LENDING TO COMPANY GROUPS - THE PROBLEMS OF CORPORATE POWER AND DIRECTORS' AUTHORITY

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It is with some trepidation that I am delivering a commentary upon Mr Justice deJersey's paper entitled "Lending to Company Groups - Pitfalls to Borrowers and Lenders".

I say trepidation for a number of reasons:

- first, I am not sure whether it is entirely "good form" to comment upon a paper delivered by a judge especially when the few thoughts I have on the many interesting issues discussed by Mr Justice deJersey in his very readable account of where things may be heading after cases such as **Qintex**[1] and **Northside Developments**[2] may not have escaped the attention of too many other practitioners;

- secondly, I am well aware that at the first judicial opportunity which may present itself Mr Justice deJersey is in a singularly better position than I to express statements in relation to this area of law which will have real application for borrowers and lenders alike; and

- thirdly, an issue of interest to lenders to which the judge makes particular reference, namely, the extent of the duty to creditors owed by directors (and others who manage) insolvent companies which arguably flows from s592 of the Corporations Law (the "Law") is clearly in a state of change having regard to the extensive amendments to the Law proposed by the Corporate Law Reform Bill 1992 (the "Bill").

INTRODUCTION

Having got those concerns off my chest the particular points dealt with in Mr Justice deJersey's paper which I believe merit some further comment are:

(a) the extent of the relevance of the "put upon inquiry" test in the context of s164 of the Law;

(b) the issue emerging indirectly from the **Qintex** case as to the segregation of companies in corporate groups; and

(c) the duty to creditors which it is suggested arises as a correlative of the insolvent trading provisions of the Law and that now proposed for the Law given the terms of the Bill.

"PUT UPON INQUIRY" AND SECTION 164

Mr Justice deJersey states in his paper that **Qintex** and **Northside** have left him with nagging uncertainties as to whether the apparent clear charter of s164 of the Law will find favour with the courts.

No doubt that is not happy news for lenders. This will be especially so for those who have been content to rely upon the assumptions which the provisions of the Law enable them to make in their dealings with borrowers.

It is often dangerous to make sweeping or generalised assertions about the practice of lenders when dealing with borrowers because lending practices vary considerably. However, in recent times many lenders have in their dealings with borrowers consciously decided to limit or narrow the extent of their inquiries as to questions of corporate power and the exercise of power.

These practices have emerged because of the existence of ss161, 162 and 164 of the Law (and their predecessor provisions in the various Companies Codes, ss67, 68 and 68A).

This practice has suited the relevant lenders. In many instances they may not employ loan officers with extensive legal experience who would be capable of carrying out the appropriate reviews without the assistance of external legal advice. The competitive world of banking has led to pressure being exerted on lenders by borrowers to minimise transaction costs resulting in some lenders being more than prepared to curtail the due diligence process.

I do not wish to take issue in any material way with the conclusions which have been expressed in the judge's paper as to the principles which may be found in **Qintex** and, in particular, **Northside**. Indeed, I believe the views which are expressed in the paper as to what **Qintex** is all about (namely, that it is a case really concerned with the basis of granting an equitable remedy) are most helpful in trying to assess the real impact of that case. Certainly that decision has provoked a healthy debate as to whether the ultra vires doctrine has in some way been revived and I commend Mr Justice deJersey for reminding us all that s162(7)(f) of the Law does provide that the doing of an act in contravention of a company's power in its constitution and, thereby, also in contravention of s162(2)(a) of the Law, is capable of restraint by application for injunction under s1324 of the Law.

So far as **Northside** is concerned I also believe that the practical application which those principles may have for lenders in their dealings with borrowers can be limited essentially to those instances where the relevant dealings arose before s68A of each of the various Companies Codes was enacted. It is suggested in this commentary that the "put on inquiry" test should be limited in its operation to such dealings.

