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# Directors beware – your duties and the use of shareholder loans

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It is common knowledge that directors owe duties to a company. Directors are, after all, responsible for its overall governance and direction. However, those duties are usually loosely acknowledged, and their scope is often underappreciated.

In smaller businesses, such as those with one or a small number of directors who are also the shareholders of the company, the risk of directors unknowingly or inadvertently breaching their duties can be higher. For example, in such operations, it may be common practice for funds to flow between the directors and the company – a director may advance funds to the company to assist its cashflow from time to time, or a director may authorise certain payments to him or herself from company funds. Payments made to a director, if not otherwise declared as a dividend or wages, would typically be recorded by way of shareholder loans on the company's records.

In adopting this common financing option within a company structure, directors would not generally contemplate or question the company's solvency, let alone intend to deprive the company from sufficient cash to meet its debts. In those circumstances, it becomes crucial for directors to have sound knowledge of the company's financial affairs and ensure accurate record and account keeping practices for the business. Otherwise, the directors' management of the company is confronted with certain risks, including inadvertent breaches of duties owed to the company and consequential personal liability.

This article explores the recent decision of the Federal Court in *Stone (liquidator), in the matter of Ironbark Blacksmithing Pty Ltd (in liq) v Mizzi* [2024] FCA 696 (**Mizzi**). Specifically, it examines the scope of the statutory and fiduciary duties owed by directors to a company, and how every day and common practices can lead to breaches of those duties and trigger other significant liabilities under the *Corporations Act 2001* (Cth) (**the Act**). These could include civil penalties, compensation orders, and disqualification from managing a company.

## Directors' duties

The duties and obligations owed by directors to a company are prescribed through legislation (primarily under the Act) and are informed through the common law (case law). They are fiduciary in nature, which means that they are based on trust, confidence, honesty and integrity. They are broadly known under the following categories of obligations:

- Care and diligence
- Good faith
- Use of position
- Use of information

### Care and diligence

Section 180 of the Act requires directors to exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

- were a director of a company in the company's circumstances; and
- had the same responsibilities within the company as its director.

The standard of care is assessed objectively, so that the focus is on what a reasonable person would have done when responding to a particular situation or circumstance. It is also appropriate and acceptable to take into consideration the circumstances of a particular director involved and the circumstances of the company. These include:

- the type of the company, its size and nature of its business;
- the terms of its Constitution, including how its board of directors is composed;
- the director's position, responsibilities, experience and skills;
- the terms on which the director has undertaken to act as a director; and
- the management of the company and the distribution of responsibilities within it.

With respect to the level of care and diligence, directors are required to take reasonable steps to place themselves in a position to guide and monitor the management of the company. This generally includes having knowledge of, and keeping updated with, the company's operations and financial position. While directors are entitled to rely on others with respect to the management and operations of the company (e.g. through their general managers, accountants, and bookkeepers), directors are still required to maintain independent and sufficient knowledge and understanding of the company's affairs.

### Good faith

Section 181 of the Act requires directors to exercise their powers and discharge their duties in good faith in the best interests of the company, and for a proper purpose. To discharge this duty, directors must:

- exercise their powers in the interest of the company;
- not take advantage of their position, or misuse or abuse their power;
- avoid conflict between their personal interests and those of the company's; and
- misappropriating company resources and assets for themselves or another.

Whether or not a director has discharged this duty involves assessing the director's subjective purpose, and if that purpose was objectively improper. It includes balancing the foreseeable risk of harm that a company may or has suffered against the benefits that could reasonably have been expected to accrue to it from the conduct in question.

### Use of position

Section 182 of the Act requires directors not to improperly use their position to gain an advantage for themselves or someone else, or cause detriment to the company. Under this duty, a director's conduct is improper if it breaches the standard of conduct that would be expected of a person in their position by reasonable persons with knowledge of the duties, powers and authority of their position as directors. It is also not necessary to show that directors have actually caused loss or harm to the company or have gained an advantage for themselves.

### Use of information

Section 183 of the Act prohibits a director who obtains information because of their directorship of a company from improperly using that information to:

- gain an advantage for themselves or someone else; or
- cause detriment to the company.

This duty continues even after an individual is no longer a director of a company.

## The decision in *Mizzi*

The company in question, Ironbark Blacksmithing Pty Ltd (In Liquidation), operated a metal fabrication business building steel stairs and iron balustrades. The directors of the company were two brothers who were also the only shareholders of the company.

Separately, the directors were in a partnership that owned the factory that the company operated in. While the company paid market rent to the partnership, there was no written agreement with respect to that arrangement, and a shortfall in rent payments accrued over time. In the later years of its operation, the company consistently held insufficient cash to meet is tax liabilities, and the ATO ultimately took steps to wind up the company.

On liquidation, the liquidator examined the company's books and records and alleged, among other things, that:

- the company had not maintained adequate and accurate books and records;
- company funds were advanced to the directors by way of shareholder loans. These advances were made by direct cash payments to each of the directors, payment of their personal credit cards, and payment of their personal tax liabilities;
- consistent with the ATO's winding up application, the company had overdue tax liabilities and outstanding compulsory superannuation payments;
- that the company continued to trade while it was insolvent; and
- the shareholder loans increased at a time when the company was insolvent.

