

Federal Court of Australia Finds Liquidator's Breach of Duty Claim Against Directors of Holding Company Valid

In Short

The Situation: The question in *Termite Resources NL (in liq) v Meadows, in the matter of Termite Resources NL (in liq) (No 2)* [2019] FCA 354 was whether, in circumstances where the strategic, managerial and major operational decisions of Termite Resources NL ("Termite") were made by the Board of its holding company, Outback Iron Pty Ltd. ("Outback"), the directors of the Board of Outback could be liable as directors of Termite for breaches of directors duties under the Australian *Corporations Act 2001* (Cth) ("the Act").

The Decision: The Federal Court found that the directors of Outback were regarded as directors of Termite under the Act and owed the statutory directors duties to Termite because the "locus of decision-making" for Termite based on the shareholders agreement between the parties and the conduct of the parties rested with the Board of Outback.

Looking Ahead: The circumstances in this case are not unusual in closely held, private companies. The decision serves as a timely reminder that shareholders in a closely held, private company who wish to make or control all major decisions of the company (or their directors) may be regarded as directors or officers of that company and owe directors duties to the company. If the company is then put into liquidation, its liquidators can make claims on the shareholders or their directors for damages for breach of those duties.

Background

The case concerned an action brought by the liquidators of Termite against six former directors and/or officers of Termite and Outback. Termite alleged breaches of the duties in sections 180 and 181 of the Act and related duties to care and diligence and good faith under the common law in relation to the adoption and implementation of a "Distributions Policy" between March 2013 and March 2014. Under the Distributions Policy, Termite would maintain a reserve of \$3 million but distribute the remainder of its proceeds to its holding company to be paid to its shareholders.

Termite's principal claim was that the \$3 million cash reserve was inadequate. Termite alleged that each of the defendants breached the duties in sections 180 and 181 of the Act by:

- causing Termite to enter into the Distributions Policy;
- causing or permitting Termite to perform the Distributions Policy by making each of the payments; and
- failing to revoke or vary the Distributions Policy or cause Termite to do so.

Facts

Termite had operated an iron ore mining project in South Australia from May 2010. Termite was a wholly owned subsidiary of Outback, a company in which IMX Resources Ltd. ("IMX") and Taifeng Yuanchuang International Development Co. Ltd. ("Taifeng") (a company incorporated in Hong Kong) held 51% and 49% of the shares, respectively. Outback's sole business was as the holding company of Termite.

In 2008, Termite had been issued Mineral Lease No. 6303 for an area which fell within the Woomera Protection Area. The Commonwealth had granted Termite permission to enter the prohibited area, but it was a condition that the Commonwealth could, in effect,

preclude foreign investment in Termite. The result was that Taifeng made its investment into Outback and appointed its representatives to the Board of Outback, not Termite.

IMX and Taifeng funded Termite's operations by advancing money to Outback that was then on-lent to Termite. By 30 June 2012, Termite had received \$48.905 million. This consisted of \$21,309,673.50 advanced by IMX and \$20.474 million advanced by Taifeng as unsecured interest free loans, and \$7,121,326.50 provided by IMX and Taifeng as equity.

Before March 2013, there had been no repayment of the monies advanced to Termite. On 12 March 2013, each of the Boards of Termite, IMX and Outback adopted the Distributions Policy. The policy stated that, provided there were no "unfavourable developments" in the current or forecast iron ore price, copper price or AUD-USD exchange rate which would warrant additional cash being held by Termite, its management was each month to distribute to Outback all of its cash, after payment of operating expenses, which exceeded \$3 million. Outback, in turn, was to distribute all the cash it received from Termite to its shareholders, apart from a nominal amount of \$5,000 plus "an amount covering any potential Termite liabilities."

In accordance with the Distributions Policy, between March 2013 and March 2014, Termite paid distributions to IMX and Taifeng in proportion to their interests in Outback. By December 2013, the loans of \$41.8 million had been repaid in full. Additional payments made in 2014 of \$4.3 million were categorised as a return of capital.

In early 2014, there was a "sudden and unanticipated" decline in the iron ore spot price. As the spot price continued to decline, the \$3 million reserve was inadequate to meet Termite's existing and expected liabilities. In June 2014, Termite was placed into voluntary administration. Three months later, the creditors resolved to wind up Termite.

In this action, the liquidators alleged that the directors of Outback were directors of Termite based on the definition of "director" in the Act and alleged breaches of the statutory duty of care and diligence in section 180 and good faith in section 181 of the Act against six directors and/or officers of Outback and Termite, as well as breaches of the corresponding common law duties against three directors.

The definition of "director" in the Act includes a person not appointed as a director where the directors of the company are accustomed to act in accordance with that person's wishes or instructions.

Termite claimed that by adopting and implementing the Distributions Policy, the directors left Termite at serious risk of insolvency, especially given the operational and market risks of the marginal iron ore mining operation in which it was engaged. Termite pleaded that the \$3 million reserve was inadequate. Termite claimed that a reserve of \$10 million was required for a short-term downturn in iron ore price and a reserve of \$50 million for a long-term downturn.

Decision

On the evidence, Justice White established that the Board of Directors of Outback was responsible for determining matters of strategy, management and oversight of the operations of Termite. Since the "locus of decision-making" for Termite rested with the Board of Outback, Justice White found that the directors of Outback were "deemed directors" of Termite and owed the statutory duties.

By adopting the Distributions Policy, and making distribution payments between March 2013 and March 2014, the defendant directors had failed to act in the best interests of Termite. Justice White held that the directors had preferred the interests of IMX and

Taifeng ahead of those of Termite. This was apparent through the acts of "ring-fencing," which were undertaken to limit the liability of IMX and Taifeng in the event of Termite's insolvency, and the preference of IMX's solvency issues and Taifeng's recovery of investment over the protection of Termite.

For similar reasons, Justice White found that the directors had breached their duty of care and diligence. In prioritising the financial interests of IMX and Taifeng over Termite, they had failed to provide for the contingency of a long-term drop in the iron ore price and failed to meet the required duty of care and diligence.

Justice White found Termite entitled to a judgment against each defendant in the sum of \$7 million. This represented the difference between the \$3 million reserve and the amount of \$10 million that, on the evidence, Justice White was satisfied was necessary. No greater amount could be awarded because Termite had failed to establish what the defendants, acting in good faith and with the required care and diligence, would have done in the circumstances.

Although Termite had pleaded that a reserve of \$50 million was necessary for a long-term decline in the iron ore price, they had failed to present sufficient evidence to support this finding. The liquidators of Termite had led evidence on the assumption that once they had established that the adoption of the Distributions Policy (and the inadequacy of the \$3 million reserve) was a breach of duty, there was no need to establish what directors, acting with the required degree of care and diligence, should have done in the circumstances.

Three Key Takeaways

1. Private company shareholder agreements commonly provide for shareholders to make the strategic and major operational decisions for the company. Shareholders or their directors should be aware of the risk that they may be deemed to be directors of the company and may owe directors duties to the company.
2. Shareholders or their directors who are found to be "deemed directors" under the Act and have breached those duties will lose the protection of limited liability and may be personally liable for the breaches.
3. For any person bringing such a breach claim, it will be necessary to establish what a director acting in good faith and with the required degree of care and diligence would have done in the circumstances.