It is considered this position is certainly supported when regard is had to the views expressed by the Full Court of the Supreme Court of Victoria late last year in **Brick and Pipe Industries Ltd v Occidental Life Nominees Pty Ltd and Others.**[3]

The facts leading to the Full Court's consideration of the appeal from the trial judge's decision[4] and which relate to the collapse of the so called Goldberg group of companies (the "Goldberg Group") in January 1990 are summarised succinctly in the headnote to the report of the Full Court judgment.

Briefly, Brick and Pipe Industries Ltd ("Brick and Pipe") was a member of the group of companies controlled by Mr Abraham Goldberg. It had executed in favour of Occidental Life Nominees Pty Ltd ("Occidental") a guarantee and indemnity agreement (the "Agreement") to secure amounts payable by other companies in the Goldberg Group under a bill facility which Occidental had provided to the Goldberg Group. The Agreement had been executed by Brick and Pipe under its common seal with two directors of Brick and Pipe, Mr Goldberg and his son-in-law, Mr Zev Furst, attesting the sealing. At the time of attestation, the legal adviser for Occidental noted that Mr Furst had witnessed the affixation of the seal as company secretary. Yet company searches conducted at the time failed to confirm that Mr Furst in fact held that position.

The evidence revealed that when the discrepancy was noted Mr Goldberg and Mr Furst remained silent while an associate of Mr Goldberg (a Mr Durlacher) confirmed that the correct officers had attested to the affixing of the common seal to the Agreement. Occidental's legal adviser was informed that he would be supplied with copies of the appropriate statutory companies forms verifying this fact. These forms were never provided and Occidental in fact proceeded to execute the Agreement itself a few days later.

When the Goldberg Group collapsed Occidental sought to recover from Brick and Pipe under the Agreement the amounts owing in respect of the bill facility which it had provided to the Goldberg Group.

Brick and Pipe sought a declaration that the Agreement was unenforceable on two grounds:

(a) there were a number of irregularities in relation to its execution; and

(b) by virtue of the prohibition contained in s230(1)(b) of the Companies (Victoria) Code - the provision now found in s234(1)(b) of the Law.

Occidental counter-claimed for indemnity in accordance with the terms of the Agreement and the trial judge, in finding against Brick and Pipe in connection with Brick and Pipe's arguments concerning the execution irregularities, held that Occidental was entitled by s68A(3)(e) of the Companies (Victoria) Code - the predecessor of s164(3)(e) of the Law - to assume that the Agreement had been duly sealed.

It was accepted by both sides on appeal that the Agreement had not been validly executed for three reasons:

(1) the actual execution of the Agreement had not been authorised in accordance with Brick and Pipe's articles of association, having been attested by two directors rather than a director and secretary as required by the articles;

(2) the execution of the Agreement had not been authorised by a meeting of the board of directors of Brick and Pipe called in accordance with the articles; and

(3) the meeting of Brick and Pipe's board that had purportedly been held between Mr Furst and Mr Goldberg was not a properly constituted meeting as provided by its articles, because no notice had been given to other directors and Mr Goldberg was disqualified from casting a vote by virtue of the "interested directors" provision of the articles.

In dealing with the operation of s68A of the Code and the assumptions therein upon which the trial judge had found Occidental was entitled to rely in respect of the

Agreement and its execution, the Full Court referred to **Northside** in the following terms:[5]

> "The facts and circumstances of **Northside** were markedly analogous to those here. Moreover, it may be observed that members of the High Court in **Northside** were strongly of the view that where, as here, a company gives a guarantee which is of no apparent benefit to the company itself the other party to it is to be regarded as having been put upon inquiry as to due authorisation and perhaps otherwise depending on the circumstances. It may well be, therefore, that the rule in **Turquand's** case may not have assisted the respondents. However, the mortgage said to have been improperly executed in **Northside** was executed in 1979, some 5 years before s68A was introduced into the Code: see **Northside** at 154.
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> Although s68A was undoubtedly inspired by the rule in **Turquand's** case and is in a sense a codification of it, **the section does not incorporate the concept of being 'put upon inquiry'** and we are obliged to have regard to the assumptions, as defined by the section, which the respondents were entitled to make subject to the exceptions in sub-s(4)". (emphasis added).

