadow director, its own directors must ipso facto be shadow directors of the company. In my judgement that simply does not follow. Attendance of board meetings and voting, with others, may in limited circumstances expose a director to personal liability to the company of which he is a director or its creditors. But it does not, without more, constitute him a director of any company of which his company is a director.[85]

Millett J further stated that:

> It is possible (although it is not so alleged) that the directors of Eagle Trust as a collective body gave directions to the directors of the company and that the directors of the company were accustomed to act in

84 Campbell N R, 'Liability as a Shadow Director' [1994] *JBL* 609 at 610.
85 [1994] 2 BCLC 180 at 184.

> accordance with such directions. But if they did give such directions as directors of Eagle Trust, acting as the board of Eagle Trust, they did so as agents for Eagle Trust (or more accurately as the appropriate organ of Eagle Trust) and the result is to constitute Eagle Trust, but not themselves, shadow directors of the company.
>
> In practice, in a case of the present kind, it is much more likely that it will be found that the executive directors of the ultimate parent company (or some of them) have form time to time individually and personally given directions to the directors of the subsidiary and thereby rendered themselves personally liable as shadow directors of the subsidiary. But if all they have done is to act in their capacity as directors of the ultimate holding company, in passing resolutions at board meetings, then in my judgment the holding company is the shadow director of the subsidiary, and they are not.[86]

Dairy Containers Limited v NZI Bank Ltd[87]

Dairy Containers Ltd ('DCL') was a wholly-owned subsidiary of the New Zealand Dairy Board. DCL's task was to manufacture cans for dairy products for the Dairy Board. The company later became a substantial investment company. The auditor of the Dairy Board and DCL was the Auditor-General.

All the members of DCL's board of directors were senior Dairy Board executives. The Dairy Board provided all market data to the company, excluded it from any discussions relating to the market, funded the purchase of the company's raw material (tinplate), and prescribed that it would not make a profit. The group's perception of the company was that it was a totally internal operation, that is, the Dairy Board's 'tinplate division'.

Over a period of five years to 1989, the three managers of DCL committed a number of frauds on the company. They were prosecuted and convicted of several offences. DCL brought civil proceedings against the A-G in an attempt to recover funds lost through the misappropriation. The A-G claimed that DCL, DCL's managers and DCL's directors were contributorily negligent. The A-G successfully applied to join the Dairy Board to the proceedings on the basis that it was liable as a joint tortfeasor. The A-G alleged that the Dairy Board was a shadow director of DCL by virtue of s 2 of the Companies Act 1955 (NZ).

In delivering his judgment, Thomas J considered the decision of the Privy Council in the *Kuwait* case. His Honour stated that:

> Their Lordships' apparent reasoning that the words 'persons occupying the position of directors' applies to the directors as a whole and not to individual directors, would not apply in this case. This is not a case where only a few of the directors were employee-directors; all directors of DCL were employed by NZDB. But their Lordships' go on to say that the Companies Act cannot impose a duty on the employer which it has not

86 *Ibid.*
87 (1995) 7 NZCLC 96,669; (1995) 13 ACLC 3211.

> assumed. With great respect, for the employer to fall within the definition of 'director' I do not think that the question whether he or she has assumed any duty of care is relevant. The question is one of fact: are the directors accustomed to act on the directions or instructions of another person? If they are, that person is subject to the duties imposed on directors under the Act.[88]

In concluding that the Dairy Board was not a director of DCL his Honour stated:

> As employees of NZDB I do not doubt that they were accustomed to act in accordance with their employer's directions or instructions, but as directors of DCL they did not as a matter of fact receive directions or instructions from the parent company. They were, as directors of DCL, standing (or sitting) in the shoes of NZDB at the board table, but they had not and did not receive directions or instructions from their employer. Even when a firm instruction from NZDB was made, it was directed at the company and not at the directors...'[89]

> 'No fiction or artificiality is involved, however, in regarding the directors of DCL as employees of NZDB acting in the course of their employment, for that is precisely what they were doing. But that does not mean that in carrying out their duties as directors of DCL they were acting on the directions or instructions of NZDB as contemplated in the statutory definition. As its employees, NZDB delegated the responsibility of running the company in its interests to them. But it did not give them identifiable directions or instructions as such.'[90]

Standard Chartered Bank of Australia Ltd v Antico[91]

This was the first Australian decision in which the courts considered the extended definition of 'director'. The case concerned the liability of company directors for insolvent trading. The insolvent trading provisions considered by the Court were substantially modified by amendments to the Corporations Law in 1993 — the detailed analysis as to the operation of s 556 of the Companies Code is now of little relevance. However, the extended definition of 'director' under s 5 of the Companies Code is substantially similar to that of the Corporations Law.

