

Banks as shadow directors

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This article discusses the role of banks in "intensive care assignments". In some circumstances, the bank may be classified as a de facto director with attendant legal obligations. Some solutions to the potential problems faced by banks are discussed.

I INTRODUCTION

The recent English decision in *Re Tasbian (No 3)*¹ has highlighted some of the dangers of "soft receiverships" or "intensive care assignments", as they are sometimes called. It is timely, therefore, to examine the background to these assignments, some problem areas and some possible solutions.

There are many reasons why banks embark upon intensive care assignments. They believe that there will be substantial savings in professional costs, both on the legal and the accounting sides of the insolvency profession, if a formal appointment is avoided. An intensive care assignment can be initiated without any of the adverse publicity which often attends a formal appointment. During the assignment, the company can sell its goods and services in the ordinary course of its business, thereby avoiding "fire sales" or "liquidation sales". The non-core assets of the company can also be sold in a rational and favourable market.

Sometimes the intensive care assignment is conducted by one of the bank's own officers. Sometimes an external consultant such as an insolvency practitioner is engaged for this purpose. Often the bank causes its customer to engage the consultant as its own agent and requires the customer to assume responsibility for his or her fees.

The scope of an intensive care assignment varies with the circumstances of the case and, in particular, the predicament of the company concerned. It may involve a simple rationalisation of surplus stock through bulk sales, thereby reducing the company's storage charges. It will invariably involve a tighter rein on expenditure and a more assertive policy of collecting book debts, to improve the company's cash flow. It may involve a detailed analysis of the different divisions in the company to determine the real cause of the liquidity problem and it may even lead to the sale of non-core assets. There are many variations on this theme.

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1 [1991] BCC 436.

II THE PROBLEM AREAS²

Most of the problems with intensive care assignments stem from the extended definition of director in section 180 of the Companies Act 1955 (NZ) and its counterpart, section 126 of the Companies Act 1993 (NZ). These provisions make it clear that persons can be directors:

- (a) if they occupy the position of director by whatever name they are called;
- (b) if they exercise or control the exercise of the board's powers; or
- (c) if they exercise or perform a power or duty of the board with its consent or acquiescence.

Consequently, a person can be a director if he or she is a *de facto* director who assumes the role and position of director without the authority of the company or the board.

The extended definition of director provides that the term "director" includes a person in accordance with whose directions or instructions a director may be required or is accustomed to act. Given the terms of the New Zealand provision, it would be sufficient if *one* director was accustomed to act in accordance with the directions or instructions of the outsider. By contrast, the English section has been interpreted to mean that the *whole board* must be accustomed to act in accordance with the directions or instructions of the so-called "shadow director"³. In short, the terms of the New Zealand provisions make it easier for a court to find that an outsider has become a shadow director.

The New Zealand provisions contain a helpful exception: the term "director" does not include a person to the extent that he or she acts only in a professional capacity. It may be noted that this exception is couched in narrower terms than its Australian counterpart, section 60(2) of the Corporations Law, which refers to "business relationship" or "professional capacity". This is particularly important for banks because it is unlikely that a New Zealand court would regard a bank's relationship with its customers as part of a "professional capacity". In other words, the omission of the words "business relationship" from the New Zealand provisions may mean that New Zealand banks will be unable to take advantage of the exception to the extended definition of "director".

There appear to be no reported New Zealand cases on the extended definition of "director" but there are some significant English and Australian cases.

2 For a comprehensive review of the range of these problems, see P B Edelberg "Legal Issues in Business Workouts" (1991) 108 BLJ 196.

3 *Kuwait Asia Bank v NML Nominees* [1990] 3 WLR 397.

In *Re Tasbian (No 3)*⁴ a chartered accountant who was engaged as an external consultant to conduct an intensive care assignment devised a workout plan himself, required company cheques to be countersigned by himself and initiated some major management decisions, in particular the transfer of the company's entire workforce to a shelf company and a rehiring of those employees from the shelf company to secure tax savings. The English Court of Appeal held that it was clearly arguable that he had become a de facto director and a shadow director. It was no defence to say that he was exerting merely a negative control or a power of veto. He was deeply involved in the management of the company. He had gone far beyond giving advice in the proper performance of his professional capacity or business relationship with the company.

This is not an isolated example. In *3M Australia Ltd v Kernish*⁵ a chartered accountant mounted a rescue operation to save a company which was in financial difficulties. He introduced some sensible cost-cutting measures and sales incentive schemes. He attempted to renegotiate the company's financial arrangements to reduce its interest costs and factoring charges. The court acknowledged that he was acting in good faith in a "personal crusade" to save the company. Yet it held that he was liable for insolvent trading under the Australian equivalent of section 189 of the Companies Act 1955 (NZ) and its counterpart, section 135 of the Companies Act 1993 (NZ).

A bank will not become a shadow director if it simply indicates the terms on which it will continue to extend credit to the borrower.⁶ Some banks take the precaution of causing the borrower to engage consultants at its own expense to advise on workout strategies. But even this may be going too far if the bank selects the consultants and requires the borrower to follow the strategies they devise. The American case, *State National Bank of El Paso v Farah Manufacturing Co Inc*,⁷ provides a sobering illustration. In that case, the lenders stacked the board of directors with their own nominees, forced the resignation of other directors and compelled the company to hire a consultant of their own choosing. The consultant caused the company to sell the company's assets in order to repay the lenders' debt prematurely. A jury verdict of \$18.9 million was awarded against the company when the company sustained substantial losses. Even if we discount the fact that this was a jury verdict in a jurisdiction which is more inclined to accept extravagant claims, this is a salutary tale.