In relation to the principal exception to s68A of the Code (now contained in s164(4)(a) of the Law) which provided that the various assumptions in s68A were not to be available if the party in question has "actual knowledge that the matter that, but for this sub-section, he would be entitled to assume is not correct", the Full Court expressed clear views as to the meaning of the exception:[6]

> "The expression 'actual knowledge' means, we think, what it says. It does not lend itself to definition or elaboration. What amounts to 'actual knowledge' is largely dependent on the facts and circumstances in a particular case and the inference they allow".

It is also worth noting that, both at first instance and on appeal, the arguments of Occidental were accepted that the failure of those who acted on behalf of Brick and Pipe to comply with the applicable provisions of Brick and Pipe's articles of association could **not** be relied upon by Brick and Pipe to defeat Occidental's claims pursuant to the Agreement by virtue of s68(4) of the Code - s162(5) being the equivalent provision of the Law.

Brick and Pipe had sought to characterise the general requirements of its articles of association as to the exercise of a company's power as "express restrictions" on each of the specified powers in its memorandum of association, and indeed on any power which could then be exercised by a company by reason of s67 of the Code. The thrust of Brick and Pipe's argument was that the rules as to internal management should be regarded as limitations upon the right of a company to act. This argument was rejected.

In passing there are two other points perhaps worthy of mention in relation to the **Brick and Pipe** case:

(a) the Full Court confirmed the trial judge's findings as to the meaning of "guarantee" and "security" for the purpose of the prohibition contained in s230(1)(b) of the Code (see s234(1)(b) of the Law).[7] The significance of the application of these views to other credit support arrangements which have a like economic effect to a guarantee (eg, put options) will itself depend upon the final terms of the amendments to the Law when the Bill is enacted - at present Part G of the Bill provides for the repeal of s234 of the Law; and

(b) it is understood that leave to appeal the Full Court decision was sought from the High Court and that Brick and Pipe's application was rejected. This does not of course represent an affirmation by the High Court of each and every view which was expressed in the Full Court's decision. However it does at least allow a conclusion to be drawn that the High Court considered there was no matter upon which the Full Court had decided which would sustain an appeal on the ground that the Full Court had erred in law.

I believe the **Brick and Pipe** decision, while clearly emphasising that the reliance on the statutory provisions in s164 will always turn on the particular facts and circumstances, does give lenders significant comfort that, in the absence of actual knowledge to the contrary, their dealings with borrowers will be upheld even though there may exist irregularities in the exercise of power by the other party or parties.

In the context of the discussion that emerges in **Qintex** and **Northside** concerning a company entering into a transaction where there is no benefit to the company or connection with its business and at a time when its solvency may be in question, it should be noted that the Bill proposes to amend the Law so that particular transactions described as "insolvent transactions" (which may be an "unfair preference" or an "uncommercial transaction") will be voidable if entered into within a specified period of the commencement of the winding up.[8]

The proposed s588FB provides that:

> "A transaction of a company is an uncommercial transaction of the company if, and only if, it may be expected that a reasonable person in the company's circumstances would not have entered into the transaction, having regard to:
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> (a) the benefits (if any) to the company of entering into the transaction; and
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> (b) the detriment to the company of entering into the transaction; and
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> (c) the respective benefits to other parties to the transaction of entering into it; and
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> (d) any other relevant matter;
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> whether or not a creditor of the company is a party to the transaction."

The relevant provisions concerning these voidable transactions are different from those contained in the current law and the explanatory paper accompanying the Bill states, in relation to proposed s588FB, that it is a provision specifically aimed at preventing companies disposing of assets or other resources through transactions which resulted in the recipient receiving a gift or obtaining a bargain of such magnitude that it could not be explained by normal commercial practice.