Giant Resources Ltd was involved in mineral exploration and mining in Australia, Canada and South Africa. During the period of November 1987 to February 1988 Pioneer International Ltd acquired a 42 per cent 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 per cent. 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.

88 (1995) 13 ACLC 3211 at 3238.
89 *Ibid.*
90 *Ibid* at 3238-3239.
91 (1995) 18 ACSR 1.

In October 1988 Standard Chartered Bank made available to Giant a bill of acceptance and discount facility of $30 million. At the end of March 1989, $30 million was owing under the facility. In 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 it 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 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 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 (s 52 of the *Trade Practices Act*).

In considering whether Pioneer was a director of Giant, Hodgson J stated that:

> It is clear that the mere fact that Pioneer owned indirectly 42% of the shares of Giant, and had three nominees on its board is insufficient to make Pioneer either a director or a person who took part in the management of Giant. Furthermore, in general, in the absence of evidence to the contrary, the Court would take it that actions performed by Antico, Quirk and Gardiner, as directors of Giant, were actions undertaken by them on behalf of Giant, and not as officers or agents of Pioneer.[92]

Hodgson J further stated that:

> I accept that a holding company is not a director of its subsidiaries, merely because it has control of how the boards of its subsidiaries are constituted; that it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of the borrower's affairs; and that it is even less uncommon for lenders to require security for a loan, and then to require the sale of property over which the security is given. Certainly these factors on their own would not amount to assuming the position of a director, or taking part in the

92 *Ibid* at 66.

> management of a borrower company. However, the circumstances of this case go far beyond these maters.[93]

Hodgson J ultimately concluded that, for the purposes of s 556, Pioneer was a director of Giant. His Honour found that the decision as to how Giant was to be funded by Pioneer, and as to the taking of security, was never the subject of careful consideration by the Giant board, but was accepted by the Giant board as something necessary or as a *'fait accompli'*. These matters were given careful consideration by Antico, Quirk and Gardiner, who were directors of Giant; but the consideration which they gave was in the context of reports to and decisions by the Pioneer board, and so, was given by them as directors of Pioneer.[94]

Hodgson J referred to the following circumstances as supporting his conclusion that the directors of Giant, including Antico, Quirk and Gardiner, simply accepted the decisions of Pioneer:

i) 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.

ii) 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.

iii) The views of Pioneer delayed a takeover and an asset sale by Giant.

iv) 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.

v) 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.

vi) The decision to fund Giant and to take security over Giant's assets was effectively made by Pioneer and simply accepted by Giant.[95]

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93 *Ibid* at 70.
94 *Ibid.*
95 *Ibid* at 68-70.

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

Australian Securities Commission v AS Nominees[96]

The AS Group consisted of 10 companies which were bound together through a complex web of interlocking shareholdings. AS Nominees Ltd ('ASN'), Ample Funds Ltd ('Ample') and AS Securities ('Securities') were all members of the group founded by Mr Windsor. ASN was the trustee of superannuation trusts, and Ample was the trustee of unit trusts. The two companies had common boards of directors, comprised of Cahill, Napper and Sutherland.

Securities acted as manager of ASN and Ample. Securities was a private company whose directors were Mr and Mrs Windsor. Its two issued shares were held by Mr Windsor and another company in the AS Group whose directors were also Mr and Mrs Windsor. Securities was the ultimate beneficiary of all management and trustee fees paid by the trusts of ASN and Ample.

Following an Australian Securities Commission investigation into the affairs of ASN, Ample and Securities, the Commission applied for a winding up order under s 461(k) of the Corporations Law. The application was founded on an alleged lack of propriety and competence in the management and conduct of the affairs of the three companies.

To support its application the Commission argued that Mr Windsor was a director of ASN and Ample by virtue of s 60 of the Corporations Law. This argument was made to facilitate findings of conflict of interest in the dealings between the companies. The Commission submitted that Mr Windsor was a person in accordance with whose directions or instructions the directors of ASN and Ample were accustomed to act within the meaning of s 60.

Mr Windsor argued that, by virtue of s 60(2), he was not a director of ASN or Ample. It was contended that his advice to the directors of ASN and Ample was given in the proper performance of the functions attaching to his business relationship with the directors of each company.

