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# CREDIT ISSUES

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## WOODGATE & CO.

Chartered Accountants

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### ARE YOU A DE-FACTO OR SHADOW DIRECTOR OF A COMPANY?

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#### Introduction

Two recent cases have highlighted the dangers for managers (including the family of appointed directors) and corporate advisors from allegedly acting as either de-facto or shadow directors. Such cases usually arise as a consequence of insolvency administrations and pursuant to legal proceedings commenced by Liquidators to recover claims for insolvent trading or breaches of directors' duties. In both cases, the Liquidators were unsuccessful. However, the cases are important because they confirm that the threshold remains high for proving allegations of either de-facto directorship or shadow directorship. The cases also confirmed that Liquidators will pursue claims against de-facto or shadow directors, despite the high threshold.

Further, one cannot underestimate the lost time and substantial emotional and financial cost of defending such proceedings.

#### History of the Swan Services case

The judgment of Justice Black, of the Supreme Court of New South Wales, *In the matter of Swan Services Pty Limited (in liquidation)* [2016] NSWSC 1724 ("the Judgment") dealt with a claim for insolvent trading by a Liquidator against Mr Robert Swan ("Mr Swan") who was the sole director of Swan Services Pty

Limited ("Swan Services") and its seven subsidiary companies ("the Companies") (collectively "the Swan Group"). The Liquidator also made a claim for insolvent trading against Ms Judith Swan ("Ms Swan") on the basis that she was a de-facto director of the Swan Group.

The Swan Group was placed into voluntary administration in May 2013. It was wound up in June 2013. Prior to the voluntary administration, the Swan Group operated in every State of Australia and employed approximately 2,500 cleaners. It marketed itself as one of Australia's five largest commercial cleaning companies.

Swan Services held the majority of cleaning contracts within the Swan Group. It also purchased cleaning products and equipment. It paid the majority of the Swan Group's creditors. The Companies employed the cleaning staff and performed the cleaning services.

Normally Swan Services charged the Companies for the wages and expenses paid on their behalf. In turn, the Companies would charge Swan Services management fees. This broke down during the period from 1 November 2012 to 22 May 2013 ("the relevant period").

Mr Swan was a director of Swan

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Services since 1969 and its sole director and sole shareholder since 1998. Ms Swan became involved in the Swan Group from 1998, after marrying Mr Swan. By the time of the trial Mr Swan and Ms Swan had separated.

Ms Swan's role changed significantly during her lengthy involvement with the Swan Group. The character of Ms Swan's involvement in the Swan Group was central in determining whether or not she was a de-facto director.

### **What is a de-facto director?**

Normally, the directors of a company can be determined by reference to a Australian Securities & Investments Commission search. However, Ms Swan was not an appointed director of Swan Services.

In order for Ms Swan to have a liability for insolvent trading, the Liquidator first had to prove that she was acting as a de-facto director during the relevant period. This is because the definition of director in Section 9 of the *Corporations Act 2001* ("the Act") extends to a person not validly appointed as a director, but who acts in the position of a director.

His Honour noted that whether a person acts as a director is determined on the facts and is a question of degree. It requires a consideration of the duties performed by that person, in the context of the operation and circumstances of the particular company. Relevant considerations include whether the person:

- exercised top-level management functions;
- had any constraints imposed on him or her;
- performed director duties in the context of the operations and circumstances of the company in question; and,
- was reasonably perceived as a director, by outsiders who dealt with the company.

The Act distinguishes between officers and directors. An officer includes a person who makes or participates in decisions that affect the whole or a substantial part of the business of a corporation, or who has the capacity to affect significantly the corporation's financial standing.

Ms Swan submitted that care ought to be exercised before concluding that a member of the director's family was a de-facto director. Justice Black distinguished *Deputy Commissioner of Taxation v Austin* [1998] FCA 1034 and stated that he would not treat a family member of a director any differently from any other person who became involved in a corporation's management, in determining whether that person was a de-facto director.

### **Why Ms Swan was not a de-facto director**

Justice Black concluded that the evidence did not support the conclusion that Ms Swan was a de-facto director of the Swan Group. The following factors were important in this determination:

- Evidence from senior management that Mr Swan micromanaged every aspect of the business;
- An organisational chart described Mr Swan as the managing director and chairman. Ms Swan was recorded as reporting to the general manager. Her title was "head of legal, human resources, risk and compliance";
- Mr Swan's approval was required before wages or supplier invoices were paid. His approval was also required for payment arrangements with suppliers;
- Mr Swan remained sole cheque signatory for all bank accounts held by the Swan Group;
- Mr Swan was focused principally on managing debtors and creditors, the most important aspect of the business;
- Despite the fact that Ms Swan engaged solicitors and accountants

and negotiated with the ATO, the instructions came from Mr Swan;

- Ms Swan received limited financial information, even though she was a secured creditor;
- Ms Swan had aspirations for a wider role for herself, but did not have any real authority within the Swan Group;
- Whilst Ms Swan exercised a significant level of responsibility and attempted to challenge Mr Swan's directions, there was no evidence that she had ever succeeded in challenging his authority over her. Mr Swan had asserted that "this is my company. I make the decisions around here"; and,
- Mr Swan continued to exercise authority in relation to significant matters affecting the Swan Group throughout the relevant period.