Mr Justice deJersey suggests in his paper that if in **Qintex** the guarantees had been given (so that, for example, there may not have been a basis for refusing to grant the equitable remedy sought because injunctive relief under the combined operation of s1324 and s162(7)(f) of the Law was not available) then by virtue of the width of the provisions of ss160 to 162 of the Law a declaration as to their validity would necessarily flow. The proposed "voidable transaction" provisions will now mean that particular transactions could, in appropriate circumstances, be capable of attack notwithstanding s162 will not afford any relief from the transaction.

SEGREGATION OF COMPANIES IN CORPORATE GROUPS

Mr Justice deJersey pointed out in his paper that in **Qintex** much was said by the trial judge and Full Court of the Supreme Court of Queensland that in the context of assessing corporate benefit the dealings of subsidiary companies needed to be regarded as separate from those of their holding companies.

In a sense these comments can be seen as being merely consistent with the previously well accepted view in Australia that there needs to be a clear demarcation between wholly owned subsidiaries in the same company group and the parent or holding company.[9]

Interestingly in a recent case involving another Qintex group company there emerged some significant questioning of the correctness or acceptability of this approach.

These views were expressed by Rogers CJ in his judgment in **Qintex Australia Finance Ltd v Schroders Australia Ltd.**[10] To avoid confusion with the earlier references to **Qintex** discussed in the judge's paper I shall refer to this case as the **Qintex Finance** case.

In **Qintex Finance** a question had arisen as to which company in the Qintex group of companies had in fact entered into a forward exchange contract with Schroders Australia Ltd ("Schroders"). Schroders had closed out at a loss a forward exchange contract which it contended it had entered into with Qintex Australia Finance Ltd.

When considering the issue for decision Rogers CJ observed:[11]

> "As I see it, there is today a tension between the realities of commercial life and the applicable law in circumstances such as those in this case. In the everyday rush and bustle of commercial life in the last decade it was seldom that participants to transactions involving conglomerates with a large number of subsidiaries paused to consider which of the subsidiaries should become the contracting party.
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> ...
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> On the other hand, as late as 1977, in **Industrial Equity Ltd & Ors v Blackburn & Ors** ... the High Court of Australia confirmed the need to preserve, as a matter of law, a rigid demarcation between wholly owned subsidiaries in the same group of companies, as well as their holding company. At much the same time, the House of Lords did likewise. That decision was not even thought worthy of being reported but is referred to by Palmer.
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> It may be desirable for Parliament to consider whether this distinction between the law and commercial practice should be maintained. This is especially the case today when the many collapses of conglomerates occasion many disputes. Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bears 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 ... If I may venture the observation there is a great deal to be said for the suggestion advanced by those in charge of the demised Hooker Group of companies that

assets and liabilities of the parent and the subsidiaries should be aggregated. It may be argued that there is justification for preserving the same attitude in relation to the demised companies as was displayed during their active commercial life."

What evidence is there to suggest that the practical observations of Rogers CJ in **Qintex Finance** as to the need to consider companies on a group basis rather than as separate entities are being, or are likely to be, pursued in one direction or another?

(1) In a reform directed towards ensuring that financial statements provide a true and fair view of the financial position of companies in a corporate group in the broadest sense, the Corporations Legislation Amendment Act 1991 introduced Division 4A into the Law whereby companies are now required to produce a single consolidated set of accounts covering both the parent company and all the corporate and unincorporated entities controlled by that company.

(2) The Bill proposes that a new Part 5.7B be introduced into the Law and in new Division 5 of that Part a proposed section (s588X) is to be included which will provide that the section will be contravened by a corporation which is a holding company if the subsidiary of the holding company incurs a debt when the subsidiary is insolvent or the subsidiary becomes insolvent by incurring a debt, and:

(a) there are reasonable grounds at the time for suspecting that the subsidiary is insolvent or will become insolvent; and

(b) that either the holding company or one or more of its directors were aware of these grounds or, having regard to the nature and extent of the corporation's control over the subsidiary's affairs, it is reasonable to expect that a corporation in the holding company's circumstances would have been aware of those grounds or that one or more of the holding company's directors would have been aware of those grounds.