In ordering that the companies be wound up, Finn J held that there were substantial conflicts of interest in the dealings of the companies. In considering whether Windsor was a director of ASN and Ample, his Honour examined the relationship of Windsor and the boards:

> The relationship of Windsor to the directors — and there is no reason for distinguishing the two companies in this — is relatively distinctive. First, it is not one in which the directors can be said at all time for all purposes to have acted entirely as his puppets without exercising any discretion at all in company matters: cf *Selangor United Rubber Estates v Cradock (No 3)* [1968] 1 WLR 1555 at 1577-1578. If such had been the case there would have been no dispute as to the applicability of s 60.

96 (1995) 13 ACLC 1822

> Secondly, the case likewise is not one of the boards acting simply in the fashion of errant nominee directors who unduly favour the interest they represent: see *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324; see also *Berlei Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150. Such without more, would not bring the 'nominor' within s 60: *Standard Charter Bank of Aust Ltd v Antico* (1995) 13 ACLC 1381 at 1436; (1995) 131 ALR 1 at 66; see Ford and Austin's *Principles of Corporations Law*, para 9.420 (7th Ed).
>
> Thirdly, it cannot be said that, if there was 'direction or instruction', this extended to all board decisions. As has been seen, some at least of the transactions I have considered — for example the Bilambee and Woden loans — have not on the evidence before me involved Windsor either at all or else significantly. I do not regard this of itself as denying s 60 any application in this matter.
>
> The reference in the section to a person in accordance with whose directions or instructions the directors are 'accustomed to act' does not in my opinion require that there be directions or instructions embracing all matters involving the board. Rather it only requires that, as and when the directors are directed or instructed, they are accustomed to act as the section requires.[97]

Finn J refused to accept that Mr Windsor, as a manager of the companies, merely offered advice to the boards. After considering the requirements of the 'business relationship exemption', his Honour concluded that Mr Windsor was a shadow director of the companies:

> In these circumstances it can and should be found that Windsor is a director of both ASN and Ample as a result of s 60. This finding does not, in my opinion, require it to be shown that formal directions or instructions were given in those matters in which he involved himself. The formal command is by no means always necessary to secure as a course compliance with what is sought. There is no reason to construe the section so as to deny this: cf Corporations Law, s.109H. The idea of the section, as Wells J noted of its predecessor in *Harris v S* (1975-1976) CLC ¶40-236 at 28,623-28,624; (1976) 2 ACLR 51 at 64, is that the third party calls the tune and the directors dance in their capacity as directors. This aptly describes Windsor's role.[98]

Elements of Section 60(1)(b)

The limited case law conceals the significance of shadow directorships. As considered above — and evidenced by the cases — there may be serious consequences for those persons held to be shadow directors. However, the courts have thus far failed to provide a definitive statement as to the ambit of the extended definition. This may, at least in part, be attributed to the nature of shadow directorships; frequently, the determining factors will be unique to the circumstances of the case. Therefore, in order to fully appreciate the possible applications of the extended definition, it is necessary to critically analyse the

97 *Ibid* at 1837-1838.
98 *Ibid* at 1838.

elements of s 60(1)(b). Markovic identifies four basic elements which are required to establish the existence of a shadow directorship: person; directions or instructions; directors of the body; accustomed to act.[99]

Person

The first element of s 60(1)(b) is that there must be a 'person'.[100] 'Person' is defined pursuant to sections 9 and 85A of the Corporations Law to include 'a body politic or corporate as well as an individual'.[101] It is evident from these provisions that a reference to a person should also include a corporation.[102] However, whether a corporation should be held to be a director by virtue of s 60 is a contentious issue.[103] Be that as it may, the promotion of the Law's underlying purpose requires that corporate entities be held accountable for their actions.

It has been suggested that s 221(3) of the Corporations Law limits the application of s 60 to natural persons. Section 221(3) expressly provides that a body corporate cannot be *appointed* as a director. It follows that only natural persons may be *de jure* directors. However, shadow directors, by their very nature, are not 'appointed' to the position of director. As such, s 221(3) does not necessarily preclude a body corporate from being held to be a shadow director by virtue of s 60(1)(b). This approach is supported by the relevant case law. In *Standard Chartered Bank of Australian v Antico*, Hodgson J held that Pioneer International Ltd was, by virtue of s 5 of the Companies Code,[104] a director of Giant Resources Ltd.[105] Further support may be gleaned from the decisions of *Re a Company ex parte Copp*; *Kuwait Asia Bank v National Mutual Life Nominees*; *Re Hydrodam (Corby) Ltd*; and *Dairy Containers Ltd v NZI Bank Ltd*.[106]

Directions or Instructions

The second element of s 60(1)(b) is that the person must give 'directions or instructions'.[107] Markovic notes that 'there appears to be little difference in the words 'directions' or 'instructions'';[108] however, a distinction can be drawn with

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99 Markovic, above n 24 at 327.

