Key words: risk management; shadow directors; workouts

Shadow directorship risk for lenders in informal workout scenarios

In the wake of the global financial crisis, it has become increasingly common for lenders to pursue 'informal workout' arrangements with distressed borrowers in an attempt to avoid the destruction of value often associated with formal insolvency proceedings. Although shadow directorship risk for lenders has been described as 'almost entirely imaginary' under English law,[2] the same cannot be said for the position of lenders under Australian law.[3] This paper makes some practical suggestions that may assist lenders in mitigating shadow directorship risk when engaging in informal workouts with Australian corporate borrowers.

ERIC FLAYE A Fin is a Solicitor with Freehills.[1]
Email: Eric.Flaye@freehills.com

WHEN FACED WITH A BORROWER that is in default under the terms of its loan facilities, a secured lender has three main options:[4]

- *Appoint a receiver and enforce its security*. This may be an unattractive option if it is likely that the net proceeds of enforcement will be less than the outstanding value of the lender's exposure to the borrower and/or if enforcement might cause damage to the lender's reputation.
- *Extend further credit in the hope that the borrower will be able to improve its financial position*. This is often an unattractive option due to the risk of 'throwing good money after bad'.
- *Engage in an 'informal workout' with the borrower*. This option, in contrast to merely extending further credit, involves the lender actively engaging with the borrower to achieve a 'turnaround' or improvement in its financial position.

Although informal workout arrangements often have the potential to achieve optimal economic outcomes (for lenders, borrowers and the broader economy), a lender engaging in an informal workout with a distressed borrower may be exposed to the risk of being held to be a 'shadow director' of the borrower.

What is a shadow director?

The definition of 'director' in the *Corporations Act 2001* includes a person who is not validly appointed as a director of a company if the directors of the company (the Appointed Directors) are accustomed to act in accordance with the person's instructions or wishes (such a person is commonly referred to as a 'shadow director').

A person will not be a shadow director merely because the Appointed Directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity, or the person's business relationship with the Appointed Directors (the Professional and Business Relationship Exception).[5]

In general terms, the potential risk of being held to be a shadow director arises whenever an individual or a company exercises a degree of control or influence over a board of directors.

What are the potential consequences of shadow directorship?

It is beyond the scope of this paper to provide a comprehensive overview of the potential consequences of shadow directorship. Suffice it to say that the primary consequences result from the fact that shadow directors are subject to duties imposed on directors under the *Corporations Act 2001*, including duties of care and diligence and, importantly, the positive duty to prevent insolvent trading.

What is an 'informal workout'?

In general terms, an informal workout can be described as a contractual arrangement and process for the rescue of a distressed debtor company (e.g. a borrower), which is supported by its creditors (e.g. lenders) and conducted outside of formal insolvency proceedings (liquidation, receivership and administration).

There is no common form for informal workouts. Options include strengthened loan documentation and separate agreements between distressed debtors and creditors that set out agreed plans for the debtors to implement over specified time-frames (often referred to as 'No Action', 'Standstill' or 'Moratorium' agreements).

What makes lenders potentially vulnerable to shadow directorship risk in informal workout scenarios?

Notwithstanding the fact that there is no reported case in Australia in which a lender has been held a shadow director of a borrower,[6] lenders engaging in informal workout arrangements with distressed borrowers are nonetheless potentially at risk due to both factual and strategic reasons.

Factual reasons

Lenders typically play a very active and influential role in informal workout arrangements and often impose requirements and conditions on distressed borrowers relating to (among other things):

- improved governance and reporting;
- restructuring initiatives (which may include asset sales);
- new or revised business plans and policies; and
- negative covenants and consent/veto rights in relation to areas of strategic importance to borrowers' businesses.

Since distressed borrowers are generally reliant on the continued support of their lenders for survival, there is often a strong degree of compulsion (actual or perceived) on distressed borrowers to yield to the wishes of their lenders, giving such lenders a degree of control or influence over their distressed borrowers in the context of informal workouts.

Notwithstanding the fact that there is no reported case in Australia in which a lender has been held a shadow director of a borrower,[6] lenders engaging in informal workout arrangements with distressed borrowers are nonetheless potentially at risk due to both factual and strategic reasons.

Strategic reasons

Lenders are often perceived as 'attractive targets' by the liquidators of insolvent borrowers due to their 'deep pockets'.