The proposed section also provides that a corporation that contravenes the section is not guilty of an offence. The section provides civil remedies only and a liquidator of the subsidiary will be entitled to take proceedings against the holding company to recover for the benefit of unsecured creditors, loss or damage suffered by unsecured creditors as a result of the holding company's contravention of s588X (see proposed s588Y).

(3) The Australian Securities Commission ("ASC") has recently made a series of class orders pursuant to s313(6) of the Law that give accounts and audit relief to wholly-owned subsidiaries within a class of companies to which the relevant order applies. A number of conditions have to be met by companies seeking to take advantage of the orders in respect of financial years ending on or after 31 December 1991 including:

(a) the execution by the parent and each relevant subsidiary and a trustee for creditors of a deed of guarantee under which the relevant companies cross-guarantee each others' liabilities;

(b) the directors of the relevant company use best efforts to cause the statement which is required to be made in the consolidated accounts of the holding company for each financial year to include a statement as to whether, as at the date of the statement, there are reasonable grounds

to believe that the companies for which the relief is to apply and the holding company will as an economic entity be able to meet any obligations or liabilities to which they are, or may become, subject by virtue of the cross-guarantee;

(c) the directors of the relevant company include in each annual return which the relevant company files with the ASC a statement to the effect that at or about the time of the company's balance date the directors reassessed the advantages and disadvantages associated with the company remaining a party to the cross- guarantee and taking advantage of the accounting relief afforded by the relevant order of the ASC and the directors resolved either that the relevant company should continue to remain a party to such cross-guarantee, or to seek its revocation, as the case may be; and

(d) the relevant company has provided the ASC with a statement of the directors of the company signed by at least two of its directors stating that in the directors' opinion immediately prior to the execution of the cross-guarantee there were reasonable grounds to believe that the company would be able to pay its debts as and when they fall due.

Under the cross-guarantee which must be executed with the approval of the ASC each relevant company member covenants with a trustee for the benefit of each "Creditor" that the member guarantees to each "Creditor" payment in full of any "Debt".

"Creditor" is broadly defined in the form of cross-guarantee to mean a person (whether now ascertained or ascertainable or not) other than a member of the relevant group to whom now or at any future time a "Debt" (whether now existing or not) is or may at any time be or become payable.

"Debt" is defined in the form of cross-guarantee to mean any debt or claim which is now or at any future time admissible to proof in the winding up of a member of the relevant group but no other claim.

The form of cross-guarantee provides that it will only become enforceable:

(a) upon a winding up of a member of the relevant group under particular provisions of the Law; or

(b) in any other case if six months after a resolution or order for the winding-up of the member any "Debt" of a "Creditor" has not been paid in full.

In terms of the statements which directors of the relevant companies must make and their duties to shareholders and (in appropriate circumstances, as referred to in the judge's paper) creditors, one imagines that directors of companies will now not seek relief under the relevant order for their companies without due consideration of the potential risks. This follows from the duty to act in the best interests of the company and to avoid conflicts of interest.

As for lenders which are creditors of one or more of the relevant companies which execute the cross-guarantee the following observations may be made as to the effect on them of any such cross-guarantee:

(i) by virtue of the granting of the cross-guarantee the creditor group of each member of the relevant group of companies is enlarged. The result is that if those lenders hold securities there will be more persons whose interests have to

be taken into account by any secured creditor in terms of the duties at general law which a secured creditor must observe in relation to other creditors on enforcement of the securities;

(ii) if a member of the relevant group of companies fails to pay amounts due to other creditors then a consequence of the existence of the cross-guarantee is that the beneficiaries of the cross-guarantee could seek to "collapse" all of, or particular members of, the relevant group of companies through demands being made under the cross-guarantee - this action may not be in the interests of all or particular lenders where the lenders concerned have decided it is in their best interests to ensure that the relevant companies continue to operate their businesses in the normal way and as going concerns; and

(iii) creditors which currently may only have a direct claim against one member of the relevant group of companies will become contingent creditors of each other member immediately upon the cross-guarantee being executed. This may impact upon the ability of lenders in particular circumstances to seek the stay or termination of a winding up of one or more of the members of the relevant group under s482 of the Law. This will also impact the ability to effect reconstructions and arrangements (both formal and informal).