100 *Ibid.*

101 *Ibid.* Section 9 provides that 'person' has a meaning as affected by s 85A. Section 85A states: 'In this Law, expressions used to denote persons generally (such as 'person', 'party', 'someone', 'no-one', 'one', 'another' and 'whoever'), include a body politic or corporate as well as an individual.'

102 See also s109H of the Corporations Law.

103 Markovic, above n 24 at 327. Following the judgment of Knox J in *Re a Company*, there were calls for the amendment of the definition of shadow director such that it would not apply to corporate entities such as banks etc.

104 The predecessor of s 60 of the Corporations Law.

105 Markovic, above n 24 at 327. Markovic notes that his Honour did not make it clear whether he considered Pioneer to be a shadow or de facto director or both. Whilst it is beyond the scope of this paper to consider the issue of de facto directorship, suffice it to say, it is difficult to contemplate a situation in which a company could be held to be a de facto director. Given s 221(3), it may be asserted that it is impossible for a company to be held out as a validly appointed director of a corporation.

106 Whilst none of these cases held a corporation to be liable as a shadow director, the decisions of the courts were each premised on the assumption that such a finding was possible.

107 Markovic, above n 24 at 327.

108 *Ibid* at 328.

the use of 'advice' in s 60(2).[109] It is suggested that 'directions or instructions' involve an element of compulsion; that the recipient of the 'directions or instructions' does not exercise any discretion in the decision making process.[110]

The case law fails to resolve whether actual directions or instructions must be given — the law appears to differ between the jurisdictions. Whilst the issue has not been directly addressed by the English courts, the judgment of Millett J in *Re Hydrodam (Corby) Ltd* suggests that the alleged shadow director must necessarily have given directions or instructions before shadow directorship can be founded.[111] This proposition is further supported by the judgment of Thomas J in *Dairy Containers Ltd v NZI Bank Ltd*. Although all the directors of the company were employees of the alleged shadow director, his Honour held that no shadow directorship existed. His Honour stated:

> As its employees, NZDB delegated the responsibility of running the company in its interests to them [the directors]. But it did not give them identifiable directions or instructions as such.[112]

The interpretation of the English and New Zealand courts may be contrasted with that of the Australian courts. In *Australian Securities Commission v AS Nominees*, Finn J clearly recognised that actual directions or instructions are not always necessary to constitute a shadow directorship. His Honour stated:

> This finding [that Windsor is a director of both AS Nominees and Ample as a result of s 60 of the Corporations Law] does not, in my opinion require it to be shown that formal directions or instructions were given in those matters in which he [Windsor] involved himself. The formal command is by no means always necessary to secure as a course compliance with what is sought. There is no reason to construe the section so as to deny this.[113]

It is suggested that where no actual directions or instructions are issued by a shadow director, there must be some discernible attempt to control or influence the board. In his extra-judicial statement, Millett J stated that a shadow director 'must have a conscious intention to control the decisions of the board'.[114] A person should not be held liable as a shadow director merely because 'a board, for reasons known only to itself, acts on its own accord only to advance the interests of an influential and substantial shareholder without formal instructions from the shareholder or the shareholder's representatives.'[115]

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109 The meaning of 'advice' in the context of the 'professional capacity or business relationship exemption' is considered below.

110 See the judgement of Finn J in *Australian Securities Commission v AS Nominees* (1995) 13 ACLC 1822 at 1838.

111 Koh, above n 25 at 344. Koh cites the following quote from Millett J's judgment in support of this proposition: 'In practice, in a case of the present kind, it is much more likely that it will be found that the executive directors of the ultimate parent company (or some of them) have from time to time individually and personally given directions to the directors of the subsidiary and thereby rendered themselves personally liable as shadow directors of the subsidiary.': [1994] BCC 161 at 164.

112 (1995) 13 ACLC 3211 at 3239.

113 (1995) 13 ACLC 1822 at 1838.

