INSOLVENT TRADING: HIDDEN RISKS FOR ACCOUNTANTS AND BANKS PARTICIPATING IN "WORK OUTS"

G SYROTA

What is the difference between a company "doctor" and a company director? This conundrum has recently been explored in an important UK decision which has implications for chartered accountants and other financial advisers in Australia as well as England, particularly those working in the insolvency field.

Re Tasbian[1] involved the appointment of a self-styled "company doctor", a chartered accountant named Nixon, to an ailing retail business (Tasbian Ltd) at the instigation of a finance company (Castle Ltd) which had loaned Tasbian substantial sums of money. Tasbian had never traded at a profit and had managed to accumulate losses of nearly £1 million over a 3 year period by the time of Nixon's appointment. The purpose of that appointment was to "turn the company around". This Nixon failed to do, despite prodigious efforts over 18 months, and eventually the business went into liquidation with a deficiency of nearly £1.5 million.

ADVISER OR DIRECTOR?

The issue was whether Nixon remained from first to last an independent, outside consultant to Tasbian, as he maintained, or whether, alternatively, he had effectively taken over the reins of Tasbian with the result that he had become a shadow or de facto director, in practice if not in name. The UK legislation, like its Australian counterpart, recognises that a person may become a director in law, notwithstanding that he has not been officially appointed as such, if he effectively controls the company, the board of directors simply rubber-stamping his policies and decisions (Corporations

1. *Re Tasbian (No 3)* [1992] BCC 358.

Law, section 60(1)(b)).[2]

The UK Secretary of Trade argued that Nixon had become such a director, that he had totally mismanaged the company and broken important provisions of UK corporate law, and that he should therefore be disqualified from holding the office of director for up to 5 years and be subject to various other sanctions applicable only to directors. Nixon claimed that he had not assumed the role of director, de facto or otherwise, so that these penalties could not be inflicted on him.

CHANCERY DIVISION (COMPANIES COURT)

At first instance, Vinelott J held that:

> [T]he dividing line between the position of a watchdog or adviser imposed by an outside investor and a de facto or shadow director is difficult to draw, and there is a serious question whether, at some stage, Mr Nixon passed over it.[3]

The factors which suggested, cumulatively, that Nixon had indeed passed over this line included the following: he arranged an amendment to the company's bank mandate so that all cheques required his counter-signature; he initiated and carried through a scheme designed to minimise Tasbian's liability for income tax; he monitored Tasbian's trading on a regular fortnightly basis; he bargained with the UK Department of Trade & Industry on Tasbian's behalf; he conducted preliminary negotiations for the takeover of Tasbian by another company; and he negotiated an informal moratorium with Tasbian's trade creditors. He was paid for these services, not by Castle, the finance company which had initiated his appointment, but by Tasbian itself.[4]

In support of Nixon's case that he was appointed and remained throughout a mere professional adviser, and not a director, it was pointed out that he took no part in ordering any goods or services for the company nor in hiring and firing its employees. Weighing up these various factors, Vinelott J concluded that there was "a triable issue" whether Nixon had become a de facto or shadow director and thus was subject to the provisions of the Company Directors Disqualification Act 1986 (UK). The matter was remitted to the

---

2. S 60(1) of the Corporations Law provides: "Subject to subsection (2), a reference to a director, in relation to a body corporate, includes a reference to:... (b) a person in accordance with whose directions or instructions the directors of the [company] are accustomed to act...". Cf Companies Act 1985 (UK) s 741(2); Company Directors Disqualification Act 1986 (UK) s 22(4), (5); Insolvency Act 1986 (UK) s 251.
3. [1991] BCC 435, 443.
4. Id, 440–442.

Registrar for final determination, in accordance with UK procedure.