The liquidator brought a claim against each of the directors to recover the shareholder loans, damages for breaches of their director duties, and for insolvent trading. Specifically, the liquidator claimed that the directors authorised payments to themselves while the company was insolvent, and that such payments did not benefit the company and instead was for the directors' own personal interests. In those circumstances, the directors breached their duties under sections 180, 181 and 182 of the Act.

In response, the directors claimed that they left the financial records, reporting and tax obligations of the company to their bookkeeper and accountant. In this regard:

- they each had very limited financial knowledge;
- they relied on their bookkeeper, being their sister, to document the company's financial transactions;
- they adopted the tax structure determined by their accountant and relied on their accountant to prepare the company's financial reports and tax returns and their own individual tax returns; and
- their accountant did not report or give them any warning in relation to the company's solvency.

With respect to the shareholder loans, the directors claimed:

- they advanced significant funds to the company in the course of its trading;
- the company funds that flowed between the directors and the company were made in the ordinary course of business; and
- that the payments they authorised for themselves were either a repayment of shareholder loans owed to them, or were set off against their respective salaries, directors' fees and the rent the company owed to the partnership.

On the facts, the Court found that:

- The partnership was a different legal entity to the directors in their individual capacities and had its own TFN and ABN. Further, the company's financial records did not record any loans made by the company to the partnership, only to the directors. In those circumstances, the company's liabilities to the partnership cannot be set off against personal liabilities of the directors to the company.

- The company's financial records did not record the full amount advanced to the directors that comprised of the shareholder loans.

- To the extent that the directors did not record or declare the company payments made to each of them in their personal tax returns as income, such advances were treated as part of the shareholder loans.

- In the absence of any supporting documents to support claims that the directors' credit cards were used only to purchase goods and services for the company, the company's payments of personal credit cards paid the directors' personal expenses. Such payments could only be treated as further advances made by the company to each of the directors as shareholder loans.

- The fact that the company was unable to meet its substantial debts to the ATO as and when they fell due, despite certain payment plans being in place, gave rise to a serious and imminent risk of insolvency and for claims to be brought by creditors. Notwithstanding this, the directors permitted the company to trade and incur debts and make payments, including to themselves. The shareholder loans owed by the directors to the company also increased during that period.

Accordingly, the Court found, among other things, that each of the directors breached the duties they owed to the company:

- Increases in the shareholder loans at a time when the company was insolvent breached section 180 of the Act, as the directors failed to act with due care and diligence by causing or failing to prevent the company from entering into transactions that did not produce any benefit to the company.

- A reasonable person in the position of the directors, given their limited financial knowledge, would have sought legal and financial advice as to the financial position of the company. A reasonable person would not have simply relied on an accountant to tell them if there were any matters for concern that might be relevant to the company's solvency.

- The directors allowed a situation where there was a real and substantial possibility of a conflict between their personal interest and the best interest of the company, in breach of section 181 of the Act. The directors failed to consider whether the withdrawal of company funds was in the best interest of the company, particularly in circumstances where the company was not able to pay its debts as and when they fell due.

- Each of the directors improperly used their position and the information available to them as directors of the company to gain an advantage for themselves, in breach of section 182 of the Act. Advancing company funds and allowing increases in the shareholders loans at a time when the company was insolvent breaches the standards of conduct that would be expected of a person in the directors' position by reasonable persons with knowledge of the duties, powers and authority of their position as directors.

The Court ultimately made orders for the directors to pay damages to the company in the amount of the funds advanced to each of them comprising of the shareholder loans.

## Key Take Away

From a practical level, the decision in Mizzi reminds us that:

- It is not sufficient for directors to wholly rely on a company's accountant and what they record in the company's financial statements and tax returns without reviewing such documents themselves.

- Directors need to independently engage with the financial position of a company. This necessarily includes reviewing the company's financial reports and having some degree of understanding of those reports to verify the company's financial position. This is particularly true in circumstances where directors are required to make a declaration that the contents of the company's financial reports and tax returns are true and correct when signing off on them.

- Existing liabilities owed to the ATO may put a company's solvency at risk, even where payment plans are in place.

- Transactions between directors and the company should be adequately and accurately recorded, with source documents readily identifiable and filed away. This includes accurately recorded reimbursements for payment of company expenses, payment of dividends, and payment of income.

- Written agreements should be in place with respect to any advances or liabilities between the directors and the company. For example, it is good practice to have the terms of shareholder loans documented, including repayment obligations and the payment of interest.

- Credits and debt claims must be between the same legal entities – amounts owed to a partnership or another company in which the directors are individually involved in will not be set off against amounts owed by the directors in their individual capacities to the company.

If you would like further information or require assistance with respect to complying with directors' duties in the everyday running of your business, please contact **Lesly Ann Cho, Partner**, or your usual ClarkeKann contact.