114 Above n 71.

115 Koh, above n 25 at 345.

The issue of control was addressed by Hodgson J in *Standard Chartered Bank of Australia v Antico*. Whilst there was limited evidence of formal directions or instructions to the board of Giant, his Honour stated:

> In my view, the conditions imposed following the decision to fund Giant in March 1989 show a willingness and ability to exercise control and an actuality of control, over the management and financial affairs of Giant.[116]

Section 60(1)(b) does not state to whom the directions or instructions must be given. Although not expressly stated, it may be argued that the wording of the section requires that the directions or instructions be issued to the board of directors. This argument appears to have been accepted by Thomas J in *Dairy Containers Ltd v NZI Bank Ltd*. In holding that no shadow directorship existed, his Honour stated that 'even when a firm instruction from NZDB was made, it was directed at the company and not at the directors.'[117] It is respectfully submitted that this interpretation is contrary to the intention of the legislation.

To require that a shadow director issue directions or instructions to the board, in circumstances where all other elements of s 60(1)(b) are satisfied, would be to promote an artificiality. It is suggested that upon the proper interpretation of s 60(1)(b), it is sufficient that the directors are 'accustomed to act' in accordance with the directions or instructions given, regardless of how and to whom they are communicated. As stated by Markovic:

> From a policy viewpoint if a person gives directions or instructions to a nominee director (or managing director) and the board is accustomed to act in accordance with the nominee director's (or managing director's) directions or instructions, then the person is effectively having a vital say in the conduct of the company' affairs. As such, there is some merit in the argument that the person should be subjected to the duties and responsibilities which are imposed upon directors.[118]

Directors of the Body

The third element of s 60(1)(b) is that the 'directors of the body' are accustomed to act in accordance with the person's directions or instructions. Whilst 'directors of the body' obviously refers to the board, there is considerable uncertainty as to its proper interpretation. As noted above, the judgment of Lord Lowry in the *Kuwait* case is frequently cited as authority that *all* the directors of the body must be accustomed to act in accordance with the person's directions or instructions.[119] However, it is suggested that Lord Lowry's judgment does little more than confirm that exercising control over a minority of directors will not constitute a shadow directorship.

The proposition that 'directors of the body' refers to *all* the directors of the board appears to be supported by Millett J. Whilst failing to address the issue in

116 (1995) 18 ACSR 1 at 70.
117 (1995) 13 ACLC 3211 at 3238.
118 Markovic, above n 24 at 329.
119 See above 16.

Re Hydrodam (Corby) Ltd, in his subsequent extra-judicial statement, his Honour opined that 'directors' refers to the whole board, not just some of its members. 'The definition, therefore, does not cover the case where one person is there to do what somebody else (a relative, a business associate, or some other company whose interests he represents) wants him to do. What the term covers is a case where the whole board has effectively abandoned its responsibility for making its own decisions and instead has become accustomed to follow the directions of a third party.'[120]

Thus far, the Australian courts have not provided an interpretation of 'directors of the body'. However, it is submitted that to require *all* the directors of the board to act in accordance with the person's directions or instructions, would be to ignore the purpose of the section. As observed by Markovic:

> Little is to be gained from requiring 'all' the directors being accustomed to act in accordance with the person's directions or instructions. The company will implement the person's directions or instructions if the majority of the board act upon them. There seems little logic in allowing the person to escape falling within the ambit of s 60(1)(b) merely because a single or a minority or the directors are not accustomed to act in accordance with the person's directions or instructions when the majority of the board are accustomed to act. To require the whole board to abandon its responsibilities and be accustomed to follow the person's directions or instructions it is submitted would allow a substantial loophole.[121]

The New Zealand legislature has firmly addressed this issue with the enactment of the *Companies Act 1993* (NZ). Section 126(1)(b)(i) of the Act provides that a 'director', in relation to a company, includes 'a person in accordance with whose directions or instructions [a de facto or *de jure* director] may be required or is accustomed to act.' This provision unequivocally extends the definition of director to include persons that control or direct the actions of a single director. It is suggested that this demonstrates a legislative intent to implicate all persons who interfere in the affairs of the board, not only those who control a majority of the directors. Whilst the Australian provision does not support such an inference, it is suggested that s 60(1)(b) should be interpreted as including those persons who direct or instruct the *majority* of the directors.[122] In the alternative, the Australian provision should be amended to unambiguously reflect the legislature's intent.