COURT OF APPEAL

The Court of Appeal upheld Vinelott J's decision, stressing two factors in particular. The first was the bank mandate, put in place at Castle's request, which required all cheques drawn by Tasbian to be counter-signed by Nixon. The Court observed:

> This meant that he [Nixon] was concerned with which of the company's creditors got paid and in which order, and to that extent it would appear - I say no more than that - that he was able to control the company's affairs. This seems to me to raise at least an arguable case that he was either a shadow or de facto director.[5]

The second point which weighed against Nixon was that he was instrumental in setting up a scheme (involving the transfer of Tasbian's employees to another company followed by the subcontracting of the employees back to Tasbian), with the sole object of defeating the Inland Revenue's claims against Tasbian for unpaid income tax. The degree of Nixon's involvement in that scheme suggested to the Appeal Court that, far from being a mere consultant or adviser to the company, he had assumed a managerial and executive role. This reinforced the view that there was a triable issue as to whether Nixon had become a shadow director.

EXEMPTION FOR PROFESSIONAL ADVISERS

Both the UK and Australian corporate laws contain a tortuous and vague provision declaring that a professional person does not become a shadow director:

> merely because the directors or members act on 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 ... [company] (Corporations Law, section 60(2)).

The aim of section 60(2) is to ensure that solicitors, barristers, accountants and the like, who are often called upon to give advice to companies, do not thereby automatically become shadow directors merely because their advice is consistently followed by the Board. The distinction between this case and Nixon's, however, is that Nixon did not merely proffer *advice* to the Board, but rather took over its major functions, the Board meekly acquiescing in this usurpation of its authority.[6]

5. Supra n 1, 364; Balcombe LJ, Lord Donaldson MR & Stuart-Smith LJ concurring.
6. Id, 363–364.

Furthermore, it should be noted that section 60(2) speaks of advice being given to the Board by a person acting in "the *proper performance* of the functions attaching to the person's professional capacity...". This formulation seems clearly to exclude Nixon since his instigation of and participation in the tax avoidance scheme is the antithesis of what most people would understand by the "proper performance" of professional duties.

IMPLICATIONS FOR INSOLVENT TRADING

1. The accountant — Nixon

It is clear that Nixon might well have overstepped the hazy dividing line between external watchdog and de facto director in Australia as well as England, thereby rendering himself open to the stringent disqualification provisions of the Australian Corporations Law.[7] It should be noted that if found to be a director, he could also be held liable, personally, for the debts of Tasbian, under the Corporations Law section 588G (insolvent trading),[8] as it is clear that he allowed the company to continue trading when there was no prospect of its being able to pay its debts.

It is interesting to consider how the recent change to the definition of insolvent trading, brought about by the Corporate Law Reform Act 1992, affects Nixon's position. Prior to the change, the definition of insolvent trading covered not only directors (including shadow directors) but also those who were "concerned in the management" of the insolvent company.[9] In *3M Australia Pty Ltd v Kemish*,[10] a consultant who virtually seized control of the debtor company's finances was held liable for insolvent trading on the basis of being concerned in the company's management. It seems likely that Nixon too could have been held liable for insolvent trading on that basis, given the depth of his involvement in Tasbian's day to day affairs.

However, the reference to "being concerned in the company's management" has now been deleted from section 588G, leaving a person potentially liable for the debts of an insolvent company only if it can be shown that he was a director, de jure or de facto. The effect of this change must

7. Ss 599 & 600.
8. S 588G repeals and replaces s 592(1) of the Corporations Law wef 23 June 1993. A director or shadow director can also be held liable for unremitted group tax under the Insolvency (Tax Priorities) Legislation Amendment Act 1993, which repeals and replaces s 221P of the Income Tax Assessment Act 1936.
9. Id, s 592(1) (repealed).
10. (1986) 4 ACLC 185.

inevitably be to focus attention on what constitutes a shadow or de facto director for purposes of the insolvent trading laws, something which it was not necessary to do prior to the recent legislative reform. The Court of Appeal's decision in *Re Tasbian*, dealing with the meaning of shadow director, has therefore assumed increased importance in Australian law.