Relevant case law and legal commentary

It is not the intention of this paper to provide a comprehensive overview of the law on shadow directors. There is certainly no shortage of academic literature on the subject, including focused commentary on shadow directorship risk for lenders.[7]

A review of relevant case law and academic literature reveals that there is an absence of clear and definitive legal principles in relation to the circumstances in which a lender might be held to be a shadow director of a borrower. Instead of a well-defined set of elements that must be proved, an open-ended list of factors for cumulative consideration has developed.[8] In *Emanuel Management v Foster's*, Chesterman J refused to accept as a general principle of Australian law that mortgagees (e.g. secured lenders) are incapable of being held to be directors of their mortgagors (e.g. borrowers), but noted that in the 'ordinary course', a mortgagee insisting that the mortgagor act to protect the mortgagee's interests will not, for that reason alone, become a director of the mortgagor.[9] This presents the vexed questions of precisely what the 'ordinary course' is in the context of an informal workout, and what 'other circumstances' or 'additional factors' might result in a lender overstepping the indistinct line between sound loan administration and undue interference in the management and affairs of a borrower.[10] In the next section of this paper, some practical suggestions will be made, which may assist lenders in navigating this indistinct line.

TABLE 1: Possible ways for lenders to mitigate shadow directorship risk in informal workout scenarios

It is important to note that given the fact-specific nature of shadow director claims, and the lack of clear judicial guidance (as mentioned above), the suggestions made below may not prove effective or appropriate for a given fact scenario. Legal advice should always be sought.

Limit nature of involvement	As mentioned above, there is a lack of clear judicial guidance regarding the degree of influence lenders can exercise over distressed borrowers during informal workouts without overstepping the traditional bounds of the lender–borrower relationship. While it would appear that the position under English law is that a lender cannot be held to be a shadow director of a borrower so long as it acts in defence of its own interests, and so long as the borrower is free to accept or reject any of the lender's requirements,[11] it is questionable whether such a 'lender-friendly' principle exists under Australian law.[12] In general terms, a lender will be in a heightened position of risk if: ● it involves itself in the 'top level management' and financial affairs of a borrower, strategic aspects, 'crucial areas' or the day-to-day operations of a borrower's business, actual supervision of management, or activities involving policy and decision-making related to a borrower's business affairs as a whole;[13] and ● the directors of the borrower become 'accustomed to act' in accordance with the lender's instructions or wishes (a pattern of behaviour emerges under which a governing majority of the directors habitually, routinely or commonly acts in accordance with the lender's wishes).[14] Although an 'arm's-length' or 'hands-off' approach is the best practical defence,[15] involvement or conduct of a lender which, in the absence of additional factors, would appear to present limited shadow directorship risk includes: • requesting further information about a borrower's financial affairs; • sending in an investigator to assess a borrower's financial position; • passive attendance at meetings of a borrower to allow the lender to monitor issues of direct relevance to the lender's position as a creditor; • demanding a reduction or mandatory pre-payment of a loan; • imposing negative covenants that are clearly referable to protection of the lender's interests as a creditor (e.g. a prohibition on incurring additional debt); • requesting that a borrower provide proposals for improving its financial position; • providing advice on ways that might assist a borrower to improve its financial position; • requesting that a borrower grant additional security in favour of the lender; and • requiring the sale of secured property. Involvement or conduct of a lender that would appear to be in the 'more risky' category, and which should be avoided in the absence of legal advice to the contrary, includes: • directly negotiating with third parties on a borrower's behalf; • exercising control over bank accounts and/or the collection and application of a borrower's cash flows (e.g. deciding which creditors of the borrower get paid and when); • appointing directors to a borrower's board; • active involvement in board or management meetings of a borrower; • involving employees or agents of the lender in a borrower's operations or management processes; • involvement in any matters that are not clearly referable to protection of the lender's interests as a creditor[16] (these may include activities or processes that relate to issues concerning employees, marketing, production or service delivery); and • conduct that may result in the lender obtaining an additional advantage above what is clearly referable to its position as a creditor[17] (e.g. the lender misusing its leverage over a borrower to obtain some form of collateral benefit above recovery of its debt).
Limit frequency of involvement	The greater the number of occasions on which a borrower defers to the wishes of its lender, the more credence that will likely be given to an argument that the directors of the borrower are 'accustomed to act' in accordance with the lender's wishes. Particular care should be taken if the borrower has a history of deferring to requests made by the lender. A lender should attempt to limit the frequency of its involvement with a distressed borrower by: • focusing on key issues of primary importance to protection of its interests as a creditor; and • limiting the number of occasions on which it provides advice or makes suggestions to the borrower.