Accustomed to Act

The fourth element of s 60(1)(b) is that the directors of the body must be 'accustomed to act' in accordance with the person's directions or instructions. Whilst there is some uncertainty surrounding these words, the courts have

120 Fidler, above n 31 at 98, citing Millett, above n 71.
121 Markovic, above n 25 at 329.
122 The judgment of Hodgson J in *Standard Chartered Bank of Australia v Antico* may lend some support to this argument. Rather than examining Pioneer's control over individual directors, in holding Pioneer liable as a director of Giant, his Honour relied on the 'willingness and ability' of Pioneer to control the 'management and financial affairs of Giant'.

provided considerable guidance.[123] 'Accustomed to act' together with the words 'directions or instructions' indicates the necessity of an ongoing relationship between the parties.[124] However, there is a divergence of opinion as to the required nature of this relationship. In *Re Hydrodam (Corby) Ltd*, Millett J stated:

> What is needed is first, a board of directors claiming and purporting to act as such; and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgment of its own, but acted in accordance with the directions of others.[125]

This test, taken literally, seems to set a higher standard than that prescribed by the statutory definition. Millett J indicates that for a shadow directorship to exist, the directors must be devoid of all discretion or judgment. With respect, it is submitted that the requirements of s 60(1)(b) may be satisfied even if the board retains some control. This proposition is supported by the judgement of Finn J in *Australian Securities Commission v AS Nominees Ltd*. His Honour stated that:

> The reference in the section to a person in accordance with whose directions or instructions the directors are 'accustomed to act' does not in my opinion require that there be directions or instructions embracing all matters involving the board. Rather it only requires that, as and when the directors are directed or instructed, they are accustomed to act as the section requires.[126]

It is suggested that this is the proper interpretation of s 60(1)(b). Whilst a shadow director and his board are often described as 'puppeteer and puppets',[127] to suggest that the board *must* not exercise any discretion or judgment is an unnecessary inclusion. It is further suggested that occasional disagreements between the parties will not, of itself, preclude the existence of a shadow directorship.[128]

In conclusion, an analysis of the elements of s 60(1)(b) confirms the unsettled nature of the law of shadow directorships. Despite the history of the definition, there has not been a definitive judicial pronouncement as to the ambit of the extended definition. Unfortunately, the courts have adopted a range of approaches resulting in confusion and uncertainty. Ultimately, it must be accepted that shadow directorship is a question to be determined on the facts of each case. Whilst the words of s 60(1)(b) cannot be ignored, the statement of Finn J in *Australian Securities Commission v AS Nominees* may provide some guidance:

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123 Unfortunately such guidance has not always been consistent.
124 Markovic, above n 24 at 331. This proposition appears to be readily accepted among commentators and the judiciary.
125 [1994] 2 BCLC 180 at 183.
126 (1995) 13 ACLC 1822 at 1838.
127 Koh, above n 25 at 344.
128 *Australian Securities Commission v AS Nominees* (1995) 13 ACLC 1822 at 1837.

> The question the section poses is: Where for some or all purposes, is the locus of effective decision making? If it resides in a third party, and if that person cannot secure the 'advisor' protection of s 60(2), then it is open to find that person a director for the purposes of the Corporations Law.[129]

Professional Capacity or Business Relationship Exemption

Shadow directorship is of obvious concern for corporate advisers, financiers, creditors, and other persons who may 'influence' the decisions of company directors. However, in recognition of the propriety of these relationships, the Corporations Law provides such persons with an exemption from shadow directorship. Section 60(2) provides that a person shall not be regarded as a shadow director merely because the directors 'act on the advice given by the person in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors or the members of the board or with the body.'

It is suggested that two elements of the exemption require detailed consideration – the meaning of 'advice', and the scope of 'in the proper performance' of the functions attaching to the person's professional capacity or business relationship.

Advice

The meaning given to 'advice' will greatly affect the ability of corporate advisers to remain free from liability.[130] In *Australian Securities Commission v AS Nominees Ltd*, the respondents 'acknowledged that Windsor had an influence upon the actions taken by the boards.'[131] However, it was contended that 'this was because he acted as manager of the companies; he introduced much of the trust business; and he was involved in its negotiation. He was a person on whose advice the directors acted.'[132] Furthermore, that the 'advice [was] given by [him] in the proper performance of the functions attaching to… [his] business relationship with the directors of each company.'[133] In rejecting this submission Finn J stated:

> When one looks to the aggregate of the transactions analysed, it cannot properly be said that the case is merely one of directors acting on the advice of a manager in the proper performance of his duties: Corporations Law, s 60(2). What so often was asked of, and conceded by, the boards was either to act partially towards Windsor or to act in ways which, in furthering his designs, required the dereliction of their own, and their trust company's, duties.[134]

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129 *Ibid* at 1838.