Banks cannot avoid liability as shadow directors simply by causing the borrower to engage a consultant chosen by the bank. It is probably safe for the bank to be consulted about the selection of the consultant and even for the bank to recommend several different consultants for appointment by the borrower but the actual appointment should

4 [1991] BCC 436.

5 (1986) 10 ACLR 371.

6 *Re PFTZM Ltd*, an English case cited in (1995) 7 Australian Insolvency Bulletin 65 in a reference to a Banking and Insolvency Bulletin by Stephenson Harwood, London.

7 678 SW 2d 661 (Tex App 1984).

be made by the borrower of its own volition.⁸ Once the appointment is made, the bank should refrain from issuing instructions or directions to the consultant to avoid any suggestion of an agency relationship between the consultant and the bank.⁹

If the court finds that the person carrying out the intensive care assignment is a "director" according to the extended definition of "director", then he or she becomes subject to a host of statutory obligations and general law duties. It is sufficient to note some of the more important statutory duties of directors. They have a duty to exercise the care, diligence and skill that a reasonable director would exercise in the circumstances, having regard to their positions as directors and the nature of their responsibilities.¹⁰ They must act in good faith and in the interests of the company and exercise their powers for a proper purpose.¹¹ Moreover, they must avoid conflicts between their duties and their own personal interests or those of their employer or appointor.

It is true that directors are entitled to delegate their powers and to rely on professional or expert advice but a bank which becomes involved in the affairs of a company as a de facto director or a shadow director will generally be unable to take advantage of these concessions.¹²

Banks which become involved as shadow directors or de facto directors may also expose themselves to a liability for misleading and deceptive conduct in their dealings with the company's property.¹³ In this regard it is important to bear in mind that misleading and deceptive conduct need not be intentional and that silence can constitute misleading and deceptive conduct in certain circumstances, for example, where one party has duty to speak out to correct a misconception by another party.¹⁴

There is the additional risk that the bank may, by its conduct as a shadow director, provide the guarantors of the company's debts with ample grounds for arguing that they should be discharged wholly or partly from their guarantees. Even if these arguments do not ultimately prevail they may be sufficient to enable to guarantors to resist summary judgment, thereby delaying the bank's recovery under the guarantee for years.

8 A mere power of veto should not, in itself, be fatal. See *Martin v Peyton* 246 NY 213 (1927) and *Re Tom the Cheap (WA) Pty Ltd* (1977) 3 ACLR 333. But cf *Re Tasbian* (No 3) [1991] BCC 436.

9 See *American Express International Banking Corporation v Hurley* [1985] 3 All ER 564; *Standard Chartered Bank Ltd v Walker* [1982] 1 WLR 1410 (receivership cases). See also *National Bank of Greece SA v Pinos Shipping Co* [1989] 3 WLR 185.

10 Section 191 of the Companies Act 1955 (NZ); s 137 of the Companies Act 1933 (NZ).

11 Sections 185 and 187 of the Companies Act 1955 (NZ) ss 131 and 133 Companies Act 1993 (NZ).

12 See ss 184 and s 192 of the Companies Act 1993 (NZ).

13 See s 9 of the Fair Trading Act 1980 (NZ).

14 See *Henjo v Collins Marrickville Pty Ltd* (1989) 89 ALR 539.

As a de facto or shadow director the bank might also incur liabilities under environmental protection legislation such as the Resource Management Act 1991 (NZ).

A comprehensive analysis of this Act is beyond the scope of this paper. It is sufficient for present purposes to note that section 17 provides that every "person has a duty to avoid, remedy, or mitigate any adverse effect on the environment arising from an activity carried on by or on behalf of that person..." Moreover, section 314 enables the Planning Tribunal to make an enforcement order against any such person requiring the person to remedy or mitigate any adverse effect on the environment caused by or on behalf of the person. These provisions could easily be applied to banks or their officers or consultants as shadow directors. The bank might well incur a substantial liability for the clean up of a contaminated site and this liability may far exceed the amount of the borrower's indebtedness.¹⁵

III SOLUTIONS

One possible solution for the bank is to ensure that the company itself engages the external consultant and that the consultant is not directed or instructed by the bank. This breaks the chain of vicarious liability which would arise if the bank itself engaged the consultant or directed one of its employees to conduct the intensive care assignment.

A more drastic solution for the bank is to appoint a receiver and manager under its mortgage or mortgage debenture. Such a receiver and manager is almost invariably expressed to be the agent of the company itself under the terms of modern mortgages or mortgage debentures. Once again, this breaks the chain of vicarious liability and saves the bank the grief it might suffer as a de facto or shadow director. The term "director" does not include a receiver.¹⁶

As yet, New Zealand law does not have a voluntary administration regime similar to Part 5.3A of the Corporations Law in Australia. The early results suggest that this new procedure is providing a return for unsecured creditors of roughly three times what they could expect to receive in a winding up. Unfortunately there is no data on the impact of the new regime on banks or secured creditors but it appears that they are adopting a "wait and see approach". They know that they will be able to enforce their securities once the administration is over.

The new regime, like a traditional receivership, avoids all the problems of de facto directorships and shadow directorships and it has much to recommend it.

15 See generally *United States v Mirabile* 15 Environmental Law Reports 20992 (ED Pa 1985).

16 Section 180 (1a) of the Companies Act 1955.