Limit duration of involvement	A lender should attempt to limit the duration of its engagement in an informal workout to the minimum time necessary to protect its interests as a creditor. The longer a lender is engaged with a borrower pursuant to an informal workout, the greater the shadow directorship risk, as an argument could later be made that the lender adopted a role of 'continuous and ongoing input' into the borrower's affairs.[18]
Provide advice, recommendations or suggestions, not instructions or directions	A lender should not, as a matter of regular practice, give instructions or directions to senior management or the directors of a borrower, particularly in relation to 'crucial' or strategic areas of the borrower's business, or in relation to senior management or board-related functions. Whenever possible, a lender should: • communicate 'requirements' that it wishes to impose on a borrower ostensibly in the form of advice, recommendations or suggestions; • try to avoid using words that connote a degree of compulsion or obligation; and • clearly specify that in relation to advice, recommendations or suggestions proffered by the lender to a borrower, the final decision regarding whether or not to adopt a particular course of action remains with the senior management or the directors of the borrower (as applicable). There is always a material risk that a court may have regard to substance over form (i.e. hold that 'advice', 'suggestions' or 'recommendations' proffered by a lender are in essence instructions if the borrower has no practical option but to yield to the lender's requirements). A lender should therefore always make a concerted effort to frame its 'requirements' as advice, as the Professional and Business Relationship Exception is limited in its application to 'advice given'.
Provide a range of alternative courses of action (avoid a prescriptive approach)	A lender and its advisers should consider the possibility of presenting a distressed borrower with a range of alternative courses of action that will meet the lender's primary commercial objectives. The rationale for doing this is that the borrower will essentially be forced to consider and make a decision regarding the course of action to adopt, and this may later assist the lender in countering an argument that the directors of the borrower simply accepted decisions made by the lender without 'careful consideration' or that they accepted the lender's advice as 'something necessary or as a fait accompli'.[19] It would appear that the more prescriptive a lender's suggestions are, the greater the shadow directorship risk for the lender.
Encourage the borrower to obtain independent advice	A lender should encourage a distressed borrower to obtain independent professional advice (e.g. legal or financial advice).[20] The rationale for doing this is that the process of the borrower receiving independent advice may later assist the lender in countering an argument that the directors of the borrower acted pursuant to the lender's suggestions without due and careful consideration.
Impose a requirement that the borrower provide board minutes	A lender and its advisers should consider the possibility of imposing a requirement on a distressed borrower (e.g. as a condition precedent to a 'standstill agreement') to provide a certified extract of board minutes of a meeting (at which the lender was not present) which includes a resolution confirming that the directors of the borrower have resolved that: • the transactions contemplated by the workout will benefit the borrower (including reasoning); • alternatives to the transactions contemplated by the workout have been given due and careful consideration by the board; and • independent advice has been obtained by the borrower and considered by the board.
Do not appoint or instruct advisers or consultants	In respect of any professional adviser or consultant who is to be appointed to a borrower: • the adviser or consultant should be appointed and remunerated by the borrower; and • the adviser or consultant should be instructed and directed by the borrower (not by the lender).[21] While merely suggesting potential advisers or consultants (leaving the ultimate selection decision to the borrower)[22] and receiving reports and updates from an appointed adviser or consultant would appear to present only limited shadow directorship risk, there is a material risk that if a lender exercises control over or otherwise influences an appointed adviser or consultant, such an adviser or consultant may be held to be an agent of the lender (and the adviser's or consultant's conduct may then be attributed to the lender in a shadow director claim against the lender).
Limit nature and exercise of consent/veto rights	Although there would appear to be an unresolved threshold question of whether or not consent/veto rights, as negative rights, can form the basis of a shadow director action,[23] in the absence of clear judicial guidance on the issue, lenders would be well advised to: • limit the nature of any consent/veto rights imposed on a distressed borrower to matters that are consistent with the commentary made above in the 'Limit nature of involvement' section; and • try to limit the exercise of any consent/veto rights imposed, as the greater the number of occasions on which a lender refuses to grant consent or exercises its veto rights, the more credence that will likely be given to an argument that the directors of the borrower are 'accustomed to desist from acting' in accordance with the lender's instructions or wishes.

Notes

1 The views expressed in this article are the personal views of the author and do not necessarily reflect the views of Freehills or its clients. The author has written this article in his own time and purely in his personal capacity, and without any input or review by or on behalf of Freehills. This article provides a summary only of the subject matter covered, without the assumption of a duty of care by the author or Freehills. The commentary and opinions expressed in this article are general in nature and may not be applicable, appropriate or effective in respect of a given fact scenario. This article is not intended to be nor should it be relied on as a substitute for legal or other professional advice.