130 The New Zealand 'professional capacity exemption' has removed the word 'advice'. Section 126(4) of the Companies Act 1993 (NZ) provides: 'Paragraphs (b) to (d) of subsection (1) of this section do not include a person to the extent that the person acts only in a professional capacity.' Clearly, acting in a professional capacity may include the giving of advice.

131 (1995) 13 ACLC 1822 at 1836.

132 *Ibid.*

133 *Ibid.*

134 *Ibid* at 1838.

It is submitted that the meaning of 'advice' must differ from that of 'directions or instructions'.[135] As considered above, 'directions or instructions' involve an element of compulsion. This may be contrasted with 'advice', which is defined as 'words given or offered as an *opinion or recommendation* about future action or behaviour'.[136] 'Advice' may, unlike 'directions or instructions', be rejected.

If such a dichotomy is accepted, s 60(2) does not create an exemption to s 60(1)(b). Rather, s 60(2) affirms that a person cannot be liable as a shadow director for the offering of 'advice'. The court must therefore determine whether an adviser has been *giving advice* or *issuing directions or instructions*.[137] This issue can only be determined on the facts of each case. However, it is submitted that a professional adviser will not be a shadow director merely because a company follows his 'advice' due to commercial or economic necessity. In such circumstances, it must be recognised that the 'locus of effective decision making' remains with the board.

In the Proper Performance…

In addition to refraining from issuing instructions or directions, s 60(2) implies that an adviser should only give advice in the proper performance of the functions attaching to that person's professional capacity or business relationship with the directors or the company.

Section 60(2) of the Corporations Law would appear to be of broader application than the corresponding English provision. Section 741(2) of the Companies Act 1985 (UK) only refers to 'advice given... in a professional capacity'. This distinction may be of particular significance to banks and other financiers not usually considered to act in a professional capacity.[138]

The important issue to be determined is whether or not an adviser will be liable for advice that is beyond the scope of his or her professional capacity or business relationship. What will the court consider to be 'in the proper performance of the functions attaching to the person's professional capacity or the person's business relationship' with the directors or the company? For example, can a lawyer (engaged to provide legal advice) advise a company on financial or commercial matters? Obviously, an adviser may be liable in tort for negligent advice, but will the provision of such advice be sufficient to render that person liable as a shadow director of the company?

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135 Markovic creates a technical construction to argue that 'advice' and 'directions or instructions' are not distinct concepts. He argues that 'directions or instructions' encompass 'advice'. It is suggested that if a similar meaning was intended the same words would have been used. It is further suggested that if the terms are synonyms, the extremely wide scope of 'professional capacity' and 'business relationship' would create an exemption so broad as to apply to virtually all persons engaged in business. It follows that s 60(1)(b) would be of no effect.

136 *Oxford English Reference Dictionary*, Oxford University Press (1995). See Markovic, above n 24 at 328.

137 Koh, above n 25 at 351.

138 Originally the Australian provision only referred to persons who offered advice in a professional capacity. Following the introduction of the Companies Code, the 'business relationship' exemption was included. The accompanying Explanatory Memorandum is of little assistance in explaining the Legislature's motivation for extending the exemption's application.

It is submitted that, whilst it is prudent for corporate advisers to limit their advice to the extent of their expertise, the offering of advice on matters beyond their 'professional capacity or business relationship' will not be sufficient to attract liability under the Corporations Law. As considered above, an essential element of shadow directorship is the issuing of 'directions or instructions' – provided that the board of directors retains its discretion it seems unlikely that a shadow directorship is possible.

It is difficult to suggest that an adviser will be liable because 'advice' given is not in the 'proper performance of the functions attaching to the person's professional capacity or to the person's business relationship'; unless there are 'directions or instructions' the fundamental elements of shadow directorship have not been established. Likewise, it would be dangerous to assume that an adviser will escape liability simply because he or she has only directed the board on matters that are within his or her realm of expertise.

It is submitted that the subject matter of the 'advice' is not of significance in determining the existence of a shadow directorship. This is supported by the cases that have focused upon the shadow director's influence over the board rather than analysing the 'functions attaching to the person's professional capacity or to the person's business relationship'.[139] The fundamental issue remains whether the person has merely offered 'advice' or issued 'directions or instructions' to the board.