SECTION 592 AND THE DUTY TO CREDITORS AND THE BILL

Mr Justice deJersey suggests in his paper that the creation of liability directly to creditors under s592 of the Law now carries with it in circumstances where there is impending or likely insolvency "a corresponding duty directly to creditors, and not one disguised as part of the duty to the company". The judge describes the duty as being the correlative of the statutory liability imposed by s592.

As explained in the judge's paper, it would seem that the rationale behind the statements in the cases as to duty to creditors focuses on the concept of beneficial ownership of company assets. When a company is solvent, the proprietary interest of its shareholders entitles them, as a general body, to be regarded as "the company" and therefore the owner of the company assets. However, when a company is insolvent, the interests of creditors intrude. Creditors are prospectively entitled through liquidation to displace the power of the shareholders to deal with the company's assets.

The nature of this duty is still unresolved. It is not clear whether it is a direct duty to creditors, independent of the director's duty to the company or merely a part of the latter duty. The majority judicial view seems to be that the duty to creditors is not independent, but is included in the director's duty to act in the best interests of the company.

But does s592 in fact impose a duty to creditors? If it does, the duty seems to be a negative duty - the section of course does not refer expressly to there being a "duty" but simply imposes liability if a debt is incurred while the company is insolvent or if incurring the debt brings about insolvency.

Whatever may be the correct analysis, proposed s588G as contained in the Bill imposes a positive duty on directors to ensure that the company does not incur debts while insolvent.

The new section also seeks to make the duty owed by the particular director commensurate with the size and complexity of the company in issue. Section 588 G(1) makes a director liable where he or she is actually aware, or where a reasonable person

in the position of director of a company **in that company's circumstance** should have been aware, of the company's insolvency (emphasis added).

It is also worth noting that the scope of proposed s558G is narrower than s592 of the Law. Section 558G applies to "directors" (as defined in s60 of the Law), whereas s592 applies both to directors and persons participating in management. The definition in s60 seems to be wide enough of course to catch persons who are de facto directors, ie, if they customarily act as directors.

Section 558G will not impose criminal liability for a breach of the section. Proposed s588M provides that the court can make an order for compensation to the company. Thus, it may not be as easy to argue that directors have a duty to creditors which is independent of their duty to the company. Individual creditors may not bring an action against a director other than in limited circumstances. Liquidators are given this power on an unfettered basis.

The requirements of proposed s588G do however arguably impose a more rigorous standard on directors:

(1) The test is one of "reasonable suspicion" of insolvency, as opposed to the current test of reasonable expectation.

(2) The defence of no implied or express consent to the incurrence of the debt will not be available.

FOOTNOTES

1. **ANZ Executors and Trustee Company Limited v Qintex Australia Limited** (1991) 2 Qd R 360.

2. **Northside Developments Pty Ltd v Registrar-General** (1991) 70 CLR 146.

3. 6 ACSR 464.

4. 3 ACSR 649.

5. 6 ACSR 464 at 475.

6. 6 ACSR 464 at 478.

7. For the purposes of s230(1)(b) the meaning of "guarantee" did not embrace an "indemnity" as "there was nothing in the context which indicates that Parliament used the word 'guarantee' with a meaning which extends beyond its usual and conventional meaning" (6 ACSR 464 at 486). Similarly it was held that "security" meant a security in a proprietary sense and the context indicated that the word was not intended to include a personal security.

8. See proposed ss588FC and 588FE.

9. **Industrial Equity Ltd & Ors v Blackburn & Ors** (1977) 137 CLR 567.

10. (1991) 9 ACLC 109.

11. (1991) 9 ACLC 109, 110-11.