2. The finance company — Castle

What is the position of Castle, the finance company which appointed Nixon? Could it be liable for insolvent trading too? Prior to the recent reforms it would simply have been necessary to show that Castle was concerned in the management of Tasbian. Now, however, it would be necessary to prove that it was a shadow director within section 60(1)(b). The case for so holding seems tenuous, but a shadow directorship could possibly be made out on the basis that Nixon acted as Castle's agent in the bid to rescue Tasbian and that Castle actively supported Nixon at every stage of the endeavour.[11]

If a court accepted this argument, and held Castle to be a shadow director, it would be swept within the net of the insolvent trading laws. The deep pockets of a finance company would naturally provide an attractive target for a liquidator contemplating launching an action under section 588M for the benefit of unsecured creditors.[12]

It should be stressed, however, that there is as yet no reported decision in Australia of a bank or finance company being held to be a shadow director in a case comparable to *Re Tasbian*. On the other hand, in England, Knox J, in a controversial ruling handed down in interlocutory proceedings, refused to strike out an application by a liquidator to have a bank declared a shadow director for purposes of the UK insolvent trading laws.[13] The matter was not pursued at the full hearing,[14] so the question whether a bank could be held to be a shadow director remains in doubt.

11. A letter written to Tasbian by a director of Castle possibly supports this agency argument: "I feel that I must emphasise that David [Mr Nixon] is acting on our behalf and accordingly, if the company chooses to counteract his instructions ... it places in jeopardy the entire relationship built up over some time ... Please ensure that the necessary bank mandate instructions to Barclays [Bank] are completed so that David may exercise control over the account immediately": supra n 1, 363–364.
12. S 588M gives the paramount right to institute an action for insolvent trading against the directors of a failed company to the liquidator rather than the creditors (a change from the previous position under s 592).
13. *Re a Company (No 005009 of 1987); ex parte Copp* [1989] BCLC 13.
14. Reported as *Re MC Bacon* [1990] BCLC 324. Note, however, that the trial judge, Millett J, suggested that the liquidator's claim that the bank had become a shadow director was "rightly abandoned" (ibid, 326).

The uncertainty surrounding Knox J's ruling has set the alarm bells ringing in UK banks and prompted calls from them to have the definition of shadow director redrawn so as to make it clear that they do not fall within it.[15] So far those calls have fallen on deaf ears. The argument in favour of the exclusion would be that an extensive interpretation of "shadow director" would simply hamstring the banks and finance companies in their efforts to rescue failed companies like Tasbian.

CONCLUSION

A consultant appointed by an outside investor to assist in the recovery of an insolvent or financially troubled company should have regard to the Corporations Law, sections 60(1)(b) and 60(2). To avoid the possibility of an inadvertent metamorphosis from consultant to director, it is imperative that the consultant's terms of appointment, and all subsequent dealings with the debtor company, clearly show that *advice* rather than *directions* or *instructions* are being offered to the Board, though the distinction between the two may not always be easy to draw. It is equally important that the consultant should not act beyond his professional expertise, nor engage in illegal or nefarious conduct, since if he does he will not be able to avail himself of the protection afforded by section 60(2).

As for banks and finance companies, they may regard themselves as generally beyond the reach of section 588G, at least for the moment. Nevertheless it would be wrong to ignore the profoundly anti-bank sentiment which currently pervades some quarters of the judiciary. As a result of that sentiment, it cannot be said with certainty that a bank or finance company will not one day be held to be a shadow director under section 60(1)(b), thereby bringing it within the insolvent trading laws. The closer and deeper the bank's involvement in the affairs of the debtor company the more likely that such a finding may be made. It therefore behoves the banks to maintain an arm's length relationship with their debtor corporations in order to prevent this danger materialising.[16]

---

15. J H Farrar, N E Furey & B M Harrigan *Farrar's Company Law* 3rd edn (London: Butterworths, 1991) 342.
16. Note that if the bank has nominees on the board of the debtor company, this is not in itself sufficient to constitute the bank a shadow director: *Kuwait Asia Bank EC v National Mutual Life Nominees* [1990] 3 WLR 297.