It has been suggested that 'directions or instructions' may encompass 'advice'.[140] If this were accepted, the scope of 'in the proper performance of the functions attaching to the person's professional capacity or to the person's business relationship with the directors or the members of the board or with the body' would be of significant importance. However, the wide range of persons encompassed by professional and business relationships would result in an exemption so broad that s 60(2) would be of little or no effect. This is clearly not the intention of the legislature.

As Markovic observes, 'there remains a large degree of uncertainty surrounding the scope or ambit of this exemption'.[141] Corporate advisers, financiers, creditors, and other persons who may 'influence' the decisions of company directors must clearly exercise caution in the offering of their advice. However, the courts appear to have adopted a sensible approach in relation to such professional and business relationships.

Whilst the judgement of Knox J in *Re a Company ex parte Copp* caused significant concern in the banking community, recent decisions indicate a reluctance to hold banks and other financiers liable as shadow directors. In *Re PFTZM Ltd*[142] the court held that, although bank officers participated in weekly management meetings over a two year period, the bank was not a shadow

139 In particular, see *Australian Securities Commission v AS Nominees* (1995) 13 ACLC 1822 at 1838.
140 Markovic, above n 24 at 334.
141 *Ibid* at 335.
142 [1995] BCC 280; 2 BCLC 354.

director of the company. Baker J concluded that the officers of the bank were acting, not as directors of the company, but in the defence of the financier's commercial interests.

In his extra-judicial statement, Millett J opined that, whilst a bank has no business managing its customers' affairs, it is entitled to attach conditions to the continuation of its financial support.[143] Although commercial necessity may require the company to accept the conditions, the ultimate decision is made by the directors of the company. Accordingly, the bank cannot be said to be a person in accordance with whose directions or instructions the directors are accustomed to act. Other permissible actions included:

- sending in an investigation team;
- demanding a reduction in the overdraft;
- demanding security or further security;
- calling for information, valuations, accounts, cash-flow forecasts, etc;
- requesting the customer's proposals for reducing the overdraft, including submitting a business plan, schedule of asset sales, etc; and
- advising on the desirability of strengthening management, seeking fresh capital, etc.[144]

Millett J's propositions appear to be supported by the judgement of Hodgson J in *Standard Chartered Bank of Australia v Antico*. Whilst holding that Pioneer was liable as a shadow director of Giant, his Honour stated:

> I accept that... it is not uncommon for lenders to impose conditions on loans, including conditions as to the application of funds and disclosure of the borrower's affairs; and that it is even less uncommon for lenders to require security for a loan, and then to require the sale of property over which the security is given. Certainly these factors on their own would not amount to assuming the position of a director, or taking part in the management of a borrower company.[145]

Conclusion

The Corporations Law seeks to protect the interests of shareholders, creditors and the public. As such, directors and other persons involved in the management of companies are subject to onerous duties and obligations. The application of these duties and obligations is extended by s 60 of the Corporations Law to apply not only to *de jure* directors, but also to de facto and shadow directors. A

143 Millett, above n 71 cited in Koh, above n 25 at 348.
144 Millett, above n 71 cited in Fidler, above n 31 at 99. Millett's article was written in the context of possible bank liability for wrongful trading of an insolvent customer.
145 (1995) 131 ALR 1 at 70.

shadow director may be described as a person with whose directions or instructions the directors of the body are accustomed to act.

There is a clear intention that the law should extend to all persons who 'dabble in the affairs' of a company. However, in adopting the words of s 60(1)(b), the legislature has employed unnecessary ambiguity. The question of who is a shadow director is not an easy one to answer. Unfortunately the case law provides limited guidance. Many issues remain unresolved and there is often a conflict of opinion as to the correct interpretation. Be that as it may, it is submitted that under s 60 of the Corporations Law:

- Shadow directors may be either natural persons or corporations.

- It is unnecessary to establish that actual directions or instructions where issued to the board of directors. However, there must be some intention by the alleged shadow director to exert control over the members of the board.

- It is unclear whether all or a majority of the directors must be accustomed to act in accordance with the directions or instructions issued. It is suggested that to require all the directors to so act would be to ignore the purpose of the section. Such an interpretation would also create a substantial loophole in the legislation.

- The fact that the directors exercise some discretion in the management of the company does not preclude the existence of a shadow directorship.

'Advice' differs from 'directions or instruction'. The fact that the directors of a company may follow the advice of an third party does not necessarily establish the existence of a shadow directorship.