2 Millet J 1999, 'Shadow directorship – a real or imagined threat to banks', *Insolvency Practitioner*, vol. 1, p. 15.

3 As noted by R.P. Austin, the assumption that the concept of shadow directorship is the same in Australia and the United Kingdom is incorrect: R.P. Austin 2007, 'Hip-pocket injuries in workouts: accessory liability for bankers and advisers', *Insolvency Law Journal*, vol. 15, p. 11.

4 As discussed in Mark Stoney 2000, 'Borrower companies approaching insolvency – the potential liability of the lender as a de facto director', *Insolvency Law Journal*, vol. 8, p. 193; R.P. Austin, see note 3, p. 7.

5 See the definition of 'director' in section 9 of the *Corporations Act 2001*.

6 *Emanuel Management Pty Ltd and Ors v Foster's Brewing Group Ltd and Ors* [2003] QSC 205 (Unreported, Chesterman J, 17 July 2003) [264].

7 For extensive commentary on the law on shadow directors and shadow directorship risk for lenders, refer to: R.P. Austin, note 3; Mark Stoney, note 4; Martin Markovic 1998, 'Banks and shadow directorships: not an 'almost entirely imaginary' risk in Australia', *Journal of Banking and Finance Law and Practice*, vol. 9, no. 4, p. 284; Pearlie M. C. Koh 1996, 'Shadow director, shadow director, who art thou?', *Company and Securities Law Journal*, vol. 14, p. 340; Ian Ramsay (ed.) 1997, *Corporate Governance and the Duties of Company Directors*, see Robyn Carroll, 'Shadow director and other third party liability for corporate activity', p. 162.

8 See Mark Stoney, note 4, p. 199.

9 See *Emanuel Management*, note 6, [269].

10 See Mark Stoney, note 4, p. 201.

11 See *Re PFTZM Ltd (in liq), Jourdain v Paul* [1995] 2 BCLC 354, 368 (Baker J), and the extra-judicial comments of Millet J, note 2.

12 For example, see Chesterman J in *Emanuel Management*, note 6, [269]; R.P. Austin, note 3, p. 16; Martin Markovic, note 7, p. 291; Mark Stoney, note 4, p. 200.

13 See *Emanuel Management*, note 6, [357]; *Standard Chartered Bank of Australia Ltd v Antico* (Nos 1 and 2) (1995) 38 NSWLR 290, 328 (Hodgson J); *Australian Securities Commission v AS Nominees Ltd & Others* (1995) 18 ASCR 459, 509 (Finn J); *Hill and Another v David Hill Electrical Discounts Pty Ltd (in liq) and Another* (2001) 37 ACSR 617, 620 (Santow J); *William Arthur Forge and 5 Ors v Australian Securities and Investments Commission* [2004] NSWCA 448; *Ho v Akai Pty Limited (in liq)* [2006] FCAFC 159 (Unreported, Finn, Weinberg and Rares JJ, 13 November 2006) [21].

14 See *Emanuel Management*, note 6, [265]; *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 620 (Harman J); *Australian Securities Commission*, note 13; *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180, 182 (Millet J).

15 See Mark Stoney, note 4, p. 200.

16 See R.P. Austin, note 3, p. 15.

17 Ibid.

18 Ibid.

19 See *Standard Chartered Bank*, note 13. Note, however, that some commentators have queried whether mere acceptance by a borrower of conditions 'suggested' by a lender will conclusively remove shadow directorship risk. For example, see Markovic, note 7, pp. 301–02.

20 Reliance on independent financial advice was a relevant factor in *Rawley Pty Ltd and Others v Bell and Others (No 2)* (2007) 61 ACSR 648, 663 (Finn J).

21 See Mark Stoney, note 4, p. 200; R.P. Austin, note 3, p. 7.

22 See the commentary of James O'Donovan 1995, 'Banks as shadow directors', *Victoria University of Wellington Law Review*, vol. 25, pp. 285–86.

23 While relevant authority provides that the Appointed Directors must 'perform positive acts, not simply forbear to act or desist from acting' (*Harris v S* (1976) 2 ACLR 51, 64 (Wells J)), a number of legal commentators have argued that this should not be construed to mean that instructions and wishes to desist from doing particular acts are excluded (for example, see Ian Ramsay and Robyn Carroll, note 7, p. 183; Pearlie M. C. Koh, note 7, p. 347). See also the comments of Markovic and Turing who are clearly of the view that the exercise of veto rights could, in an appropriate fact scenario, form the basis of a shadow director action: Martin Markovic, note 7, pp. 301–03; Dermot Turing 1994, 'Lender liability, shadow directors and the case of re Hydrodam (Corby) Ltd', *Journal of International Business and Law*, vol. 9, no. 6, p. 246.