Mr Swan was not relieved from liability. Justice Black held that the presumption of insolvency applied under Section 588E(4) of the Act during the whole of the relevant period, because Swan Services had failed to maintain adequate financial books and records. The quantum of the Liquidator's claim against Mr Swan for insolvent trading has not been fully quantified.

### **Implications of the Swan Services case**

The judgment is an example of a person with significant involvement in a company, without exerting the authority or control required to be acting as de-facto director. It shows that a person need not be an appointed a director to be legally considered to be a director. Such cases usually turn on their facts. In this case, the Liquidator did not have sufficient evidence to prove Ms Swan was a de-facto director.

### **Shadow directors**

There is a distinction between de-facto directors and shadow directors. Shadow directors tend to give instructions. Those decisions are then accepted or implemented by the appointed directors.

Unlike de-facto directors, shadow directors tend to act behind the scenes, as noted in *Standard Chartered Bank of Australia Ltd v Antico & Ors* (1995) 13 ACLC 1381.

It is not only an individual who may find themselves liable for insolvent trading. Section 9 of the Act defines a director to include a person who is not validly appointed as a director, where the directors of the company are accustomed to act in accordance with that person's instructions or wishes. This is commonly referred to as shadow directorship. On this basis, a company may be considered a shadow director of another company. In *Re Akron Roads Pty Ltd (in liquidation) (No 3)* [2016] VSC 657 ("Akron Roads case"), Justice Robson, of the Supreme Court of Victoria, considered a claim for insolvent trading by a Liquidator against Crewe Sharp Pty Ltd ("Crewe Sharp"), a firm of management consultants. The Liquidator argued that Crewe Sharp was a shadow director of Akron Roads Pty Ltd ("Akron").

Justice Robson followed the New South Wales Court of Appeal judgment of *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2011) 81 NSWLR 47, which stated that to prove shadow directorship, the Plaintiff must show:

- who were the directors of the company; and,
- that the defendant gave instructions or expressed wishes to those directors of the company on how to act in relation to that company; and,
- a pattern of behaviour whereby the directors of the company did not exercise discretion or judgment but rather followed the instructions or expressed wishes of the shadow director; and,
- instead were accustomed to follow the instructions or expressed wishes of the shadow director.

His Honour noted that:

- it was not necessary for the putative shadow director's instructions or wishes to cover every aspect of running the company, as long as the directors acted in accordance with the instructions or wishes;
- the instructions or wishes must have been habitually complied with, by the appointed directors, over a period of time; and,
- a mortgagee, who had taken a genuine interest of its own in providing advice to a company, was not automatically a shadow director simply because that company accepted that advice to avoid the mortgagee's wrath.

Justice Robson concluded that there was no evidence that Crewe Sharp had overborne the directors of Akron or that they acted in accordance with its wishes or instructions. The fact that Crewe Sharp was deeply involved in the management and administration of Akron was insufficient to establish that Crewe Sharp was a shadow director.

If Akron had been a subsidiary of Crewe Sharp, then the insolvent trading provisions under Section 588V of the Act could have been enlivened.

### **Conclusions**

The intention behind Section 9 of the Act was to prevent persons from escaping

liability under the Act, simply because he, she, or it had not been formally appointed as director of the company.

The Swan Services trial was held over 11 days, whilst the Akron Road trial was held over four days. The law in this area is complex. Even though Ms Swan and Crewe Sharp were successful in defending the allegations of de-facto directorship and shadow directorship, the financial costs would have been considerable, as Senior Counsel were briefed in both cases.

Liquidators usually rely on the books and records of the company, without necessarily having a complete understanding of how the company operated. Therefore, it is important that officers or advisors do not act as directors, or are seen as acting as directors, through ambiguous or poorly crafted documents, particularly emails, as well as other indicators. Liquidators will, and should, investigate allegations of de-facto or shadow directors. However, history shows that they are rarely successful in proving allegations to a Court's satisfaction.

If you are concerned about whether or not you may be considered to be a de-facto director or shadow director of an insolvent company, do not hesitate to contact Woodgate & Co. for guidance on governance.

## **WOODGATE & CO.**

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